

# WILL THAT BE CASH OR CREDIT?

BILL GATES NOTWITHSTANDING, MOST OF HOTELS/RESORTS RELY ON CREDIT FOR FINANCING NEW WATERPARK PROJECTS—BUT WHICH TYPE OF FINANCING IS MOST COMMON?

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## THE PHONE RINGS IN THE WORLD WATERPARK ASSOCIATION OFFICE.

The caller wonders, “How can I get financing for my waterpark project?” The question is, by far, the most common one the WWA receives. And, because the hotel/resort indoor waterpark segment is one of the fastest-growing in the water leisure industry, many times these calls are in reference to hotel-related projects.

Over the past 10 years, Ramaker & Associates—an engineering firm—and the Central Group Cos.—a development/design/financial/builder/management firm—have been involved in the financial discussions of numerous waterpark projects in their earliest development stages. Based on their involvement in the projects, these two companies also get financing questions on a regular basis. While the types of financing options are nearly limitless, several tend to be most common. Here, then, we’ve compiled some details of the most popular financing mechanisms for hotels, hotels with waterparks and existing hotels wanting to add waterparks to their facilities:

- Conventional financing
- Small Business Administration (SBA) 504
- U.S. Department of Agriculture (USDA) loans
- Tenant-in-common (TIC) structures
- Mezzanine financing.



## CONVENTIONAL FINANCING

Most of the hospitality projects, including waterpark hotels, with which Central Group Cos. has been involved, have used a conventional financing structure. This type of financing typically consists of a bank loan for construction in which the construction loan is for a term of 12 to 14 months. At the end of the term, the loan converts to a permanent loan. Total loan costs are usually 1 percent to 1.5 percent of the loan. In recent months, the interest rate on a waterpark hotel construction loan has been about 5.75 percent to 6.5 percent, and interest is paid only during construction.

The permanent portion of this type of financing typically has an interest rate tied to the Wall St. Journal prime rate, LIBOR (London Interbank Offer Rate) or 3- to 10-year treasuries. Maximum terms on conventional permanent financing usually are 10 years or less, and mini-perms at 3 to 5 years, which matches the treasuries to which the loans are indexed.



## SBA 504 LOANS

The SBA 504 loan program has been extremely popular with developers and owners of smaller hotels with waterparks. Roger Poganski, Community Banking President of Stearns Bank, St. Cloud, Minn., reports that the 504 program works well for new construction but also is widely used for expansions of existing properties. In these types of loans, a community development corporation—such as the Minnesota Business Finance Agency in the state of Minnesota—provides a portion of the financing for a project under the SBA 504 loan program; a commercial bank takes on the balance of the debt. This loan is attractive to commercial lenders because they get a first-security position on the project even though they provide only as much as 65 percent of the financing and 55 percent of total project costs. The community development corporation’s 504 portion of the loan is subordinate to that.

Depending on the lender, then, a loan to a new hotel with a waterpark might include:

- *Commercial lender:* 50 percent of the total project costs
- *504 program:* 35 percent of the total project costs
- *Owner equity:* 15 percent of the total project costs.

The commercial lender makes the entire 85 percent of the loan for the construction phase of the project after receiving a commitment for 35 percent of that amount from the community development corporation under the 504 program. Upon completion of the project, the community development corporation sells a debenture for its 35 percent part of the project and assumes that portion of project debt by paying the commercial lender that amount.

Some details on this type of loan are:

- The debentures are typically for 20 years and fully amortized, so the borrower has a 20-year loan if not prepaid.
- The bank portion of the loan might have a 10-year balloon, which could, for example, be indexed to 10-year treasuries or Wall St. Journal Prime plus a spread and is usually variable. Alternatively, the rate can be fixed.
- The loan fees for the 504 portion are typically 1.5 percent of the 504 loan amount. These fees include what is paid to the SBA, the community development corporation and Colson (the servicing arm for the SBA). You usually can build these fees into the loan.
- The commercial lender has an origination fee of typically 1 percent to 1.5 percent plus closing costs.

- The SBA has a monthly service fee that averages about 1 percent annually with an adjustment downward every 5 years.
- The total interest on the SBA portion of the loan, based on recent debenture sales—including fees—has been about 6.4 percent.

You also can place the SBA 504 program behind a first mortgage provided you have sufficient equity (as appraised) in the existing financing structure or you add enough additional cash to the existing financing structure to satisfy the SBA that its position is secure—or even enhanced.

SBA 504 loans do not finance franchise fees, working capital or inventory. The SBA 504 program does not refinance entire projects, but you can use it for expanding existing projects or building new projects.

## USDA LOANS

The USDA loan program was designed—and is primarily used—for rural areas, typically communities with a population of less than 50,000. Smaller community lenders say this type of loan works very well for its borrowers.

You can use a USDA loan to refinance an existing loan. It allows you to include franchise fees, working capital and inventory in the loan proceeds.

The commercial lender actually makes the loan to you, but the USDA guarantees 60 percent to 90 percent of it to the commercial lender. This partnership provides the commercial lender with a security to sell, which helps keep the lender's liquidity high and allows it to offer more of these types of loans.

Some details on this type of loan are:

- You can obtain 90 percent financing through this program provided you have 10 percent tangible equity on your balance sheet.
- The loan term is for 20 years and can be floating or fixed.
- Both the USDA and SBA programs are subject to annual funding by the federal government. (Stearns Bank is a preferred lender for SBA loans and is the largest SBA loan originator in a five-state area. It is also one of the top-10 lenders in USDA-loan originations in the United States.)

## TENANT-IN-COMMON (TIC) LOANS

TIC loans—or fractionalized sales of commercial properties—are another increasingly popular financing method. Investors who invest in TICs purchase pieces of real-estate deals in which interests range from less than 1 percent to 30 percent or more of the total project.

TICs have been popular with investors who want to make tax-deferred investments through a 1031 Exchange. Such investments allow the reinvestment of the proceeds of a sale of a commercial property into another commercial property, tax-free. You must pre-arrange several specific requirements to qualify for a 1031 Exchange.

TICs are usually a prepackaged investment that typically comes with a promised return to the investor of 7 percent to 10 percent annually, along with a pro-rata share of depreciation and appreciation of the asset.

You might typically use a TIC to raise the equity portion of the project. Your developer or owner then would use a mortgage banker to obtain his or her conventional, mini-perm financing.

Scott McLinden, with Oppenheimer Investment Banking's Minneapolis office, says most of his firm's loans are in the \$10 million to \$80 million range. The loan-to-cost ratio for first-time hotel-waterpark developers is usually 60 percent to 65 percent.

Origination fees for the bank or senior portion of the debt average 1 percent plus a quarter-of-1-percent-per-year servicing fee. These loans most often require personal guarantees by someone, if not the developer/owner. The guarantees, however, can have a release or "burn-off" provision after the property operates for a negotiated number of consecutive quarters at appropriate debt-service coverage levels.

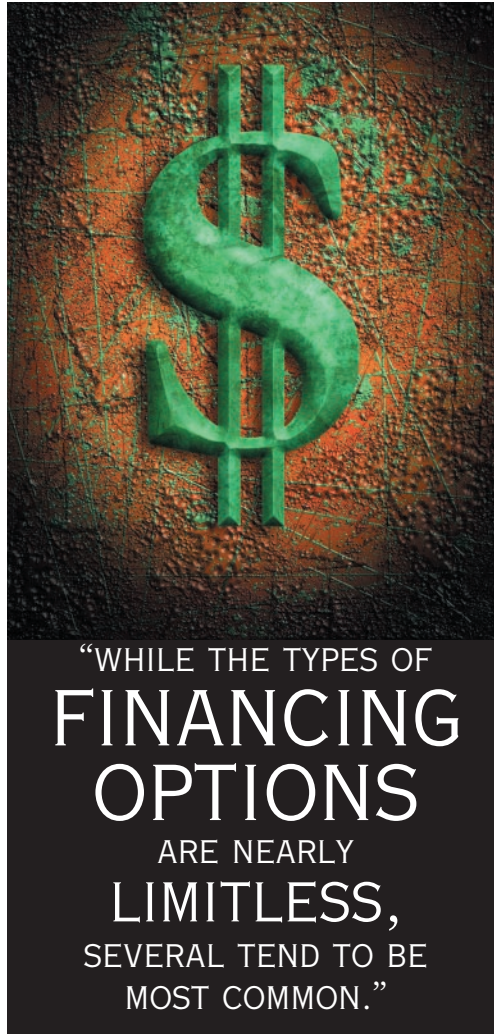
Some details on this type of loan are:

- The construction loan is commonly 12 to 16 months, and you only pay interest during this term.
- The debt-service coverage requirement for the mini-perm portion of the loan is usually a minimum of 1.25 percent to 1.5 percent in today's market.
- The mini-perm loans are typically 5 years in duration after you complete construction. They are commonly indexed to the Wall St. Journal Prime plus a minimum 1.5 to 2 points, with a floor—or a minimum—rate.
- The mini-perm loans don't convert to longer term, permanent financing in most cases, so you refinance the debt at the end of the term.

Oppenheimer Investment Banking has extensive experience in originating financing for waterpark hotel loans throughout the country.

## MEZZANINE LOANS

Mezzanine financing is another loan vehicle that, although not used as frequently as those previously mentioned, can still be an important element to completing





## COMMON FINANCIAL TERMS

a transaction. Private investors provide this type of loan and can assist a project developer or owner who has a shortage of equity.

This debt typically comes with a high rate of interest—15 percent to 22 percent—and will normally have a 2- to 5-year term. The mezzanine lender also normally receives a subordinated security interest in the project. In this manner, if the borrower defaults, the mezzanine lender can step in, own and operate the asset without the property going through foreclosure.

The mezzanine debt can be interest only, fully amortized or have a coupon payment of, for example, 10 percent, which would be paid on this debt annually with a lump sum or balloon payment at the end of the loan. The final payment amount would bring the total loan interest rate to the levels previously mentioned.


In some communities, where there is a strong public interest in the success of a project, a city may be willing to issue Industrial Revenue Bonds for the project. The owners/developers purchase the bonds using financing from a conventional source. The city actually owns the property, and the developer leases the property from the city for \$1 over the annual bond payment amount until the bonds are paid. The term is typically 10 years. The developer can purchase the property from the city for \$1 at the end of the 10-year term. The developer, who then obtains conventional financing to purchase the project, refinances his or her debt at the end of the 10 years.

With the city owning the property in this manner, no one has to pay real-estate taxes for a period ranging from 10 to 25 years, depending on the municipality.

Some details on this type of loan are:

- It is possible to achieve zero taxes on material for all improvements in these types of scenarios.
- The Industrial Revenue Bonds can be taxable or tax free, but the city issues these at very attractive rates that help the owner/developer obtain financing at favorable rates to purchase the bonds.

While the loans described here are the most common, keep in mind that additional costs may be added based on the financial institution with whom you work. For example, for nearly any loan, you'll typically have to fulfill a cash requirement of 1 percent to 4 percent of the project cost. This capital is required for preliminary engineering, feasibility studies and the cost of raising debt and equity.

Depending on project location and feasibility, this money will be nonrefundable if the project does not go forward. As with most commercial lending, partners will be required to, in many cases, provide the project equity and be willing to guarantee the debt on the facility. So be prepared going in to your project, and don't get caught by surprises that could end your project before it's even begun. 



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**Amortization.** The gradual elimination of a liability, such as a mortgage, in regular payments over a specified time. Such payments must be sufficient to cover both principal and interest. *OR* Writing off an intangible asset investment over the projected life of the assets.

**Community development corporation.** A corporation established to develop economic programs and provide financial support for a community.

**Debenture.** Unsecured debt backed only by the integrity of the borrower, not by collateral, and documented by an agreement called an indenture. One example is an unsecured bond.

**Debt-service coverage.** The ratio of cash flow available to pay for debt to the total amount of debt payments to be made.

**Equity.** Ownership interest in a corporation in the form of common stock or preferred stock. It is the risk-bearing part of the company's capital and contrasts with debt capital, which is usually secured and has priority over shareholders if the company becomes insolvent and its assets are distributed. *OR* Total assets minus total liabilities; here also called shareholder's equity or net worth or book value. *OR* The difference between what a property is worth and what the owner owes against that property. *OR* Something that is fair, just and impartial in law.

**Industrial Revenue Bond.** Bond used to finance the construction of manufacturing or commercial facilities for a private user.

**Origination fee.** A fee charged by a lender for processing a loan application, expressed as a percentage of the mortgage amount.

**Mezzanine financing.** Late-stage venture capital, usually the final round of financing prior to an IPO (initial public offering).

**Permanent financing.** Long-term debt or equity financing. In general, permanent financing is used to purchase or develop long-term fixed assets such as factories and machinery. Because the pay-off from a long-term asset tends to be over time, financing through long-term options reduces the risk of principal pay-off not being made (in the case of debt-financing).

**Prime.** The interest rate that commercial banks charge their most creditworthy borrowers, such as large corporations. The rate is a lagging indicator. Also called prime rate.

**Security.** An investment instrument, other than an insurance policy or fixed annuity, issued by a corporation, government or other organization that offers evidence of debt or equity. *OR* Property that is pledged as collateral for a loan.

**Venture capital.** Funds made available for start-up firms and small businesses with exceptional growth potential. Managerial and technical expertise is often also provided. Also called risk capital.

Source: *InvestorWords.com*