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Material supply effecting every industry - by Earle Wason

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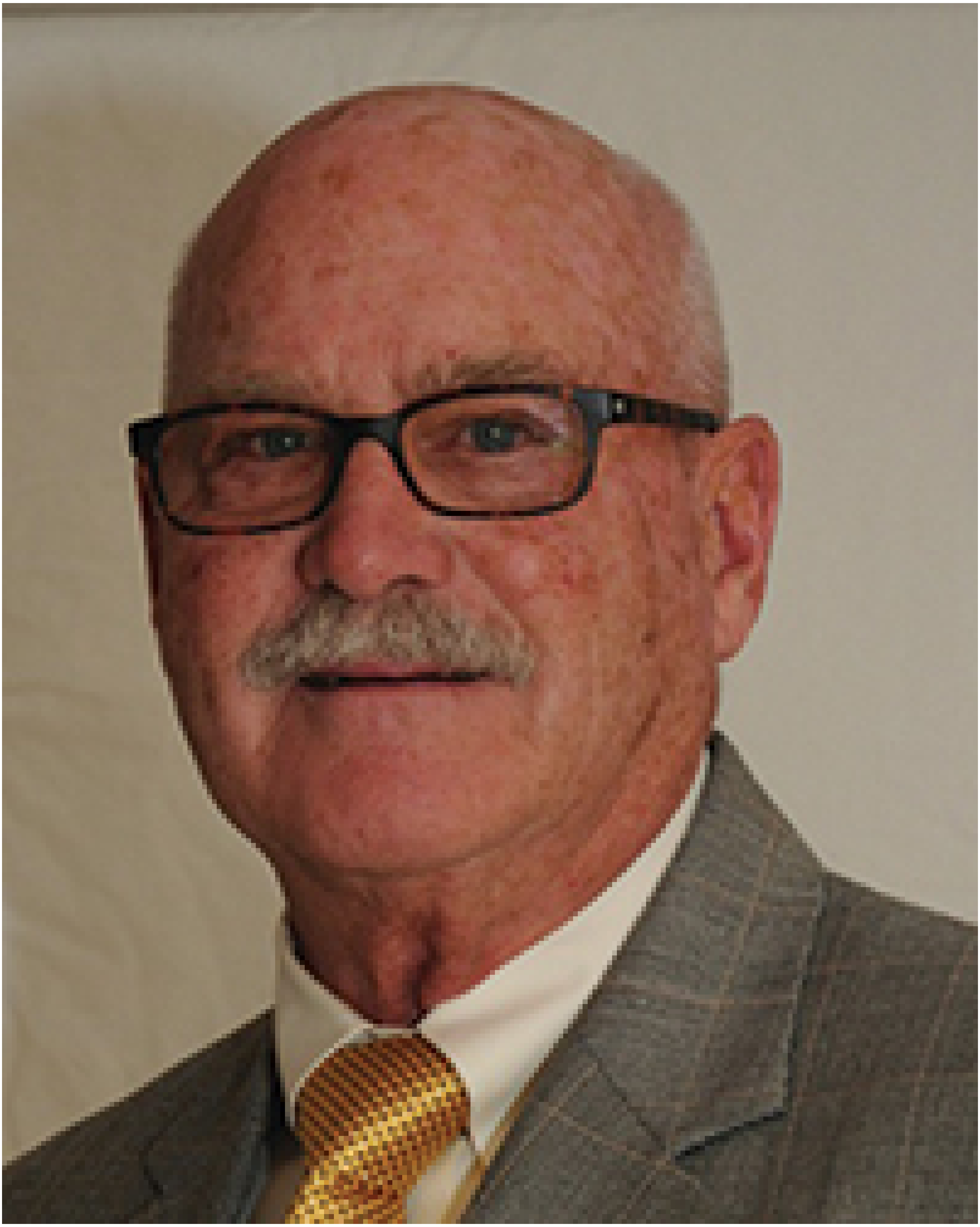

Earle Wason

Yogi Berra was credited with the following line, “its deja vue all over again.” There are some exceptions to my article last year but not many. I know those who read this article are aware of the strange times we live. In my 50 years in the real estate business, I have never seen anything like it. The Jimmy Carter years were tough on our industry, long lines at the gas pumps; even or odd license plate determination of the days you could go to the pumps; a prime rate of 18.5%; high inflation; high unemployment. The inflation of today, high gasoline prices, war in Ukraine, steady increase in the interest rates will have to have an effect. But when and how? We have enjoyed three very good years in the hotel brokerage business and destination resorts have benefitted greatly. I am very proud to say that next week I will be closing a resort hotel for $100 million. That is right, the real number but the asset and cash flow justify it. Corporate hotels are beginning to show signs of life. I suggested over a year ago that the pent-up demand would create a strong hotel recovery after the pandemic. Yes, I was right about the pent-up demand and travelers have inundated destination resorts throughout New England.

Thankfully, my company’s business model placed a great deal of emphasis on destination locations, a wider range of property values while still being effective in the brokerage of mid-market hotels. As a result, we have sold numerous resort inns, boutique hotels and larger motels. The demand for destination locations and the amounts of money available is unprecedented. We have hotels under agreement and to close in the next couple of months. Most of these were confidentially marketed and not promoted on our web site. So now our problem is finding inventory. Which is interesting as there is not much for sale in New England no matter the market as there have been numerous transactions over the past 12 months.

There are areas for all to consider and monitor.

Cost of new construction: For the past three years the cost for new construction has risen dramatically. New hotels will be still built especially with the push for new brands. There are so many brands now that it is impossible to know them all. I do think that building in tertiary markets will ease considerably from 2019 levels. I have heard construction cost estimates for mid-market, hotels and all-suites hotels from $250,000 to $300,000 a key. As a result, it will be very difficult to build new in tertiary markets where occupancy and average daily rates will not reach a level needed to justify the costs. The result is that companies are now looking to find well-built three to six-story hotels that can be purchased in the $35,000 to $70,000 a key range. The ideas are to put another $20,000 or more per room into the property and have a good quality property for much less than new construction. These opportunities will also allow the operator to monitor their room rates to below the new hotels room rates and thus compete very effectively. One other issue that is driving costs is materials supply and this is effecting every industry and until solved all can expect costs and inflation to continue.

Lack of staff: The lack of workers for the hospitality industry is reaching a breaking point. Hotels are, in cases, unable to sell rooms because they do not have the housekeepers to clean all the rooms. Restaurants are closing one or two days a week which in the summer, when business is the strongest, will reduce revenue significantly and make it harder to have the cash flow to make it through the winter. I have seen Dunkin Donuts locations that close at 2 pm as there is no staff to remain open. Everyone in the hospitality business is aware of this major problem and it is happening in other industries as well. It is great to know there is a problem, now how can it be solved? All of us should be continually providing information about this to our senators, congressmen, and women. It seems that Washington either does not get the problem and/or wants to do nothing about it. The first obvious change would be to increase the J-1 and H2B visas allowed. Increase our vocational schools and recognize not everyone should go to college and encourage those that would be good chefs, cooks, and other hospitality positions to be educated properly.

Room rates: They must go up. Wages have increased significantly; interest rates are on the rise; continued pressure to make regular capital improvements. My concern is that although rates may need to be increased, we could start to see some pricing wars and that is the last thing the hospitality industry needs.

Capitalization rates: During the last few years and even immediately after the pandemic, the overall capitalization rates have been the lowest the industry has ever seen. This has continued recently as the competition for high-quality resort hotels has been high and all in cap rates can vary for those properties. At this time it is unusual to see cap rates under 6 to 6.5 with an 8% cap rate very common and the REITs are now looking at non-recourse financing over 9% interest rates. Other types of properties have traded in the 8% to 13% cap rate range depending on age, number of floors, location, uninstalled elevators, and it goes on. The capitalization rates we have seen will go up. They must, as the cost of capital increased so do the rates. The Fed has been on a mission to rapidly raise rates, as usual we may again hit a brick wall. As I said earlier, “deja vue all over again.”

One of my main concerns; I hear from others in the industry that “2023 will still be good but watch out for 2024.” I hope we do not allow the “self-fulfilling prophecy” to become our guide.

Earle Wason, CCIM, is president and owner of Wason Associates Hospitality Real Estate Brokerage Group, Portsmouth, N.H.