Reflections about rising inflation, interest rates on values

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It has been 40 years since the U.S. economy has experienced a dramatic rise in inflation and interest rates. Countless Americans who have never lived through such a period are concerned with rising prices. Over the course of the past two years, many have been the beneficiary recipients of economic impact payments from the government. Massive government monetary stimulus to combat negative financial effects of the pandemic resulted in an overstimulated economy fueling an unprecedented consumer spending spree and a resultant spike in inflation. For all the voiced concerns about rising prices, consumers continue to spend with abandon suggesting more inflation may lay ahead.

In Q1 2022, earnings for many publicly traded hotel companies exceeded expectations as post-pandemic travel, particularly leisure demand, continues to rally. While occupancies continue to generally lag, achieved U.S. average daily rates are now consistently above 2019 record levels, paving the path for a robust recovery and an inflation hedge for hotel investors. Furthermore, the strong pace of actualized and future bookings for business and group travel points to a broadening and robust recovery of the lodging sector, albeit with headwinds due to rising labor costs, high energy prices, and intensifying geopolitical conflicts.

Slowing the rise of inflation through targeted interest rate increases, which is now a significant policy priority for the current administration, has been complicated by the unknown effects of the war in Ukraine. Irrespective, tight monetary policy and rising interest rates are inevitable for the balance of this year and possibly into next.

Theoretically, rising interest rates place upward pressure on capitalization rates which reflect a weighted average cost of debt and equity capital. However, other factors including change in net income also affect pricing of lodging properties.

Given daily leasing of guest rooms and scientific knowledge that allows for continuous unit repricing, many hotels can increase revenue as quickly if not faster than rising operational expenses. Additionally, an unprecedented amount of domestic and overseas investment capital raised since the beginning of the pandemic and targeted toward the U.S. lodging sector remains sidelined and under pressure for deployment, with some now willing to accept reduced returns. Finally, many large scale, high quality urban U.S. full service and convention hotels and resort properties continue to trade below replacement cost, which is generally appealing to buyers.

While the influence of rising inflation and interest rates create new challenges for the lodging industry, during the near term, investment in U.S. hotel property is anticipated to remain desirable and at attractive valuations.