How to Finance Your Hotel’s Property Improvement Plan

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As the hospitality industry continues to improve and recover from the recession, Property Improvement Plans (PIPs) have become a priority for hotel owners once again. Whether the goal is to simply improve the property to remain competitive in the market, adhere to current company branding standards or to complete a brand conversion (or “reflagging”) of your hotel, one thing is certain: PIPs can create a major financial burden. Unfortunately, noncompliance with a branding company’s PIP is quite risky. Not only could the hotel lose their brand affiliation, but doing so could also cause a loan default if there is breach of loan requirements.

Despite the changes in PIP requirements, hotel owners can breathe a sigh of relief knowing that the lending environment is becoming increasingly flexible in providing more financing options. In fact, owners that believe selling the asset is their best option may be surprised to find out that there are financing opportunities that would not only allow them to keep the hotel, but avoid booking their capital gains taxes, paying transfer taxes and losing a cash flowing asset from their portfolio.

Most owners focus on the daily operations of their businesses, and unless they pay attention to the capital markets, he or she may not know that they now qualify for low-cost fixed-rate financing that would cover part or all of the PIP. In this competitive lending market, cash flowing assets that sell at a single-digit cap rate may be able to reap financing proceeds at a 10 to 11 debt yield. There are a number of factors that play into this kind of scenario, including strength of sponsorship, potential for exit for the lender, barriers to entry for new hotels in the market and last-dollar-in basis for the senior debt holder. Not only would this option give the owner enough capital to complete the renovations, but the majority of the costs could be financed at low, senior mortgage rates on a non-recourse basis.

However, some hotel owners are not viable candidates to add new debt and may not meet the eligibility requirements to take on a new loan. This situation simply requires owners to take a different approach to acquire the necessary funding to complete their PIPs. Despite the increased risk for lenders, subordinated leverage, typically structured as a mezzanine loan, is becoming a more widely available option. Investment institutions that offer this option will structure their position behind the existing mortgage. The difficult aspect to negotiate is the lender’s requirement of the loan to be co-terminus with the maturity of the senior mortgage. Often times the providers of the subordinate debt have regular “partners” for these structured transactions, which helps to ease the difficulty of the agreement process. Although this option may require the hotel owner to jump through a lot of hoops, it provides a good solution for hotels that have an impending PIP deadline.

Lastly, the best option for a hotel owner may be to take the best of both worlds, by combining a low-cost non-recourse senior mortgage with a mezzanine component. Not only would this solution provide all the necessary financing for the PIP, but it would also clear existing debt. Hotels located in a market with limited supply growth potential and that can prove their Net Operating Income will vastly improve post-renovations are the ideal candidates for this option.
Paradigm Tax Group’s national hospitality team is well equipped to assist each owner as they go through PIPs. There are many tax strategies that we employ to not only minimize the property tax liabilities throughout the renovation, but perhaps save owners money as they consider exiting the investment once they’ve extracted all the value. If you are planning on initiating a PIP and would like more information on how Paradigm can help to maximize your tax savings, contact Sharif Mitchell at (646) 670-7481 or smitchell@paradigmtax.com and Cameron Moore at (678) 954-6002 or cmoore@paradigmtax.com.

Paradigm Tax Group’s hospitality team works with our 30 local offices to provide the best combination of hotel industry expertise and local relationships across the country. From working to ensure the correct recordation of allocations for state and local tax purposes, to enrollment of real estate valuations via the appeals process, our combination of unparalleled industry expertise and local knowledge and relationships provides hospitality owners with the best of both worlds. Please visit our website for additional information on Paradigm Tax Group; www.paradigmtax.com.