



Hilton Debt Clogs Lenders' Balance Sheets

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Blackstone Group's \$26.2 billion takeover of Hilton Hotels, the last big real estate transaction before the market downturn began in late-2007, has left seven banks - and the Federal Reserve - holding massive chunks of debt that they can't sell without taking big losses.

Blackstone has continued to make loan payments, giving the banks breathing room. But the real estate collapse has significantly driven down the values of the underlying hotels, seriously eroding Blackstone's original \$5.7 billion equity stake in Hilton. And market players question how well the \$20.6 billion debt package will weather the deep recession, which is hurting hotels more than most other property types.

The original lending syndicate consisted of seven banks: lead lender Bear Stearns, plus Bank of America, Deutsche Bank, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. They gave Blackstone about \$8.6 billion of senior debt and about \$12 billion of mezzanine debt to complete the takeover in October 2007. The Federal Reserve Bank of New York later assumed Bear's share to facilitate the sale of Bear to J.P. Morgan.

The lenders have sold \$2.2 billion of the senior debt and at least \$3 billion of the junior debt, leaving as much as \$15.4 billion on the books of the banks and the Fed.

The debt package originally called for a blended spread of about 185 bp over 1-month Libor, according to people familiar with the matter. But when market conditions deteriorated before the closing, a "material adverse conditions" clause in the loan documents was triggered, causing the spread to widen out to about 245 bp.

The lenders initially planned to securitize the senior portion of the debt package, but were unable to do so when the commercial MBS market froze up. They then sold \$2.2 billion of the senior debt in the first half of last year to GE Capital at a spread of about 300 bp over Libor, according to people familiar with the matter.

The loan syndicate also sold four of the seven mezzanine tranches, totaling \$3 billion, early last year to 10 investors, including Goldman's Archon Capital unit, Capital Trust, CWCcapital, Lehman, Morgan Stanley Real Estate and Singapore's sovereign wealth fund.

The lending syndicate made a big push in the third quarter of 2008 to sell their remaining shares of the senior debt to large-loan buyers at about 300 bp over Libor. But the effort fell flat.

Late last year, Hilton informed the lenders that its hotels could see a 10-20% decline in revenues in 2009, according to people familiar with the matter. That prompted the six banks to write down their Hilton positions at yearend by 10% or more, the people said. The lenders and Blackstone either declined to comment or didn't return calls. The Fed also declined to comment on Bear's assets, which are now being managed by BlackRock. The Fed is believed to have assumed about \$4 billion of Bear's original \$4.7 billion share, which was larger than the shares of the other syndicate members.

Blackstone and the lenders have a few things working in their favor. First, the debt package has a 3-year term with three 1-year extension options. That means that Blackstone is under no pressure to refinance the debt.

What's more, Blackstone is benefitting from the fact that 1-month Libor is now an historically low 0.4%. That means Blackstone's loan rate, including the spread, is currently just 2.9%, which minimizes the monthly loan payments. However, Blackstone is susceptible to any spike in Libor. The company bought a 4.5% Libor cap, so its rate could conceivably rise by 4.1 percentage points, to as high as 7%. If that happened for a sustained period, Blackstone would be hard-pressed to make its loan payments, lenders said. One-month Libor briefly spiked to 4.5% last October when the financial crisis worsened. The benchmark rate has averaged 3.9% over the past four years.

Blackstone also is benefiting from the quality of Hilton's hotel portfolio. "Hotels have their problems," said one veteran lender, "but the Hilton chain is among the best. These hotels still throw off enough cashflow to cover the debt service."

But hotel performance in general has been hitting the skids. A Moody's report released this week said that revenue per available room fell 9.8% in the fourth quarter from a year earlier. Another 7% average decline is likely this year, which would translate into a net cashflow decline of about 16%, the rating agency said. The net effect could be a 30% peak-to-valley decline in hotel values, according to Moody's.

Commercial Mortgage Alert, 5 Marine View Plaza, #400, Hoboken, N.J. 07030-5795. Tel: 201-659-1700, Fax: 201-659-4141, E-mail: info@hspnews.com
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