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Lessons from a black swan: What COVID-19 has taught us - by Ken MacKenzie

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A black swan is an unpredictable event that is beyond what is normally expected of a situation and has potentially severe consequences. Black swan events are characterized by their extreme rarity, severe impact, and the widespread insistence they were obvious in hindsight. While whether the outbreak of the COVID-19 pandemic was in any way obvious is debatable, its impact on the hospitality industry in New England is not. In the wake of a year and a half of COVID's assault, it seems nearly all of our industry friends are asking whether business will ever return to "normal" and "what have we learned from all of this?"

Hotel and restaurant businesses will indeed return, but not in the way we remember them in the days before March, 2020. All stakeholders in the industry are adjusting to the new mandates regarding sanitation, safety and health. During the pandemic, there have surely been extremes both of over-reaction and unwarranted risk-taking. The industry now seeks to define some rational middle ground for best practices in the new reality we now inhabit, driven by the knowledge that "it could happen again." Hotels now under construction or those retrofitted with state-of-the-art HVAC and air scrubbing will enjoy a competitive advantage. Hotel brands are at work establishing standards around sanitation, safety, health and wellness that will be imposed upon owners. Employees who worked through the pandemic and who are just now returning to work will expect that their employers have their well-being front and center, with the local union acting as watchdog.

Force majeure, frustration of purpose and impossibility of performance, arcane legal doctrines rarely encountered or much thought about before 2020, sent lawyers and their clients off in a frantic scramble to read those clauses in loan documents, management agreements, franchise agreements and leases that no one ever thought would be relevant...until they were, and in a very big way. Many of these clauses did not anticipate a global pandemic and virtually none of them excused any payment obligations. When the industry then turned to its business interruption insurance to satisfy those payment obligations, it learned to its dismay that such insurance was utterly useless insofar as it either contained an express exclusion for communicable disease or would not pay unless the loss was accompanied by physical damage to the insured real estate. While business interruption insurance which would cover communicable disease might be available, it is prohibitively expensive.

Pre-2020, the typical hotel management agreement provided for a base management fee payable as a percentage of gross revenue of the hotel, with no alternative base minimum fee to compensate the manager in the event of a dramatic reduction in gross revenue. Management companies found, to their chagrin, that they were effectively working for free. It will be interesting to see where negotiations regarding alternative base minimum fees land now that the issue is on everyone's radar screen. As noted above, business interruption insurance will not be available to cover payment of alternative base minimum fees in the event of another pandemic.

A well-worn tenet of the hotel business holds that every hotel executive should be able to do any job in the hotel. More than at any other time, COVID put that tenet into play throughout our region as vice presidents replaced furloughed housekeeping employees in changing linens and making beds. One of the greater ironies to emerge from COVID is that, as we do emerge from COVID, hotels and

restaurants are having difficulty hiring employees although we remain in a state of high unemployment. Whether this is because of the continued relaxation of rules for unemployment compensation or because people are still leery of returning to work is open to question. It will be interesting to see what happens when vaccination rates are robust and unemployment benefits are no longer a better economic result for the worker than a paid wage. Until then, hotels and restaurants are short-staffed in the face of resurgent leisure demand.

While we might debate the wisdom of governmental policy on unemployment benefits as it impacts employers' ability to fill jobs that now need filling, the governmental decisions made to relax mark to market regulations on banks, to allow for relief to be granted on hotel debt without requiring banks to classify that debt, and to extend PPP loans to hotel operators was arguably good policy. One of the most remarkable aspects of COVID's black swan event is the paucity of distress transactions driven by banks, particularly when compared to what occurred in the late 1980s and early 1990s. Lessons from that era were learned.

We may also legitimately expect that governments, generally, will be nimble in response to nascent outbreaks of any potential pandemic virus. No one alive now remembers the flu pandemic of 1918, but no one alive now will forget the pandemic of 2020. In any case, what followed the Spanish Flu was the Roaring 20's. As someone who has hunkered down at home for nearly a year and a half, I can only hope that history may repeat itself. Early signs of the recovery abound. "Drive-to" destinations are awash in deferred weddings and pent-up demand for "safe" leisure travel. Business travel and large group business will inevitably follow.

As we emerge from the tunnel, blinking in the light, is everything alright? Alas, no. For during the pandemic, rather than foregoing payment of interest on hotel debt, lenders and brands permitted owners to tap FF&E reserves to pay operating expenses and debt service and to stave off foreclosure. The bill for a refresh will be coming due before long and there will be no reserves to pay that bill. That will be the next challenge to face the industry. Since prospective investors are flush with capital raised to seek the anticipated distress transactions that have not materialized as they did in the black swan of the late 1980s and early 1990s, perhaps that capital will soon be deployed in purchase transactions driven by owners' lack of reserves and the need to fund large property improvement programs.

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Formerly MacKenzie was the co-leader of the hospitality and recreation group at Goulston & Storrs. MacKenzie represents institutional investors, private equity funds, investment managers, pension funds, university endowments, REITs, major lending institutions and developers in the acquisition, financing and disposition of all classes of real estate assets both nationally and internationally.

MacKenzie specializes in transactions involving hospitality assets and has significant experience in large-scale joint-ventured deals, often involving non-profit institutions such as universities or hospitals. He frequently assists clients in structuring their responses to RFPs for complex mixed-use

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