The return of hospitality: The pandemic took hotels to the brink. How are they faring now?

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by Sheila Hopkins

"The hotel industry experienced the most devastating year on record in 2020, resulting in historically low occupancy, massive job loss and hotel closures across the country. Hotels were one of the first industries affected by the pandemic after travel was forced to a virtual halt in early 2020, and it will be one of the last to recover. The impact of COVID-19 on the travel industry so far has been nine times that of 9/11."

That quote leads off the *State of the Hotel Industry 2021* report put out by the American Hotel & Lodging Association. For the hotel industry to experience a record-setting downturn is saying quite a lot, given that the industry is known for its downturns. As shown in the "Hotel REIT total return" table included with this story, nearly anything can spook hotel investors — global recessions, rising gas prices, an outbreak of Legionnaires Disease, Jack Nicholson breaking down a bathroom door of the Overlook Hotel. But that same chart shows that the industry always bounces back. In fact, it seems that simply being down is all the reason investors need to expect an imminent recovery. And the current downturn looks like it will continue to follow that pattern. In fact, based on REIT returns, it already has.

SHORT STAY

The hotel industry is still reeling from the nearly total cessation of travel in spring and summer 2020, and probably will continue to do so for quite some time. Some analysts predict travel will not return to 2019 levels until 2024. Yet, looking at the pent-up demand and explosion of leisure travel already evident in this summer's reservations, it appears that portions of the industry will rebound much quicker than expected. At least for some subsectors, the hotel crash could be much shorter than forecast, even if other subsectors continue to struggle.

"The economy segment was the least-impacted during COVID and has quickly recovered," says Eva Wassermann, a managing director at GEM Realty Capital. "In April, the economy segment's RevPAR was ahead of April 2019 by 4.7 percent. Generally, this segment did well because it accommodates traveling work crews and individuals who found themselves in transit. These hotels are often close to highways and the extended-stay properties have kitchen facilities, which were very desirable."

Other quick-rebounding segments include leisure and resort hotels within driving distance of major population centers. In April 2021, resort RevPAR was down 13.8 percent compared to 2019, but this looks pretty good when compared with the urban hotel sector, which posted a RevPAR of just 57.0 percent April 2019. Another beneficiary of the upturn in leisure travel has been the short-term vacation rental industry (e.g., Vrbo). Expectations for summer 2021 are for higher occupancy than 2019.

"This will be a phenomenal summer," asserts Daniel Lesser, CEO of LW Hospitality Advisors. "There is a tremendous pent-up demand. People are bursting to get out of their homes and go someplace. The drive-to-leisure destinations and lodging are coming back strong. The question will be what happens after Labor Day. That's when the business/convention/group meeting hotels typically see their highest demand. Will that happen this year?"

At the moment, some regional and small-meeting sites are seeing an uptick in reservations, but the venues that typically host thousands of conventioneers are still struggling.

That quick leisure rebound has proven disappointing to all those opportunistic funds that raised billions of dollars at the beginning of the pandemic with expectations that there would be massive amounts of distressed properties and debt to scoop up. Taking Rahm Emanuel's mantra to heart, these investors were not about to let a serious crisis go to waste. However, while the industry is undoubtedly still in a serious crisis, the predicted distress has never materialized — at least not at the expected level.

At the end of Q1 2021, 18 percent of hotel sales involved a distressed asset. This looks quite high when only 3 percent of total retail assets involved a distressed asset, but it doesn't reach the level everyone expected. And even that 18 percent might be an outlier.

“So far, distressed asset sales have jumped only for the hotel sector,” says Jim Costello, senior vice president at Real Capital Analytics. “But the spike seen in Q1 2021 was mostly due to one large portfolio, some of which were troubled” (the sale of a portfolio of nearly 200 hotel properties by Colony Capital to a JV between Highgate Holdings and Cerberus.)

The reasons behind the lack of distress, despite the industry crash, are varied. But one of the main drivers is that banks and lenders always assumed this was going to be a relatively short-term situation. Bankers don’t want to own hotels. They want to own mortgages. So, they kicked the can down the road and gave their property owners more time to pay off their debt.

The debt on the properties involved in the distressed sales recorded during the first quarter was likely held by CMBS servicers. Real Capital Analytics data found that CMBS and financial funds made up 75 percent of the lenders involved in these deals. This makes sense. There is no personal touch involved with these debt providers, and they are just as likely to force a sale as let things slide.

While having a flexible lender helped many hotels weather the pandemic, other factors also played into separating those that survived from those that didn’t. These included deep pockets, which allowed assets to fund operating shortfalls; strong management teams on property willing to do every job required; and local jurisdictions allowing business activity to continue. We also can’t discount the effects of the Dodd-Frank legislation, which kept lenders from taking on too much risk and, thus, prevented hotels from being overlevered. Then, you have just plain luck. Having a hotel in a drive-to leisure market resulted in continued traffic when compared with 24/7 urban core sites.

OPEN FOR BUSINESS

Given the significant growth in hotel deal volume in first quarter 2021 (March year-over-year volume jumped 180 percent) you would expect investors to be dancing in the ballrooms. It is true that the March numbers were skewed by the Colony Capital sale, but the trend is still good. Deal volume involving individual assets was up 56 percent year-over-year in March on sales of $1.1 billion. Hotels are clawing their way back.

“As swiftly as the pandemic led to widespread closures and cancellations beginning in March 2020, signs of an equally robust recovery are percolating, with 2021 expected to show the strongest growth ever in key lodging industry metrics,” says Lesser.

Yet, investor interest seems muted. As already noted, the prime interest and enthusiasm had originally come from opportunistic players who expected to capitalize on distressed sales. There may still be opportunities in this strategy, as nearly $27 billion in lodging sector debt is set to mature through the end of 2021, and not all of it will be granted forbearance. However, the bloom may be off the rose here.

“By the end of the year, and into the first quarter, workouts exceeded new inflows of distress, and the total pool of distressed assets shrank,” notes Costello.

Investors are now more likely to be looking at growth opportunities than distressed debt plays.

“GEM has historically focused on opportunities with diversified demand,” says Wassermann. “We still believe in that approach and, going forward, will increase our focus on the leisure segment, a component of total demand. Increasing leisure travel is a trend we expect to continue. We will also continue to target markets with strong growth fundamentals and demographics that support increased corporate transient travel, as well as group meetings.”

Hotel investing takes a very specific skillset that not all investors have. It takes very specific local knowledge, as well as a knowledge of hotel business practices. While national trends point to a resurgence of leisure market and a not-so-resurgent urban 24/7 market, investing in hotels really comes down to individual assets in very specific locations. Assets that might have been core in the past might not be now.

“The hotel business is a neighborhood business, a street corner business,” says Lesser. “It really boils down to the submarket within a metropolitan area. It's very product and submarket driven. The urban locations, such as New York and San Francisco, that used to be several of the darling markets of the hotel sector are now perceived as the dogs. Is it going to stay that way? I'd like to think not. But because business and convention travel are still limited, it's going to be a long road back for a lot of these downtown urban cores.”

CALL THE DESK

Although the prime drivers of the hotel crash are mitigating, the industry is now facing a more secular challenge: labor. Or, more precisely, a lack of labor.

To survive the pandemic, hotels laid off staff, eliminated unprofitable food and/or beverage outlets, and stopped offering many guestroom amenities, such as daily housekeeping. These moves contributed to dramatically reducing full- and limited-service hotel break-even points and allowed them to survive. Now, however, these same hotels are looking to restart some of these offerings, and they are finding they don’t have the people to do so.

“I'm the court-appointed receiver on a portfolio of hotels around the United States,” says Lesser. “Demand has come back for most of the hotels. However, in several markets, we just don't have enough people to clean rooms. As a result, we have had to take rooms out of service. A deep, wide and swift collapse in room-night demand followed by a boom rebound is an unprecedented and, frankly, interesting phenomenon that nobody would've ever anticipated to occur.”

Many hotel industry workers who were furloughed or terminated may never return, as they have moved on to other jobs that are perceived as more stable and lucrative. Furthermore, many corporations including ecommerce and customer service call centers are adopting permanent and attractive work-from-home arrangements. Finally, the challenge of a worker shortage could quickly compound next year, as most economically viable hotels will have re-opened.

SO, WHERE TO STAY?

Despite the challenges and uncertainties, investors are still giving hotels a close look because the sector is still attractive when compared with other real estate property types.

"When one looks at the four major classes of commercial real estate, office and retail are severely challenged by the complex, still-evolving changes in demand for those assets, while multifamily and industrial have seen prices soar powered by low interest rates and a torrent of equity capital," says Stephen O'Connor, a principal and managing director of RobertDouglas. "Put more simply: office investment is a conundrum, everything but grocery-anchored retail is toxic, multifamily is overpriced and warehouse is wildly overpriced."

That leaves hotels as one of the only commercial real estate classes where (1) assets can be acquired at a discount, (2) there is a reasonable expectation that demand will eventually return, and (3) valuations are expected to recover to pre-COVID levels, he adds.

The economy also favors the hotel sector. Many institutional investors expect some level of inflation in the near term. Daily leasing of guestrooms coupled with the continuous repricing of room nights, position hotel investment as a particularly good hedge against inflation.

"Additionally, savvy and patient sponsors know that over the long term, the notion of urbanization will endure as corporations will always follow the preferences of young, skilled talent into cities in primary markets and the downtowns of secondary and tertiary metropolitan areas," says Lesser. "Sophisticated long-term contrarian investors, who at the right basis, acquire lodging assets in oversaturated markets, those with strong labor unions and/or unfavorable ground leases, as well as big box convention hotels are still likely to realize tremendous returns on investments over the long term."

Travel is part of an American's DNA. We need to explore. We need to visit. We need to stay in hotels. Businesses people, likewise, need to travel and network and meet in person. They, too, need to stay in hotels. Hotels might be down now, but they will be back. It's simply in their nature.