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From Heck NO to OK, Maybe! - by Jim O'Connell

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Jim O'Connell

Good bye 2023, we hardly knew ye! But we're thrilled that you're gone! Welcome 2024! Come, let us do some business! Skyrocketing interest rate increases caused a panic in the financial markets during the beginning of the year. With banks leading the way, everyone involved with real estate transactions headed for the exits!

The hotel transaction market was down over 62% in 2023. Although actual hotel performance was considered very good and in most cases it was back to 2019 levels, lenders headed for the hills and took with them any reasonable expectations for loan terms that could produce values acceptable to seller's expectations.

Interest rates went from 5% to 10% in a matter of a few months. Investors held fast to their Internal Rate of Return hurdles and the rise in interest rates caused a gap between seller's expectations and buyer's requirements. The perception of value of the hotel net operating income grew to an approximate 20%. Meaning that in 2022, the owner of a well-positioned, well branded hotel, in good physical condition, that produced a \$2.5 million net operating income enjoyed a value of approximately \$30 million. In 2023, with the rise in interest rates, that same cash flow was valued at \$25 million. Effectively a 20% negative spread in value from 2022 to 2023. Sellers perceived the drop in value as a "discount." Buyers perceived the spread as a "premium." Brokers were unable to bridge the gap and we put on our Maytag repairman uniforms and waited by the phone for someone not to call! It felt like there was more transaction activity during COVID than in 2023.

By the fourth quarter of 2023, the fear and anguish over rising interest rates began to dissipate and as we move into 2024, the gap in value perception seems to be closing. Consequently, the transactions market is revving up again.

The country's largest hotel investment conference, Americas Lodging and Investment Summit was held in Los Angeles this past January. The audience is comprised of hotel owners, investors, brands, management companies and lenders. With year end 23's operating performance at our back and 2024 budgets completed, LA became the melting pot for deals around the country. The atmosphere was upbeat and encouraging. Lenders stopped polishing their resumes and got back to issuing terms that investors could depend upon. Sellers understood the new reality and reluctantly accepted the downgrade in cash flow values. Even those searching for "deeply distressed" hotel deals shed that misconception and accepted the new normal.

The post-COVID "work from home" phenomena that has swept the globe, coupled with the excellent performance of the hotel industry in general, has hotels surpassing "office" as the preferred asset class! They have shaken off the stepchild stigma and now lenders are calling hotel investors again. About the only good thing that has transpired with the rise in interest rates is the descent of the loan defeasance payments. During the low interest rate years, this trap caused many hotel owners with CMBS debt to hold off selling their properties. Now that they have the ability to forego their payment to the mortgage servicers, many of those hotels will be coming on the market. HREC has over 100 hotels across the country available for sale. Presently, there are approximately 20 major hotel

portfolios (with five or more properties) on the market, available to qualified investors.

HREC is projecting a very healthy 2024 transaction market. Interest rate cuts in the second, third and fourth quarters will only help close the gap between sellers and buyers. The high costs for new hotel construction is keeping a lid on any over-supply issues. The only real problem being experienced is the high cost of renovations for “product improvement plans” issued by the national brands. Pre-COVID, the “PIP’s” had an average cost of \$20,000 - \$25,000 per room. That number has ballooned to +/- \$40,000 per room. Brand product improvement plans will be the next major impediment to sale issue we face as an industry.

In the never-ending quest to remain positive for hotel transactions, we are very pleased to once again hear our lenders go from “Heck NO to OK, Maybe!!!!”

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.

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