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All I wanted for Christmas was a brand new hotel real estate cycle! - by James O'Connell

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James O'Connell

All I wanted for Christmas was a brand new hotel real estate cycle! One of those new cycles like the ones where you start from a standing stop and take off with the wind at your back! I was tired of the old cycle. It had been going since 2008. That one ran all the way to 2016 before it started to run out of steam. With positive RevPAR performance declining at an ever-increasing rate, until we hit bottom in 2019! People say, "What about 2020 and COVID?" Think of taking an elevator to the basement. The basement was 2019. 2020 was just the trap door that led to the pit, under the elevator.

The end of a cycle is typically marked by bank foreclosures and bankruptcy and those heartless CMBS Servicers taking properties back and putting them on the market for pennies on the dollar. Not this time! In 2020, everyone just went home! Banks kicked the can down the road. Servicers knew that no judge in the country would grant their takeover petitions during that emergency. New supply projects dried up. 2021 came around and, Americans, sick of being stuck in the house, tore off their masks and started traveling again!

In 2021, mom, pop and the kids, those leisure transients, flush with checks from the government, bailed out the hotel industry. Banks didn't have to "mark to market," so hotel businesses were allowed to come back online and without the typical over building that ends every cycle, they had "rate integrity" and didn't have to claw back those room rates that had taken years to gain. They just charged (or over charged) whatever they wanted!

In 2021, if a coastal property wasn't beating 2019 numbers, there was something really wrong with management. I laughed when a Maine innkeeper told me he was charging \$600 per night and no one was complaining. He thought he should charge more. I hope someday a BU Hotel School student writes a book entitled "2020 The Lost Year" because every hotelier was more than happy to burn their 2020 calendar!

Every other cycle ends with crushing over supply which causes competing hoteliers to cut room rates to maintain occupancy, chasing the "heads in beds" theory right to the bottom. This time, we had a "rate driven recovery". It was the first time in history that most markets were able to brush off the catastrophic 2020 and pick up where they left off with their profits in place. 2021 was a new baseline for a new cycle. We went into 2022 with threats of inflation, a messed up supply chain that pushed construction costs so high, it became infeasible to build a hotel. In 2022, as we started a new cycle, over supply of hotel rooms became a nonfactor.

Simply put, for new construction of a hotel to be profitable, \$1 of room rate in a market should equal \$1,000 of project cost. If your market room rate is \$160, it should cost \$160,000 per room to build, in order to be a profitable development. BUT in New England in 2022, in order to build an upscale select service hotel, it cost approximately \$215,000 per room. AND, there are very few markets that can charge \$215 per night for a room. Therefore, no new construction! Therefore existing hotels have an opportunity to get back up and running in a new cycle without the worry of oversupply sucking all the froth off the market.

Thankfully, we were able to confirm that the leisure transient market in 21' wasn't a fluke. 2022 was another good year for innkeepers and coastal hotel owners. In 23', we await the return of the corporate groups and those high rate paying corporate transient clients!

Unfortunately, every new cycle begins with some distress. There are some rough waters shaping up for the first half of 2022, still the beginning of our new cycle. Sharp increases in interest rates have put pressure on those that have loans coming due in 23'. In June of 22', a \$30 million loan could be underwritten with a 4.5% interest rate. In December, in most cases, the same hotel, with the same cash flow but at 7.5% interest rate, experiences about a 15% drop in value for that same net operating income. Someone with a loan due will have to put up more equity or sell. When they go to the market, they are finding that the same \$30 million is now worth about \$25 million. With that bump in interest rates, buyers are underwriting approximately a 15% drop in value for the same cash flow.

We anticipate the first quarter of 2023 will be one for the bargain hunters. Distressed asset buyers trying to pick up deals. We'll see a few headlines over some steals of deals. As in any new cycle, this phase never lasts very long and adjustments back to fair market pricing will occur. We'll be back to normal when the snow begins to melt.

Now that cold weather is upon us, every winter jacket pocket I reach into has an old facemask! We got through COVID and we're in a new cycle! December 20th is the shortest day of the year. Every day after that gets more sunlight! Every day after that is another day on a new cycle!

Happy New Year to all my friends and colleagues!

James O'Connell is a principal of HREC Investment Advisors, a national hospitality and real estate company specializing in hotel brokerage and capital markets transactions. He is charged with managing the New England region and works with over 50 HREC hotel brokers in 15 offices around the country.

In June of 2000, Jim founded O'Connell Hospitality Group, LLC a regional hotel brokerage company which exclusively represented hotel REIT's, institutional investors, private equity firms and high net worth individuals. He and his team are responsible for over \$1 billion in hotel transactions.

OHG merged with HREC Investment Advisors in September, 2016. Jim remained a Principal within the newly expanded firm. He has spent his entire career selling hotels and credits his initial experience of managing hotel dispositions for the former Bank of New England and RECOLL Management Corp.

He is a 1982 graduate of Massachusetts Maritime Academy and holds a Master's License for Unlimited Tonnage Vessels. He is a devoted husband celebrating 30 years of marriage and is the proud father of two very successful, fine young men.