Breaking with tradition

A look at the unique challenges hotel developers face when building with modular construction, and how private lenders can help overcome those obstacles.

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As the economy has picked up in recent years, there's been almost insatiable demand for hotel rooms. Despite developers' best attempts, they just can't build hotels fast enough.

In response, a growing number of hotel brands are testing the waters with modular construction. Rather than building on-site, these projects involve constructing a building—either partially or completely—off-site. Hotel room "pods" are built in a factory and then transported to their final destination. Once on site, the developer stacks each pod, one by one, into a steel-framed structure to complete the hotel.

"Construction is the next frontier for innovation, and modular is leading the way," said Eric Jacobs, Marriott International's chief development officer last year. Marriott planned to sign 50 hotel deals in 2015 that incorporated prefab guestrooms or bathrooms.

Yet despite the hotel industry's growing interest in modular construction, many hotel developers underestimate how difficult these projects are to finance.

TRADITIONAL HOTEL CONSTRUCTION FINANCING

When hotel developers do a traditional stick-built project, they usually begin by shopping the project around with lenders. Most lenders are familiar with ground-up construction projects, so it's a pretty straightforward process.

Once a deal has been reached, a developer usually gets the project started with his own equity. Then, as the project moves forward, the bank reimburses the developer.

Each month, the general contractor will submit a draw to the bank for work completed that month.

With a traditionally built hotel, payments usually represent a hockey stick: money goes out the door slowly at first but then grows exponentially as the developer nears the end of the project.

MODULAR HOTEL CONSTRUCTION FINANCING

Financing a modularly-built hotel is a totally different ball game. Modular construction requires a significant up-front investment, usually far more than a developer and/or his equity partners can afford.

Most modular manufacturers ask for as much as 50 percent of the total project budget up front to finance the procurement of raw materials. These are the materials the factory will use to build your walls, floors, and bathrooms. Material procurement generally begins six to eight weeks before module construction even begins, which is why the modular manufacturer needs such a large chunk of the money from the outset.

Thinking back to a hockey stick: unlike a traditional hotel construction project, the financing of a modularly-built hotel resembles the inverse of a hockey stick. Hotel developers have to provide almost all of their project funds up front.

WHY BANKS GIVE PAUSE TO FINANCING MODULAR HOTEL CONSTRUCTION

Most lenders don't feel comfortable putting forth the large chunks of money modular hotel construction requires. Doing so would be a huge risk.

See, most banks require the developer to provide some sort of collateral. At a minimum, they want to know that their loan is tied to some piece of secured real estate. This is pretty straightforward with a traditional construction loan because the hotel is being built right there on site. If a traditional bank were to advance large sums of money without any collateral or secured real estate, it would need to reserve a certain amount of money on their equity. Otherwise, the bank could be written up by regulators for taking on too much risk.

This is what makes financing modular hotel construction so complicated. There's not enough equity in reserve for the bank to hold; that money needs to go out the door. And until production of the units is in full swing, the hotel developer doesn't have much to offer in terms of collateral. All collateral is owned by the modular manufacturer. In the early stages, most modular construction projects are completely unsecured.

Typically, the only collateral the hotel developer has at this point is a piece of raw land awaiting pod delivery.

If something goes wrong—for instance, if there's a manufacturing complication or shortage of raw materials—the lender is in a bind. The bank doesn't have any recourse. The hotel hasn't been built yet. The units haven't even moved to their final destination yet.

Generally speaking, most banks won't finance modular hotel construction for these reasons. Those that do will only release construction financing once the modules are received on the site. As a result, depending on the size of the project, the modular manufacturer may need $20 million or more in advance of receiving any compensation from their construction lender—no small feat to overcome.

The challenge of capitalization is perhaps the largest barrier for the widespread adoption of modular hotel manufacturing.

THE NEED FOR FLEXIBLE PRIVATE CAPITAL

Modular hotel construction, though growing in popularity, is still relatively new. There aren't many lenders, traditional or otherwise, who want to take a risk on modular while the industry is still in its nascent stages.

That said, while financing modular hotel construction is complicated, it isn't impossible.

A handful of private funds have stepped up in recent years to finance these projects. For companies like these, ours being one of them, the most important thing is understanding that these projects carry inherent risk—and then understanding exactly where the risks lie. Private funds that are familiar with the modular construction process are generally more comfortable advancing large sums of money up front to help these projects move forward.

In fact, private lenders tend to be a great fit for modular hotel construction because they can provide more flexible capital. Private lenders are not subject to the same regulatory boundaries that a traditional bank is. Private lenders can finance projects more creatively, with quick decision-making, and can be more nimble if problems arise.

A RECENT CASE STUDY

Just last month, AVANA Capital closed a $60 million construction loan to Mogul Capital so it could begin the modular construction of a dual-branded Marriott Courtyard and TownePlace Suites hotel located in downtown Hawthorne, California. The 354-key hotel will include a restaurant, swimming pool, and various business facilities.

"We were very pleased that we found in AVANA Capital a partner that believes in our vision and has the understanding of the conventional and modular construction for a large project like this one," said Brad Wagstaff, president of Mogul Capital.

Financing includes a $50 million conventional loan and a $10 million mezzanine loan with above market leverage.

AVANA Capital was attracted to this deal for a few reasons. First, Idaho-based Guerdon Modular Buildings will be manufacturing the units—this is a modular construction company that AVANA has worked with previously, and a company considered one of the premier modular hotel manufacturers in the nation.

The second reason revolved around Marriott's involvement. The Marriott hotel group has already created highly technical modular architectural drawings. They share these drawings with their hotel developers to assist with construction.

In other words, it wasn't anyone's first rodeo with modular hotel construction, a factor that helps mitigate risk and provides comfort to investors.

To be sure, modular design isn't right for every hotel project. But in instances where it does seem like a good fit, hotel developers would be well served by contacting a variety of private lenders. Private capital, in our experience, is typically the best solution for financing modular hotel construction. hT

ABOUT THE FIRM

AVANA Capital is a nationwide commercial real estate lender based in Glendale, Arizona. AVANA offers hotel financing through conventional and SBA 504 lending programs for acquisition, refinance, and construction. AVANA also provides interim and bridge loans. Since its founding in 2002, the company has funded more than $1 billion in loans. For more information, visit www.avanacapital.com.

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