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Starting a new hotel investment cycle - by James O'Connell

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James O'Connell

During preparations for an upcoming championship boxing match, Mr. T was asked what he predicted for the fight between he and Rocky Balboa. All Mr. T predicted was, "PAIN." Sadly, all that can be accurately predicted for the Northeast's and National hotel industry, over the next six to eighteen months is, PAIN.

In January 2020, with nothing but blue sky in sight, we all wondered what was going to be the trigger to end the nine year upward trending hotel/real estate cycle. Over building was a threat in some markets. Rising costs for construction was a concern that looked to head off over-supply situations in several markets like Boston. Despite a declining rate of RevPAR increases, the lending environment remained favorable with many options for borrowers.

In March of 2020, the hotel industry came to a crushing, tractor-trailer on Storow Dr. crashing halt, that no industry elder had ever experienced before. Every day since has been a walk through uncharted territory. We have been through cycle ending catastrophes before. The 1989-1993 banking crisis with the FDIC and RTC helping to drive real estate values into the ground. SARS and the "Dot Com" bubble burst of the late 90's. September 11, 2001 had people saying they would never fly again. Then there was the CMBS crash of 07'-08' that took us until 2010 to begin turning positive for a nice long run through 2019.

The Pandemic phenomena has affected every single person in the world. The hotel industry has been hardest hit and remains in very dire straits. In June of 2019, according to the "Pinnacle Perspective", the Back Bay/Fenway area experienced a monthly Occupancy of 89.5% with a \$306 Average Daily Rate for a \$268.80 RevPAR. In June 2020, the same market, for the same month, experienced a 2.5% Occupancy (-87%), a \$206.03 ADR (-31.4%) and a RevPAR for the month of June of \$5.21. Other neighborhoods within the city experienced similar results.

This is unprecedented, off the cliff, fly a plane into a mountain type of crash. AND the real PAIN is yet to come. In the month of May, 68.4% of all commercial real estate, CMBS loans, that were classified as "bad debt" were hospitality related. The only thing that has kept the hotel investment world from collapsing has been "forbearance" agreements. Balance sheet lenders allowed borrowers to kick the can down the road for 90-120 days in order to get a handle on their business. For most of the loans that received forbearance, those agreements expire September 1st, 2020.

Here in New England, no matter what market, there is always a seasonal cycle whereby hotels experience their greatest revenue-generating months from June through October. The theory of forbearance in March and April was to allow a hotel to suspend mortgage payments in order to bank summer profits which would allow them to pay their debt during the slower, late fall and winter months. That theory had made sense since the pilgrims got off the Mayflower, until 2020 and Covid-19. Because this summer, with quarantines, guidelines and the general fear of the virus, hoteliers cannot generate enough revenue to pay the debt during the next slow period. Their forbearance agreements will expire at the end of the summer (September 1st) and there is no money to restart paying mortgage debt.

September 1st is when the REAL PAIN begins. Mortgagors can't pay the debt. Lenders must reserve against the surge in loans, newly classified as Bad Debt. Banks scramble for cash in order to meet required reserves which means that new dollars cannot be lent to the marketplace. The lack of available debt slows the transaction market and a cash crunch cripples the real estate sector. All Cash transactions drive down the value of all commercial real estate. Now EVERYONE feels the PAIN.

Every real estate investment cycle begins with a period of illiquidity. Lenders aren't lending, so stagnation sets in. There will be headline-grabbing, deeply discounted, "All Cash" transactions. Cash is ALWAYS King at the beginning of every cycle. Billions of dollars are being accumulated by private investors in order to capture hotel deals at historically low basis. The investment returns on these early cycle acquisitions will be huge when looking back, in 2030.

Congress and the Federal Reserve can assist with the oncoming PAIN by providing relief to banks and their reserve requirements. Not having to use fresh funds for reserves allows money to flow back into the markets and pricing will rebound faster.

Several meetings and lengthy discussions with the top hotel asset managers and industry consultants from around the country have afforded us the opportunity to conclude that travel, both corporate and leisure will not rebound until there is a vaccine. That is projected to be the Spring of 2021. One year is long enough to start a trend and one particularly important trend will negatively impact corporate travel significantly for years to come. Remote workplaces, Zoom and Microsoft Team calls have shown companies that they do not have to have employees sitting at desks in an office. On a percentage basis, the value of face-to-face interaction and networking will be diminished. That will impact the most profitable segment of the hospitality industry, the corporate transient and corporate group segment. "Virtual" saves money.

The hotel industry is like one of those Hurricane Hunter aircraft that fly into hurricanes to gauge temperatures and wind speed. We flew into the first wall of the hurricane from March through June. Forbearance Agreements have smoothed out the ride while in the "eye". Starting in September, we will fly into the back, most turbulent side of this oncoming hurricane. Hold On. Blue Skies always follow hurricanes.

Millennial hotel professionals will someday become their parents and bore their kids with stories that begin with "I remember the time the Back Bay had a \$5.21 RevPAR."

James O'Connell is principal, ISHC at HREC Investment Advisors in Boston. Over the past 25 years, O'Connell has earned a reputation for succeeding on the toughest assignments by assembling all of the moving pieces within a transaction that has stretched to both coasts.

He gained his national contact base while advising workout professionals and managing the ORE hotel portfolio of the Bank of New England/RECOLL Management Corp. O'Connell has represented public companies, private equity funds and high net worth individuals across the country and is

known for having completed more hotel transactions in the region than any other broker.

O'Connell is a graduate of Massachusetts Maritime Academy.

New England Real Estate Journal - 17 Accord Park Drive #207, Norwell MA 02061 - (781) 878-4540