Slow US Hotel Deals Pace Likely To Continue in Second Half of 2023

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U.S. hotel transactions slowed in the second half of 2022 amid hopes that pent-up capital, a better grasp on pricing expectations and a slowing of interest rate increases could translate to more deals in 2023.

That didn't quite happen, at least in the first half of the year.

Capital is still pent up. The cost of debt is still high. The bid-ask gap is still wide.

A common refrain from the recent NYU International Hospitality Industry Investment Conference was that if a hotel owner doesn't have to sell, they shouldn't, said Jan Freitag, national director of hospitality market analytics at CoStar.

Hotel owners are buoyed by rates that are higher than in 2019, without adjusting for inflation, and occupancy on par or just below, unless it's a city hotel. That gives them a sense of what their properties are worth, but they're not finding buyers who are underwriting the same way.

“There’s still this bid-ask spread — chasm — and that is going to take a while to unfold,” Freitag said. “That’s why if you’re not motivated, if you’re just sort of sitting on the sidelines, there’s really no catalyst for you to really be aggressive in marketing your property.”

A Drop in Deals

LW Hospitality Advisors’ Major U.S. Hotel Sales Surveys for the first two quarters of 2023 show year-over-year decreases in hotel sales and dollar volume as well as price per key. The surveys track hotel transactions valued at $10 million or more.

According to the surveys, there was a 36% decrease in the number of transactions priced at $10 million or more. Total dollar volume declined by 50%, and the price per key dropped 4%.

Eighty-three single hotel assets sold for $10 million or more in the first quarter, totaling almost $3.5 billion. That comprises roughly 12,500 hotel rooms with an average price per key of $279,000. In the second quarter, 84 single-asset sales totaled $3.1 billion — comprising 12,100 rooms and an average price per key of $257,000.

Interest rates are high compared to 18 to 24 months ago, but are at the long-term average over the past 40 years, said Daniel Lesser, president and CEO at LWHA. Regardless, that has slowed transaction volume.

“People say that debt’s not available,” he said. “Debt’s available, but you have to pay for it in terms of a return on that money. The notion of borrowing money for free, as was the case 18 to 24 months ago, that was an anomaly that we’re probably not going to see again in our lifetimes.”

There’s a disconnect between hotel operators who say that the key performance indicators are positive, and lenders who say that doesn’t translate to activity, Freitag said.

Resorts and similar property types continue to garner interest because they’ve shown resiliency to downturns, he said. For hotels toward the lower end, the story is different.

On top of that, regional lenders have pulled back as they try to prop up their own balance sheets, increasing competition among all types of borrowers, who view hotels as riskier investments.

“Even if you have a strong sponsor, if you’re a strong owner with a relationship with that bank, the bank may just say: ‘Look, we like you, but it’s just the environment right now is such that we need to watch our own books very closely. We’re extended; we’re done lending on hotels this year. Certainly, this is a good idea; come back to us in the future,’” he said.

Looking Ahead

There's a logjam in hotel transactions, and everyone is waiting for the first person to blink, Lesser said. The industry needs price discovery, and that comes with a robust transaction market.

During the second half of the year, he said he expects the bid-ask spread to narrow. There will also be a significant buildup in momentum of existing debt coming due, along with deferred property-improvement plans. Assuming there's no black swan event, the change will be gradual, Lesser said.

"Something needs to happen," he said. "It either needs to get refinanced or the property is going to need to be sold. ... It's really going to be a forced issue to get the transaction market moving again."

Through the pandemic, investors raised capital in anticipation of distressed deals that never materialized, Lesser said. There is still a lot of capital on the sidelines, but that money is losing value, he added.

"If you're sitting on cash today in the inflationary environment that we live in, you're losing money every single day because of inflation," he said. "There is tremendous pressure to get it out and get it deployed whether it's equity or debt. Nobody makes money sitting on cash."

Many would-be buyers are saying they have the money, but they don't have the sellers, Freitag said. Over the past six months, some of that private equity money has been changing to private debt.

"You can get equity-like returns on very short-term loans that allow the owner to bridge the financing gap to get some financing, to get a larger loan in place," he said.

Freitag added the amount of capital raised for deals each downturn keeps the pricing floor high. Owners have many options besides selling as they can find other capital that allows them to resize their capital stack and live to fight another day.

"They can take money for two years," he said. "It's expensive, but then you've got to refinance it. Two years from now, the interest rates are going to be lower, and there's going to be certainty in the financing market, which then breeds more people being active."

Owners' Perspectives

Since the start of the pandemic, AWH Partners has acquired six hotels and sold three, Chad Cooley, co-founder and managing partner, said in an email interview. Despite the slow transaction market over the past 12 months, the company has reviewed roughly 150 investment opportunities and submitted 40 offers. It's also running five sales processes for select assets in its portfolio.

Compared to previous cycles of market dislocation, AWH is focusing more on A- and B-grade markets that have consistent long-term growth and less on C- and D-grade markets despite the increased opportunities for distressed deals, he said.

“This is a function of both stronger markets still seeing a better volume of deal flow, and also a lesson learned through previous cycles that high-quality markets are more resilient in challenging capital markets environments from a value-preservation perspective,” Cooley said.

Peachtree Group has acquired four hotels in the first half of the year with another one under contract — on par with its pre-pandemic pace of about 10 to 15 deals annually, said Michael Ritz, senior vice president of investments. Three of the four deals have been off-market, which represents a change in how the company has historically bought hotels.

While the overall industry’s deals volume is down compared to recent years, Peachtree has been able to move forward on deals because of its focus on branded select- and limited-service hotels that range in price from $15 million to $40 million, with a few exceptions. Ritz said Peachtree also has the ability to pay cash for some hotels, as it did with one of its acquisitions this year, which gives it an advantage with sellers as there’s no lending risk involved.

He added that much more due diligence is required in underwriting to evaluate a hotel and align with lenders.

“Every conference we go to, we always say that it feels like we’re doing twice the work to get half as much done,” he said.

Ritz said sellers are in one of two positions — it’s either a new asset that has recently opened in a good location and checks a lot of the boxes; or the hotel is older, but still attractive, and is highly deferred in maintenance and renovation costs.

The owner either has faith in the equity that exists in the asset and wants to play the long game, so they’re open to preferred equity and capital solutions that keep them as an owner, or wants to wipe their hands and take whatever the market gives them as they don’t have the ability to do a renovation and don’t see the value.

The preferred equity route has been a growing opportunity for Peachtree, Ritz said. The properties his company has been interested in aren’t distressed themselves, but the balance sheets of the would-be sellers are, which leads to a wider bid-ask gap.

Historically, the move would have been to sell to make a premium on the asset, Ritz said. The current viewpoint is there’s still value to be had, but the problem is access to capital markets.

“That’s actually bred a lot of partial sales and preferred equity opportunities for us that we’ve spent a lot of time on recently,” he said, “We’ve seen a really large wave of those.”

Generally the owner says they have a loan maturity coming up in a year, and while they don’t want to sell, they know bringing in fresh equity to the capital stack can get them a two-year extension, he said. Lenders are more willing to work through near-term maturity stress, he said, as a result of guidance from the Federal Reserve on working with borrowers.

Back-Half Expectations

AWH Partners' Cooley said August and September are typically slower for deals even in good years, but his company doesn’t expect deal volume to shift meaningfully for the remainder of 2023.

He said more brokered assets are being described as having a “market seller,” but it’s not clear how many of those will materialize into a trade.

“At some point, if the current uncertainty in the capital market persists, more deals will be pushed towards a ‘market’ sale due to debt maturities and unfavorable alternative options, but this will likely still not materialize in a large and sudden deluge of sales, but more as a gradual unwinding of particularly challenged deals,” he said.

Soon after the Fed indicates an interest rate reduction, there should be a real increase in investor sentiment, Cooley said. That will lead to a return to historically normal transaction volumes.