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THE WEEKLY UPDATE ON THE INSTITUTIONAL MARKETPLACE

Hotel Leaseholds Under Extra Stress in Crisis

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With many hotels closed due to the coronavirus pandemic, owners whose revenues have dried up are negotiating with lenders for forbearance on debt payments. On top of that, in cases where the buildings and underlying ground are held separately, the hotel owners have another problem: ground rent.

"Typically, the ground leases require payment of rent no matter what . . . They are very strict," said **Thomas Kearns,** an attorney in the real estate practice of **Olshan Frome.** "There's going to be a lot of leasehold mortgagees scratching their heads and saying, 'Should I write this check and protect the collateral?' "

In a market already squeezed by oversupply, falling revenues and rising expenses, the current crisis further complicates cases of distress — such as The Row, a 1,331-room Times Square hotel with $315.2 million of nonperforming debt, and the 476-room Hilton Times Square, with $77 million of securitized debt now in special servicing.

How each case plays out will depend on a landowner's willingness to work with its tenant — or its appetite to take over a property. In many cases, it will require negotiations among the two owners and separate holders of debt on the hotel and the land. "You can sometimes have a four-party story going on," said Kearns. "It can get pretty complicated."

In roughly the last decade, structuring hotel properties to create a ground lease became increasingly common in urban markets, where land values tend to be higher, said **Suzanne Mellen,** a senior managing director and practice leader at hotel consulting and valuation firm **HVS.** It was a form of "financial engineering" that allowed an owner to unlock the value of the land, which could trade at a much lower capitalization rate than the hotel itself.


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THE GRAPEVINE

Peter Casey joined apartment investor **Sack Properties** last week as a managing director. He is based in the firm's San Francisco headquarters, focused on fund formation and lining up debt for the shop's properties. Casey previously was a director at multi-family fund operator **Interstate Equities** of Los Altos, Calif., where he spent about six years before leaving in January. He earlier worked at **J.P. Morgan.**

Industrial giant **Prologis** has drastically scaled back its disposition plans for 2020 — a sign of the turmoil the pandemic is causing even in the resilient warehouse sector. The San Francisco REIT initially planned to shed up to $1.5 billion of properties this year. But in its first-quarter earnings report, Prologis cut the target to $250 million, representing deals that already are under contract. The firm

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Banks Held Little Bad Debt Before Pandemic

Banks are less likely to be a major source of distressed-debt opportunities resulting from the coronavirus crisis than they were in the last downturn, investors say, because they are better positioned to absorb the shock.

Nonperforming loans on the balance sheets of large U.S. banks hit a post-Great Recession low last year, according to regulatory data compiled by **Trepp Bank Navigator** (see tables on Pages 7-9). And while a spike in commercial mortgage defaults is anticipated due to the pandemic, opportunistic investors expect the banks to see less overall distress than mortgage REITs, debt funds and private-equity lenders.

"I believe the banks are in relatively stronger shape, with robust balance sheets and more conservative underwriting in the past few years," said **Santosh Govindaraju,** chief executive of Tampa-based **Convergent Capital,** which buys distressed debt. "The real opportunity in the immediate future is going to be with nonbank specialty lenders who aggressively came in over the past few years. Many of them

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Deal for SF's Pyramid Tower Faces Hurdles

The coronavirus crisis is complicating one of the highest-profile deals of the year: **Michael Shvo's** bid to pay $711 million for the iconic Transamerica Pyramid Center in San Francisco.

Sources said Shvo, a New York investor, and his German partners, **BVK** and **Deutsche Finance,** have been unable to line up financing. Meanwhile, loan spreads have widened so much in the past six weeks that the cost would be prohibitive even if the partnership could find a lender.

The property's namesake owner, insurer **Transamerica,** and its parent, Dutch financial-services company **Aegon,** are willing to give the Shvo team more time, sources said. When the deal was announced, Transamerica said the transaction would be completed by the end of the second quarter. But with the clock ticking, the parties have yet to set a closing date. Transamerica is being advised by **JLL.**

The economic fallout from the pandemic has scuttled pending property trades

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A buyer of the land holds a leased-fee interest in the hotel, typically with a term that spans multiple decades and rent that rises with inflation and may periodically reset based on the

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ground's fair market value. At a time when net income is flat or declining, those payments "will slowly — or quickly, as we are seeing with the impact of Covid-19 — erode cashflow and choke off the value of the leasehold interest in the asset," Mellen said.

Maintaining value becomes a problem for both owners. "The hotel is the least attractive asset for a ground-lease owner to take back, simply due to the operational nature of the asset, unless the owner is themselves in the business," said **David Eyzenberg,** president of **Eyzenberg & Co.** His New York real estate capital advisory group manages a vehicle that invests in leased-fee positions. He said negotiations over deferments, resets or other relief are likely to prevail, "to make sure at least the property is maintained or operated, albeit at a loss."

The Row, the fifth-largest hotel in New York, has become a prime example of a leasehold in distress. A joint venture between **Rockpoint Group** of Boston and New York-based **Highgate** paid $250 million in 2010 for the then-shuttered hotel, formerly known as Milford Plaza. It sold the underlying ground in 2013 for a whopping $325 million to New York investor **David Werner.** The next year, it sold 26,000 square feet of retail space to **Thor Equities** for $65 million. That left just a leasehold interest in the hotel — which the Rockpoint team shopped unsuccessfully.

Early this year, lender **Colony Credit Real Estate** listed the hotel's $315.2 million of nonperforming senior and junior debt for sale, via **Eastdil Secured.** In a quarterly filing, Colony said the Rockpoint joint venture had stopped making interest payments two years ago. Colony had been collecting revenues generated by the property and paying the ground rent on the 92-year lease. With the hotel now closed due to the public health crisis, that revenue stream has stopped.

The debt was already expected to trade at a heavy discount, and now the fate of the offering is unclear. Meanwhile, the land acquired by Werner backs $275 million of securitized debt, carved into two pieces. The ground lease generated $17.5 million of net income in the year ending June 30, 2019 — more than enough to cover debt service. But the loans were put on a watch list this month, when Werner requested "Covid-19 relief," according to servicer reports.

What happens when the owner of a leasehold interest cannot pay its ground rent? One option is simply to hand the keys to the landowner. The holder of debt on the leasehold interest also could take over the hotel and the ground-rent payments. Alternatively, the landowner can negotiate to keep the tenant in place.

"With very reasonable landlords, they are working on short-term deferrals for all or a portion of the payment and then working on how that will be repaid," said **Janice Mac Avoy,** a partner at law firm **Fried Frank** and co-head of its real estate litigation department. "We've absolutely been seeing a lot of that."

But any landowner granting concessions would likely want the tenant to seek some relief from its lender at the same time. What's more, the landowner may have its own lender to contend with, limiting its flexibility.

Landowners that are less inclined to negotiate with their tenants can move rather swiftly to end a lease. While **New York Gov. Andrew Cuomo** has halted all evictions, including those involving commercial tenants, a landowner can still file to terminate the lease and, when the order is lifted, move to take over the property. "If the leasehold tenant doesn't contest the termination, it could happen within five days," Mac Avoy said. Inability to pay rent hasn't been accepted as a reason to stop a termination, she said, adding: "It's a very tough provision."

More hotel and ground owners are likely to face these decisions going forward. Case in point: the Hilton Times Square. **Sunstone Hotel Investors,** a REIT in Aliso Viejo, Calif., paid $242.5 million, or $546,000/room, for a leasehold interest in the 444-room property in 2006, when hotel sales in New York were frothy.

The hotel's debt comes due in November. Last year, the property's net cash flow was barely enough to cover debt payments, prompting the servicer to begin a full cash sweep. The loan was transferred last month to special servicing — in part because "ground rent is scheduled to increase substantially in May of 2020." The servicer noted the hotel was still open, but occupancy was 1-2%.

In a February earnings call, Sunstone said it was disputing the landowner's valuation, which would push the ground rent up by $3 million this year, but would have to pay it until arbitration is completed. **Bryan Giglia,** Sunstone's chief financial officer, said that when the debt comes due, "we will assess any options we have at that time and come up with what the best course is for us." ❖