Columbia Sussex Hotels: The Other Shoe?

An analysis of Bear Stearns Commercial Mortgage Securities Trust 2006-BBA7

Columbia Sussex Corporation, owned by William J. Yung, went on a buying spree when credit was easy. It bought hotels, individually and in packages, making wide use of debt issued as commercial mortgage backed securities (CMBS). Mr. Yung also acquired the Tropicana casino assets in a bidding war, relying heavily on debt financing. On May 5, 2008, Tropicana Entertainment, owned by Mr. Yung, filed for protection under Chapter 11 of the U.S. Bankruptcy Code.

The salient question for hotel investors is: What becomes of Columbia Sussex's CMBS loans?

One particular CMBS – Bear Stearns Commercial Mortgage Securities Trust 2006-BBA7 – is dominated by hotels owned by Columbia Sussex. This report analyzes the following risks associated with the loans backing 2006-BBA7:

- Columbia Sussex hotel loans comprised 79% of the original $700 million Loan Trust, and they now comprise 93% of the outstanding balance.
- In October 2007, the maturity date of the Columbia Sussex hotel loans in the Trust was extended by one year to October 2008, in the first of three possible 1-year extensions under the terms of the loans.
- Bear Stearns, Co-Lead Manager of this CMBS, has been acquired by JP Morgan Chase under duress since the loan extension was granted.
- Columbia Sussex may have a difficult time refinancing this package of loans, given the Tropicana Entertainment bankruptcy, a limited CMBS market, and the substantial leverage supported by these Columbia Sussex hotels.
- Columbia Sussex is engaged in a protracted labor dispute at the second largest hotel in this Trust, the Baltimore Sheraton.
- Lastly, new hotels will be opening in markets where the Columbia Sussex portfolio competes, at a time in the cycle when RevPAR growth in hotels is decelerating.

Background on 2006-BBA7

In October 2005, Columbia Sussex bought a portfolio of 14 hotels from Wyndham for $1.4 billion, concurrent with the acquisition of Wyndham by Blackstone Group.

Columbia Sussex borrowed $1.1 billion, financing 79% of this portfolio acquisition, from Bear Stearns Commercial Mortgage Inc. and Bank of America: $570 million in Senior Notes and $532 million in Mezzanine Loans. The Senior Notes are cross-collateralized and cross-defaulted, as described in the Offering Circular.[1]

The 14 hotels have a total of 5,821 rooms in 13 urban markets, and many of the hotels have undergone renovations and/or brand changes since acquisition.

In 2006, Bear Stearns and Bank of America were Co-Lead Managers of the 2006-BBA7 CMBS, which was backed by $700 million in hotel loans. The Note secured by the Columbia Sussex portfolio comprised 79% of the Trust Assets upon securitization.

In March 2008, Fitch Ratings reaffirmed its

UNITEHERE! *represents approximately 100,000 non-gaming hotel workers in North America and represents workers at five non-gaming hotels owned and operated by Columbia Sussex, including two with active labor disputes.*

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Columbia Sussex 14-Hotel Portfolio	Rms
Sheraton Philadelphia City Center	758
Sheraton Baltimore City Center	707
Wyndham New Orleans	438
Westin San Diego at Emerald Plaza	436
Wyndham Suites Chicago	417
Westin Chicago Northwest	408
Westin Washington DC	400
Hilton Ft. Lauderdale Airport	388
Hilton Boston Financial District	362
Marriott Buttes Resort	353
Marriott Atlanta Downtown	312
Westin Harbour Island	299
Westin Bristol Place	287
Hilton Burlington	256

ratings on the CMBS classes, noting that the Columbia Sussex portfolio now comprises 93% of the outstanding balance of the pool: "Although three of the five loans have paid in full, affirmations are warranted due to concentration by loan and property type."

Securitization in theory contemplates bundling a variety of loans with diverse risks to minimize and structure the risks for the benefit of investors. Instead, Bear Stearns 2006–BBA7 has concentrated the risks associated with Columbia Sussex as a borrower.

Tropicana Entertainment Bankruptcy

Since the issuance of 2006–BBA7, the risks associated with Columbia Sussex as a borrower have increased greatly.

Tropicana Entertainment, the gaming arm of Mr. Yung's hospitality empire, filed for protection under Chapter 11 of the U.S. Bankruptcy Code on May 5, 2008, with $2.67 billion of bank and bond debt outstanding.[2]

The bankruptcy filing was precipitated by the leveraged nature of Tropicana Entertainment and the New Jersey Casino Control Commission's decision not to renew the Tropicana Atlantic City gaming license and to place the casino's operations and assets under control of a state-appointed trustee. *USA Today* quoted Casino Control Commission Chairwoman Linda Kassekert:

"'Staffing was slashed in pursuit of profit,' Kassekert said. 'Cleanliness was disregarded in order to meet a predetermined bottom line. Customer service was dismissed.

'Simply put, I do not believe this applicant has the business ability to operate a facility of this size and magnitude given the decisions that were made.'"

Early in the bankruptcy case, Tropicana Entertainment's bondholders filed a motion seeking the appointment of a Chapter 11 Trustee by the Bankruptcy Judge. That motion alleges that Mr. Yung's interests – as the Chairman of Tropicana Entertainment and the sole owners of Tropicana Entertainment and Columbia Sussex – may be conflicted by the agreements that Tropicana-related entities entered into with Columbia Sussex subsidiaries to provide employment services, payroll processing, accounting, marketing, risk management, insurance programs, and other services.

It is difficult to predict whether the court will conduct an investigation of payments from Tropicana-affiliated entities to Columbia Sussex subsidiaries or what such an investigation might reveal. Perhaps more relevant is the question of whether any portion of such payments will be recoverable by the creditors of Tropicana Entertainment. This is one issue associated with the bankruptcy filing that may affect Columbia Sussex Corporation, a guarantor of the portfolio loan backing 2006–BBA7.[3]

Loan from Columbia Sussex Subsidiary to Tropicana Casino and Resorts

A second potential issue raised by the Tropicana bankruptcy is the $504 million loan made by CSC Holdings LLC, a subsidiary of Columbia Sussex, to Tropicana Casino and Resorts Inc. [TCR], a parent of Tropicana Entertainment. Tropicana Entertainment's SEC filing states: "The loan was retained by TCR and was not contributed to the Company [Tropicana Entertainment]. Funds from these borrowings by TCR were used to partially fund equity contributions to the Company in 2006 and 2007."[4] We do not know whether the debtor made or proposed to make any payments to TCR on account of amounts received by Tropicana that were derived from this loan. Full repayment of Columbia Sussex's loan to Tropicana Casino and Resorts can be questioned.

When asked by the New Jersey Control Commission why this equity contribution was structured as a loan from one William Yung controlled entity to another, TCR Secretary-Treasurer and Chief Accounting Officer Theodore Mitchell said, "Otherwise, if Columbia Sussex had made a direct investment in TCR, it would have triggered some additional regulatory filings."[5]

Columbia Sussex's guaranty of the 2006-BBA7 CMBS predated Mr. Yung's acquisition of Tropicana's casino business, the sizeable loan it made to Tropicana Casinos & Resorts, and the recent bankruptcy case – events which have likely contributed negatively to Columbia Sussex's financial health and the value of its guaranty. Furthermore, while we do not know the terms of Columbia Sussex's guaranty agreement, we urge CMBS investors to determine whether that agreement may have restricted Columbia Sussex's ability to directly invest such a sizeable sum in Tropicana Entertainment.

Extension and Refinancing Risks to 2006–BBA7 Investors

The Columbia Sussex Portfolio Loan backing 2006–BBA7 had an original maturity date of October 12, 2007, with the option of three 1-year extensions under certain conditions. The first 1-year extension was granted, extending the current maturity date to October 12, 2008. The final maturity date, if all extensions are granted, would be October 12, 2010.

Changes in the lending markets for hotels as a result of the American credit crisis could make further extensions or refinancing of the Columbia Sussex Portfolio Loan more difficult now than anticipated at securitization.

The CMBS market has all but come to a halt, with a 90% reduction in securitizations. The first quarter of this year has seen $5.9 billion worth of CMBS issues for all asset types, down from $61.2 billion in the first quarter of 2007.[6] Moreover, the shotgun takeover of Bear Stearns, a prolific CMBS underwriter, by J.P. Morgan Chase may pose additional complications to extending or refinancing the Columbia Sussex Portfolio Loan.

One condition to extending the loan is a requirement that the Columbia Sussex Portfolio Loan Borrower purchase an interest rate cap agreement on terms consistent with the cap agreement it purchased from Bear Stearns Financial Products Inc. for the original term of the loan, and from a counterparty with a AAA rating by Standard and Poor's or Aaa rating by Moody's.[7] Since the October 2007 extension, Bear Stearns Financial Products and its obligations have been assumed by JP Morgan. It is reasonable to question whether or at what cost JP Morgan or another highly rated counterparty will assume the risks of Columbia Sussex as a counterparty to an interest rate cap agreement, given the high profile and contested nature of the Tropicana bankruptcy case.

The growing controversy over the veracity of LIBOR could further complicate Columbia Sussex's efforts to obtain another interest rate cap agreement. As reported by the *Wall Street Journal:* "In a development that has implications for borrowers everywhere, from Russian oil producers to homeowners in Detroit, bankers and traders are expressing concerns that the London inter-bank offered rate, known as Libor, is becoming unreliable."[8]

A lack of confidence in LIBOR could make an interest rate cap agreement more challenging or costly for Columbia Sussex to reach.

Refinancing Risks of 2006–BBA7

With a dearth of CMBS issuance and changes in the U.S. credit markets, hotel borrowers may face tougher underwriting standards to obtain financing and refinancing. Observers note that equity requirements are higher than in recent years and lenders are measuring loan limits not by asset values, but by cash flow from the last twelve months.[9] This environment could make it difficult for Columbia Sussex to refinance the loan backing 2006–BBA7 and the accompanying mezzanine loans.

Columbia Sussex is known for a particular operating style focused on cutting costs. According to the Offering Circular, the 14 Columbia Sussex hotels had an average RevPAR of $99.60, with occupancy of 76% and an average daily room rate (ADR) of $131, for the twelve months ending March 31, 2006.[10] When Fitch reaffirmed its ratings assigned to the CMBS classes, it noted that as of the year end 2007, the portfolio's average

	RevPAR Increase '05	RevPAR Increase '06	RevPAR Increase '07
U.S. Hotels[13]	8.5%	7.5%	5.7%

RevPAR was $99.40, essentially flat when compared to the 12 months ending March 31, 2006. For the year end December 31, 2007, average occupancy for the portfolio had declined to 62.5% with an increased ADR of $158.90.[11] In contrast, RevPAR for U.S. hotels overall increased 7.5% in 2006 and another 5.7% in 2007, according to Smith Travel Research. Additionally, "Fitch stressed YE2007 net cash flow (NCF) also declined 6% compared to issuance NCF."[12]

Reduced occupancy and increased room rates may have been a stable performance for this portfolio during years of unprecedented increases in room rates, however, the hotel cycle is turning. Major hotel operators are reducing forecasts for RevPAR increases in 2008 to 2-4% as the U.S. business economy moves closer to recession.[14] Columbia Sussex's 14 hotels are heading into the next stage of the hotel cycle with an average 62.5% occupancy.

This analysis is relevant to the Columbia Sussex portfolio because the Portfolio Loan and accompanying Mezzanine Loans constituted 79% of the acquisition price for the 14 hotels. If lenders base their refinancing standards on cash flow, which according to Fitch Ratings declined 6% since issuance, Columbia Sussex may not be able to refinance the entire outstanding balance of the loans without contributing additional equity.

Cross-collaterization Risk

The 2006-BBA7 prospectus states, "Cross collateralization arrangements involving more than one Borrower could be challenged as fraudulent conveyances by creditors of the related Borrower in an action brought outside a bankruptcy case or, if the Borrower were to become a debtor in a bankruptcy case, by the Borrower's representative." Given the risk outlined here for the Columbia Sussex portfolio, the underwriter's caveat regarding the legitimacy and enforceability of the cross-collaterization agreement should be taken seriously as it could pose further risk to investment – especially in light of the Tropicana Entertainment bankruptcy where Mr. Yung's companies are both debtors and creditors.

New Competition

With the average occupancy for this portfolio down, more rooms coming online in these hotel markets could augment the challenges to refinancing the Portfolio Loan and the Mezzanine Loan. Several markets, which contain some of Columbia Sussex's largest hotels in the 2006-BBA7 portfolio, have had competing hotels open since the initial offering and/or may have looming competition with rooms opening from projects currently in construction or in the final planning process.

As noted, Fitch reports that occupancy for the Columbia Sussex portfolio has dropped from 76% at issuance to 62.5% at year end 2007. While this decline may be attributed to a number of factors, it has occurred in years of strong RevPAR growth in the upper upscale segment of the industry. Additional rooms coming online in several markets has the potential to drive occupancy yet lower. Construction pipeline data from Smith Travel Research show that for Boston, Chicago, and Philadelphia hotel projects either in construction or final planning stages would represent roughly 5-6% growth for each market, if they are completed.

In the Boston downtown area, nearly 2,000 rooms have come to the market since the 2006-BBA7 initial offering. In addition, approximately 850 rooms are in construction or final planning and could open in the next two years. If they do, the new supply would represent approximately 5% growth.[15]

In the Chicago downtown area, nearly 800 rooms have opened since the CMBS offering, and more than 2,000 rooms are in construction or final planning stages – which would represent 6.3% growth in the market, if they are completed.

In Baltimore, the August 2008 opening of the 757-room Hilton Convention Center Hotel provides significant new competition to Columbia Sussex's 707-room Sheraton, the second largest hotel in the 2006-BBA7 portfolio.Moreover, the new Hilton opened with a labor peace agreement, in stark contrast to the Sheraton, which has provoked a protracted labor dispute.

Labor Dispute

The two largest hotels in this portfolio have collective bargaining agreements with UNITE HERE covering their employees. The Baltimore Sheraton is subject to an ongoing labor dispute and ten-month-old boycott.

The Baltimore Sheraton has negotiated collective bargaining agreements with its workers since the 1970s. However, since it was acquired by Columbia Sussex, agreement on a new contract for the hotel's 180 workers, which expired in 2006, has not been reached. Management's contract proposal, which calls for unacceptable concessions like eliminating seniority, increasing housekeepers' daily work load, and increasing employees' health care costs – has remained unchanged since August 2006.

In November 2007, a boycott of the Baltimore Sheraton was declared, and to date $2,142,000 worth of hotel business has moved to other venues. Hotel properties, unlike many commercial business uses, are subject to instability arising from customer perception and choice. If this boycott – the only boycott of a hotel in Baltimore – continues, it is possible that even more business could move from the Sheraton as more options will exist for consumers who want to avoid labor disputes.

Notes

1 Offering Circular, p. 83.

2 Wall Street Journal, May 5, 2008

3 "The Columbia Sussex Portfolio Loan is generally non-recourse. Under certain circumstances, it is recourse to the extent of resulting losses to the Borrower arising out of certain circumstances, including, but not limited to: (i) the fraud or intentional misrepresentation by the Borrower or by any guarantor in connection with the Columbia Sussex Portfolio Loan; (ii) the gross negligence or willful misconduct of the Borrower or any guarantor; (iii) the breach of any representation, warranty, covenant or indemnification provision in the environmental indemnity agreement made by the Borrower and guarantor in favor of the lender or in the Mortgage concerning environmental laws, hazardous substances and asbestos and any indemnification of the lender pursuant thereto; (iv) the removal or disposal of any portion of the Mortgaged Property after a Mortgage Event of Default; (v) the misapplication or conversion by the Borrower of any insurance proceeds, condemnation awards, rents following a Mortgage Event of Default, or rents paid more than one month in advance; (vi) the failure to pay charges for labor or materials or other charges that can create liens on any portion of the Mortgaged Property; (vii) any security deposits, advance deposits or any other deposits collected with respect to the Mortgaged Property which are not delivered to the lender upon a foreclosure of the Mortgaged Property or action in lieu thereof, except to the extent any such deposits were applied in accordance with the terms and conditions of any of the leases prior to the occurrence of the Mortgage Event of Default that gave rise to such foreclosure or action in lieu thereof; or (viii) the Borrower's failure to obtain and maintain the interest rate cap agreement required by the related Loan Agreement." Offering Circular, p. 76.

4 Tropicana Entertainment, LLC, Form 10-Q, September 30, 2007.

5 Testimony before the New Jersey Casino Control Commission, November 26, 2007.

6 Commercial Mortgage Securities Association, "Compendium of Statistics," May 2, 2008.

7 Offering Circular, p. 88.

8 Wall Street Journal, "LIBOR Fog: Bankers Cast Doubt On Key Rate Amid Crisis," April 16, 2008, http://online.wsj.com/article/SB120831164167818299.html

9 NYU Hotel Investment Conference panel sessions, June 2-3, 2008.

10 Offering Circular, p. 85.

11 Fitch Ratings press release, March 19, 2008. In a telephone conversation, Fitch Ratings noted that the occupancy number for 2007 was transposed in the press release and should have been 62.5%. The RevPAR number was correct.

12 Fitch Ratings press release, March 19, 2008.

13 Smith Travel Research, NYU Hospitality Conference Presentation, p. 38.

14 Marriott's North American RevPAR projection for the rest of 2008 is 2% increase; Starwood's projections are in the 3-5% range.

15 Smith Travel Research Pipeline Report.