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Hotel Financing Series, Part 6: Cash Control

By **Duncan Hubbard**
Partner | Real Estate

By **Livia Li**
Associate | Real Estate

Running a hotel is a complex business. There are constant streams of different types of cash inflows and outflows, as well as reserves required for a capex-heavy business. In this final part of our hotel financing series, we look at some of the typical cash structures and some of the control measures lenders put in place.

In a typical hotel operating structure, the hotel manager operates the main hotel account, which collects all the hotel revenues as well as the day-to-day expenditure. There may be several different accounts required for the operations, as there may be separate accounts for suppliers, staff payments and so on. These accounts could be solely operated by the hotel manager or operated jointly with the hotel owner.

The hotel manager then transfers the gross profit on a periodic basis to the owner's account. The practice here usually starts to diverge. In some instances, the hotel manager deducts all the franchise fees and hotel management fees and other associated costs before making this transfer, and in some instances, no deductions are made and the hotel owner needs to separately account for these fees.

There are many different ways in obtaining security and control over the cash accounts. The first key question for a lender is to examine the inflows and outflows of the particular hotel and at what level should the control be exerted. If the control mechanics are too tight, it may hinder the operations of the hotel. Too loose may provide plenty of scope for cash to leak out of the structure. For example, costs and expenses that are essential to the day-to-day running of the hotel should be paid as a priority, and any restrictions on these kept to a minimum. Often the amount required for debt servicing will have to come out after these essential costs have been paid, as otherwise, the hotel may be devalued if the business is not operating with sufficient cash. Some lenders provide free rein with a floating charge on the operating account so long as there are frequent reporting and financial reports. Other costs which must be paid are generally amounts payable under the franchise agreement and certain hotel management costs, as failure to pay these would give rise to termination of the franchise agreement and/or HMA, which impacts the value of the hotel.

The dynamics between the need to meet hotel operation expenditures and debt service has been put under the spotlight this year. As a result of the COVID-19 pandemic, this year has been a difficult year for the hotel industry, to say the least. With hotels being mandated to close, or having to run at minimum capacity, it has been difficult for hotel owners to manage cashflows and make meaningful projections, given that revenue streams have been destabilised. Many borrowers have requested the banks to suspend certain financing payments during this time or even enter into standstill arrangements with respect to financial covenant/payment defaults in order to preserve cash to meet necessary expenditures throughout this period. One of the key issues to be decided between the bank and the borrower is to ensure that, whatever cash is left in the structure to meet necessary expenditures, such cash reserves are justified on a line-by-line basis, and that whilst payments are suspended and/or financial covenants are not met, there are controls around ensuring that the cash is used for the agreed purpose to minimise any risk of leakage.

In addition to the operating accounts, usually (in the ordinary course of hotel operations) there is a separate dedicated capital expenditure account which maintains cash reserves allocated to maintenance of the hotel and also ongoing upgrades to adhere to brand standards. Lenders may want to impose capex restrictions (*e.g.*, an annual cap, or in accordance with an agreed budget) and require any capex expenditure to come out of this account so that the cash in the other accounts would not be affected.

Sometimes it is not possible for a lender to obtain the most ideal cash control position due to the way the account structure is set up. It is therefore very important for the lender to keep a close eye on the financial reporting, which covers periodic revenue and expenditure, as well as projected expenditures, so that any major expenditures should be withdrawn and spent in accordance with the approved plans as much as possible.

Due to the cyclical nature of the business and the cashflows, another method which lenders use is the requirement to provide cash collateral by the sponsor, or set a minimum surplus amount on the debt service account, so that there will be some buffer which could be drawn against to service the debt during any period when cash may be a bit tight.

Finally, where the bank accounts are held with another financial institution, the lender may wish to enter into an account control arrangement with the account bank to assist with quick access in controlling the account and the cash when exercising enforcement rights.

We hope you found this six-part hotel financing series informative and useful, and we are of course available to answer any questions or provide any support.