Articles for Aspiring Innkeepers

InnFinancing.com

Financing B&B's, Inns & Boutique Hotels

Presented by Richard Newman

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Goldmoor Inn, Galena, Illinois

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Can the Inn I love be…

"The Inn of My Dreams?"

This is the million-dollar question…

Most aspiring innkeepers who contact me do so before beginning a serious search for a property. This makes sense to me, as they have been successful in some other career and have learned that "An ounce of prevention is worth a pound of cure." They want to do their homework to narrow their search to a price range they can afford. Whether they are single pursuing a lifelong dream to run their own business or partners moving on to a new challenge in a new place, it is my goal help make the experience a positive, productive and profitable one.

Step 1 - Prequalification: My first task is to understand what assets are available, where they are invested and what the buyer/s are willing to commit to funding an acquisition. We need to verify assets, what assets are available, and how. Credit history and professional qualifications are also important to understand so that any limitations or challenges can be managed early on. My most important job as I see it is to get aspiring innkeepers focused on identifying an inn that is well suited for their qualifications, to make sure their energy may be appropriately directed and their expectations are realistic and achievable.

Most sellers will be more receptive to a buyer who has been prequalified, in fact, this is generally a requirement before sellers will share or authorize their realtor to provide financial information at all. A strong buyer may be able to purchase an under-performing inn if they have adequate capital and an abundance of direct industry experience, but a strong performing inn helps offset a borderline buyer's shortcomings in experience and or capital.

Step 2 - Identifying qualified properties: I recommend that a knowledgeable "B&B Industry Specialist Realtor" be engaged very early on to recommend available inns matching the aspiring's qualifications and vision. Many of these professionals have been innkeepers themselves and are intimately familiar with operations and valuation methods. They can expertly compare the asking price with their analysis of the inn's financial performance and comparable sales. They can also critically analyze expenses, ADR, and occupancy rates as compared to industry norms considering location and the seasonal nature (if any) of the business.

Since the underwriting of a commercial loan combines the qualifications of the buyer with the financials of the inn, it is essential to collect as much data as possible from the current owners to sort through available inns in the geographical areas of interest. It makes little sense to invest time and money to visit a list of available inns until you have reviewed as much information and data as possible.

Why get excited about an inn, love the sellers, have them like you, and see yourself as the next innkeeper if the deal can't work because the net income cannot support your lifestyle, the desired level of debt. What is the asking price is unsubstantiated by the inn's historical performance? It is in the interest of all concerned to know that the asking prices are well supported by comparable sales and three (3) years of financial data derived from the business tax returns.

Any offer should be based on historical data—not what the inn is capable of under new management. You don't pay the price based on what an inn can do, the value is determined by a combination of its historical performance over time, real estate value and other assets of the sale.

It is my professional mission to guide aspiring innkeepers along their journey, to enhance their experience and increase the likelihood they will be successful in finding the "The Inn of Their Dreams."

Prequalification

The Prequalified Buyer™ evaluation and designation provides Aspiring Innkeepers a credible way to quantify how much purchasing power they have as it relates to identifying hospitality properties that best fit their financial qualifications and professional/personal objectives.

A Prequalified Buyer™ designation identifies a person or persons as having submitted, the required proofs and documentation for verification and analysis; before identifying or contracting to purchase a specific hospitality property. Prequalified Buyer™ designation, confirms that all parties to an acquisition who will have an interest greater than 20% complete an application including, identification, i.e., Driver License/s,

Financial Statement/s, Account Statements, Credit Authorization, Personal Debt Schedule, three (3) most recent years Federal Tax Returns, Pay Stubs for Current Year, and Resumes for all partners.

The Prequalified Buyer's purchasing power and limitations are determined before requesting the financial data from the seller. Realtors and sellers alike are more receptive to investing time with a Prequalified Buyer™, because their qualifications and assets have been independently verified. A Prequalified Buyer™ negotiates with confidence knowing they can consummate a transaction.

Prequalification Check List

List of items required to begin the Buyer Prequalification Certification Process:

- Commercial Loan Application
- Borrower's Financial Statement/s
- Verifiable Proof of Assets to be applied to a down payment and reserves i.e.
  - Checking Account/s
  - Savings and Investment Statements
  - 401k/IRA Statement/s
- Three (3) Years Borrower's Personal Tax Returns
- Resumes for all Principals
- Borrower's credit report/s with credit scores for all three (3) bureaus
- Proof of Identity
  - Valid passport <u>OR</u>
  - Driver License (Both Sides)

Prequalification Vs. Preapproval

A Preapproval differs from Prequalification in commercial lending, in that the “Preapproval” is issued after a preliminary underwriting determination has been made. The buyer’s qualifications and the data from the commercial property are combined to assess the risks versus the merits of the loan application.

Financial records on the business/property being acquired will be necessary to determine that the Debt Service Coverage Ratio (DSCR) will comply with general underwriting guidelines after items such as depreciation, officer's salaries, mortgage interest, and certain non-re-occurring expenses are added back to the net profit/loss. A Preapproval will have issued conditioned upon specified events, and due diligence has been completed. After all data from the borrower's and the subject property is compiled and analyzed by one of our Commercial Loan Underwriters.

The following items will be required on the subject property before a Preliminary Preapproval can be issued:

- Three years of business Federal Tax Returns
- Year to Date Balance Sheet/P&L
- For comparison purposes, Year to Date Balance Sheet/P&L for the same period for the prior year
- A detailed list of capital improvements made within the last five years
- Photos of the property or Web Address

Using Retirement Assets to Purchase a B&B/Inn…

Few investors/entrepreneurs realize that they can self-direct their retirement assets. Most believe the only two options are to borrow or withdraw from their account/s if they wish to invest in real estate or purchase/start up a new business. The downsides are…

1. Borrowing from the account/s would require repayment of the principal with interest.

2. Early withdraws would be subject to taxes and penalties.

There is another way… The Employee Retirement Income Security Act (ERISA), which created the IRA in 1974, places surprisingly few restrictions on how retirement money can be invested. Except for life insurance or collectibles—such as artwork or coins—IRA funds can be invested in just about anything. Tens of thousands of investors have switched their retirement savings to self-directed accounts since the stock market correction of 2000 and 2001. By some estimates, 3% of the $3.5 trillion held in IRAs is now in alternative investments—and the number is growing.

Here is how it works… A Retirement Account Facilitator can create the legal entity and structure that allows for checkbook control of your funds. A new C corporation will be formed which in turn sponsors a Qualified Retirement Plan. The new plan will receive a roll-over of all or part of your existing /previous 401(k) and or IRA Qualified assets. The new corporation will own the real estate, goodwill, FF&E and other assets of the business. The plan invests in the company by purchasing stock in the corporation, providing the necessary capital to fund the down payment, closing costs, reserves, and working capital. The new qualified retirement plan purchases the stock of the C Corporation you control, similar to what your IRA/401(k) does currently, that allows you to buy shares in a publicly traded company.

Here are the benefits to this program…

- You do not repay a loan, which adds to overhead and you will not incur taxliabilities and penalties
- Profits can be sheltered by either:
- Making contributions to the plan which grow tax-deferred
- Paying dividend to shareholders at the end of the year
- Ultimately, any gain from the sale of the business/property will flow into your retirement account proportionate to the stock it owns in the corporation.

Very Important! When the cash requirement of an acquisition/start-up exceeds the available account balance, multiple investors may invest in a single project through the same self-directed 401(k) plan; this feature may be very useful/attractive to family members or outside investors who wish to provide financial assistance or take advantage of an investment opportunity.

No outsider can guarantee the soundness of your investment strategy. Seeking advice talking from a trusted financial advisor would be prudent. Unless you have both time and capital to spare, you should be cautious before putting your entire nest egg into a new business; however, investors with a robust do-it-yourself streak and a compelling alternative investment strategy may want to consider joining the growing ranks of people who have decided to invest their retirement funds in themselves. Note: The material contained in this overview is provided for your general information and should not be acted upon without prior professional consultation with the appropriate experts.

Financing a Bed & Breakfast/Inn

All Bed & Breakfasts/Inns are unique by design. It is that unique quality that separates one Bed & Breakfast/Inn from the next. Innkeepers invest their energy and capital over time to create a welcoming and hospitable environment that is special to them, their community and valued guests who appreciate the inn and the experience the owners provide. While the charm and ambiance of an inn add to a patron's experience, such intangibles have only an indirect effect on its actual commercial value.

An Inn's commercial value will ultimately be determined by a combination of the real estate value, cash flow, goodwill, and furniture, fixtures, and equipment (FF&E). Together, this value will be its value as a "Going Concern." It is important that you are comfortable with this value before making an Offer to Purchase or a Contract of Sale. Realtors who specialize in marketing and selling Bed & Breakfasts/Inns have access to comparable sales data and property specific financial information that should support the asking price and may be made available to "Qualified Buyers." Lastly, we can analyze the financial data to be sure that income from the property can support the debt service relative to the down payment and your investment objectives.

The Contract of Sale is the controlling document in a purchase and should reflect terms that are practical, relative to the down payment and financing terms for which you are best qualified. The value of the business's "Good Will" and FF&E may be assigned separate values from the real estate in the Contract of Sale. Try to avoid this if possible, as loan programs that accommodate financing anything other than real estate are less flexible and sometimes difficult to obtain. It is always a good idea to consult with us before entering into a Contract of Sale since a lenderwho is familiar with bed & breakfast properties can prequalify you specifically to the property you have identified.

Most Contracts of Sale contain a mortgage contingency clause of 30 to 45 days, the exception being cash transactions, 1031 exchanges of equal value, or sales where the seller has agreed to be the primary lender.

The contract will also contain inspection clauses for items such as insect infestation, plumbing, HVAC, electrical, and the structural integrity of the building(s). During this due-diligence period, it is also common to incur attorney, survey, and title fees.

It is therefore essential to note that should the appraised value be determined to be less than the contract sale price, that value will be used to determine the actual loan-to-value, rather than the contract price. If this should occur and the parties cannot agree on a revised amount or contract terms, the buyer risks losing all or a portion of his/her due-diligence expenses.

Value Determination: The lender will require an appraisal of the property. Appraisal fees generally range from $2,400 to $5,000 depending on the nature of the property and customary charges in a geographical area.

Down Payment may be as little as 15% for qualified buyers, although interest rates typically increase proportionately to the Loan to Value (LTV). Funds from 401ks or IRAs can be used as a down payment on a B & B/Inn. The programs are quite complicated but can be managed professionally by a qualified plan facilitator.

A resume containing experience in the hospitality and/or restaurant industry will be extremely beneficial, as the lender must determine that the borrower's work history is sufficient to maintain and/or improve the cash flow of the business. Transferable skill sets may be used to offset this requirement

Credit Scores are critical to a lender in evaluating the merits of a loan. Your credit (or FICO) scores have a direct impact on the rate, term, and loan program for which you qualify. Note: Individual lender guidelines may vary. For a copy of our Credit Guide, please visit our web site at: www.InnFinancing.com.

Conventional Commercial Loans: Because each property is unique in some way, each financing option must be analyzed carefully to determine which programs are available in your state and what options will suit the property you desire to purchase. A Conventional loan application package will contain such information as the Contract of Sale, three years business tax returns, an interim financial statement, bank statements, and a business plan. Also, for all partners with an interest greater than 20%, a credit profile, two years' personal tax returns, and resumes will be required.

- For "Viable Inns" (inns that cash flow principally on the business income, however, underwriting may use global Debt to Income Underwriting DTI)
- 75% to 80% Loan to Value (LTV)
- 20 to 25 Year Term
- 2% to 3% in Closing Costs
- Cash Flow 1.2 to 1.3% Debt Service Coverage Ratio (DSCR)

SBA FINANCING OVERVIEW: The 7a Program allows for financing of all types of business needs from purchasing real estate and fixed assets to working capital and business acquisitions. SBA's 7(a) Loan Guaranty Program offers the actual lender, Bank or Non-bank, a loan guarantee currently up to 85% of the loan amount for hospitality properties as they are considered a higher risk property type. The SBA guarantees or insures the lender against loss resulting from a default and collateral shortfall. This guarantee allows the lender to provide for financing not ordinarily offered using conventional programs.

The SBA 7(a) loan program highlights are:

- Up to 85% financing
- Fully amortized loans with no balloons
- Terms to 25 years
- Loans up to $5 million
- Loans may be assumed
- Variable and fixed rate financing at 1.25% to 2.75% over prime – 3 and five years fixed may be available
- Closing costs 3 to 4% including the SBA Loan Guarantee Fee – 3% of loan amount

The SBA 504 loan program highlights are:

The SBA 504 Program provides a method to finance real estate expansion projects through long-term, fixed-rate financing and is differentiated from the 7(a) program in that it is offered in partnership with a participating lender (Bank or Non-bank)."

The 504b loan program consists of two loans. The first loan and lien position is offered by an authorized lending institution (Bank), and the second loan or second lien position is being provided by the SBA via the efforts of a certified development company (CDC). Most CDC's are private organizations used by the SBA to process the 504-loan application and assist borrowers in obtaining proper funding which meets their needs.

504b eligible project costs include:

• Land and building acquisition & Site improvements

• Building improvements

• Professional fees, including architect, appraisal, environmental

• Other costs, including title insurance, survey, points and interest on the interim

loan the main advantages of the SBA 504 program are as follows:

• Loans to 15 Million

• Small equity injection, as little as 15% toward the total eligible project

• Long-term financing available, up to 25 years on loan 1 and up to 20 years on loan 2

• Very favorable, fully amortizing fixed-rate pricing

• Most closing costs are eligible for project financing

• SBA 504 loans may be assumed

Viable versus Lifestyle Inns

Commercial real estate financings are generally presumed to be serviced by the income from commercial property ONLY, as such a Debt Service Coverage Ratio (DSCR) is used to underwrite the loan. The DSCR or debt service coverage ratio is the relationship of a property's annual net operating income (NOI) to its yearly mortgage debt service (principal and interest payments).

Example: $125,000 in NOI and $100,000 in annual mortgage debt service - DSCR = 1.25

Commercial lenders use the DSCR to analyze how large of a business loan can be supported by the cash flow generated from the property or to determine how much income coverage there is at a specific loan amount.

Two of the most critical considerations used to determine the viability of a commercial loan request are the DSCR and loan-to-value (LTV). The loan amount may be constrained and the maximum LTV not obtainable due to the DSCR or lack thereof. If the maximum LTV is 80% and the DSCR is less than the lender's required minimum coverage requirements at 80% LTV, the loan amount will be reduced until the minimum DSCR is obtained. In commercial underwriting, this is referred to as loan dollars being debt service constrained, not leverage (LTV) restricted. Income earned outside of the business by the individual/s can only be used to offset the cost of living and personal debt and is not considered in this calculation.

Lifestyle Inns: Some percentage of all inns are operated by one partner who runs the inn and another or others who will maintain his or her career. Innkeepers with smaller inns often rely on this additional income to enhance their financial picture. The innkeeper/s may indeed need income from other sources outside the inn to make ends meet. The extra income may be necessary to offset actual losses or losses shown on the inn's tax returns. In these cases, a Global DSCR approach to underwriting is required as the simple DSCR is insufficient and will not satisfy the underwriting guidelines.

This approach adds all liabilities/debt and divides it into the income from all sources (personal and business).

Credit Reports & Reporting Agencies

Note: This material is being provided for general information purposes. This overview is intended to alert the reader to the importance of managing his/her credit. General guidelines, material, and other information are offered as a courtesy. No representations or warranties are made as to the accuracy or processes covered herein. The Credit Tier Examples listed below are for informational purposes only, as lender guidelines vary.

Credit Scores are significant to a lender in evaluating the merits of a loan. Your credit or FICO scores have a direct impact on the rate, term and loan program for which you qualify.

Credit Score Guide:

A+ Borrower 750+

A Borrower 680+

A- Borrower 640+

B Borrower 600+

Time should be devoted to researching your own credit file/s before you apply for a loan. Consumers are entitled to one free credit report each year by going to www.annualcreditreport.com. Once a reference number is obtained from the repository, a dispute can be opened online. Be sure to print out your report/s while you are online!

Note: FICO scores provided to consumer credit requests are very often higher than the scores given a lender, so any scoring should only be viewed for general informational purposes only.

Disputing Your Credit Report If inaccurate information still appears on your credit report, you have the right under the Fair Credit Reporting Act (FCRA) to challenge the data by:

1. Correctly identify the inaccurate information on your credit report. Look closely at your personal data, account information, and paymenthistory. Review the report/s to see when your
2. negative records are scheduled to be removed. Be sure to note any item/s you feelare inaccurate.

When you find an inaccuracy on your credit report, you should first investigate the details and find out what exactly is wrong. To begin the dispute process, you should contact the creditor or lender responsible for reporting the mistake directly. Your financial institutions will be able to correct most minor inaccuracies over the phone. Not sure of the contact information? You can find it at the bottom of your credit report/s under "Contact Information."

Credit Tips:

Derogatory information reported to the credit bureaus significantly impacts on your overall FICO Scores. Rating agencies also factor high credit limit to loan balance in their scoring algorithms. It is therefore vital to maintain a ratio of 50% or less if at all possible. A low loan to credit limit to balance is believed to improve scores more than actually paying off credit accounts.

It is also worth noting that excessive lender inquiries may harm the FICO scoring process, so it is crucial to keep annual inquiries to a bare minimum.

FAQ’s

How long will it take, beginning to end, to close once I have identified the Inn of our dreams and made a buying decision?

Afterthe offer and contract have been negotiated and accepted, the mortgage contingency period will begin. Contracts generally allocate 45 days to obtain a mortgage commitment. Due diligence now starts in earnest with the ordering of inspections, title insurance, environmental and survey (if needed). Once received, the mortgage processors review the title, appraisal, and environmental issues if any, to build their file for closing. The contract should best case allow 90 days for closing, but closings often occur in 45 to 60 days on average.

How can I know if I qualify for a loan to purchase an inn?

A prequalification involves the review of a loan application and supporting documentation and is comprised of data and documentation for the buyer/s and quite often a property that is of particular interest. The buyer/s must have adequate capital, credit, and credentials, and the property in question (PIQ) must be able to support the desired level of debt; the Prequalification process is most useful to evaluate the buyer/s price range before the search begins of course but may be employed to assess the feasibility of an acquisition.

How do I determine a fair offering price for the inn/s I am considering?

A knowledgeable “B&B Industry Specialist Realtor” should be engaged very early on to consult on matters of value. Realtors who have been innkeepers themselves and are intimately familiar with their market area provide time-saving expertise. They can expertly evaluate the viability of the business and support your offer with their analysis of comparable sales data, the inn’s Financial Performance, Real Estate Improvements, Good Will, and Furniture and Fixtures & Equipment (FF&E). “A buyer or seller of a business who chooses to represent himself/herself has a fool for a client."

Are inns offered "For Sale by Owner" worth considering?

They could be, but it is difficult for a seller to impartially establish the value of the business and its assets without the benefit of a valuation undertaken by an industry specialist realtor or an appraiser. The asking price should be backed up with three (3) years historical financial data and comparable sales.

How much do I need to have for a down payment to purchase an inn?

Buyers should have 30% of the project cost to cover the following:

1. Down Payment – 10% to 25%
2. Closing Costs – 3% to 6%
3. Reserves – 6 Months Principal &Interest

What should I look for when shopping for the inn of my dreams?

Aspiring innkeepers should attend industry conferences and aspiring seminars to get a feel for the kind of operation that would best suit their financial and lifestyle objectives. This is fundamental to the beginning of a well-planned investment and will save time, capital and energy. Do all that is possible to enjoy the journey by learning from the unpleasant experiences of others.

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environmental issues if any, to build their file for closing. The contract should best case allow 90 days for closing, but closings often occur in 45 to 60 days on average. How can I know if I qualify for a loan to purchase an inn? A Prequalification involves the review of a loan application and supporting documentation, and is comprised of data and documentation for the buyer/s and quite often a property that is of interest to the buyer/s.

About – Richard K. Newman

Rick Newman founded Commercial Capital Network in 2004. His website www.InnFinancing.com provides useful information to aspiring innkeepers who wish to purchase “the Inn of their dreams” and Innkeepers who seek to re-finance or re-structure debt obligations.

In 2007 Rick introduced an innovative program to the hospitality industry, which liberates the use of retirement assets for the purchase of an inn without incurring penalties or tax liabilities. This program has helped many of Rick’s clients access capital to fund a more significant down payment.

Rick’s connection to the hospitality industry has its roots in his family’s 30-year ownership of a twenty-eight-room inn in New Hope, Pennsylvania. He maintains relationships with leading hospitality professionals and industry specialists. He has authored numerous articles on subjects of particular interest to aspiring innkeepers, and his testimonials pay tribute to the relationships he has developed with his valued clients. Rick has supported the mission of state, regional and national B&B/Inn trade associations since 2006.

To read Rick’s reviews, please visit - www.InnFinancing.com

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