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What We Learned About Hotels In 2023

By **Nathan Hale**

Law360 (December 18, 2023, 7:59 PM EST) -- Just as hotels appeared to be moving past the formidable struggles instigated by the COVID-19 pandemic, owners, investors and developers confronted significant new challenges in 2023 as rising interest rates and other economic headwinds roiled capital markets, slowing transactions and new development.

Solid figures on major operational metrics, such as average daily rate and revenue per available room, illustrate why the segment remains desirable compared to other real estate sectors. But with the cost of financing rising and traditional lenders largely pulling back, valuations have suffered and good deals have been harder to find and put together, industry players and other hospitality experts told Law360.

In an aerial view, the Hilton San Francisco Union Square stands in front of the Parc 55 hotel in San Francisco. Solid figures on major operational metrics, such as average daily rate and revenue per available room, illustrate why the hotel segment remains desirable compared to other real estate sectors. But with the cost of financing rising and traditional lenders largely pulling back, valuations have suffered and good deals have been harder to find and put together. (Photo by Justin Sullivan/Getty Images)

"It's a very interesting crossroads … where you've got assets that are now performing well, but they got their business plan back on track at what is the worst timing from a capital market standpoint," said Greg Freedman, co-founder of BH3 Management, a vertically integrated real estate investor, operator and developer with hospitality interests. "So it's this very interesting dynamic where there's both pain and opportunity at the same time."

Here, Law360 looks at what we learned about hotels in 2023 and what those lessons signal for 2024.

Leisure Slows, But Business Grows

COVID-19 slammed the hotel industry as it brought travel restrictions and widespread avoidance of public gatherings, but pent-up desire to travel and unspent cash led to gangbuster results for U.S. and Caribbean hotels in 2021 and carrying into 2022.

Luxury and resort properties on the leisure side were the biggest beneficiaries, especially in major vacation markets like Miami, as a return to normal looked less certain for corporate and especially group travel initially. However, in 2023, even those segments moved back to or even past pre-pandemic levels from 2019, Freedman and others said.

CoStar-owned hospitality researcher STR recently reported that the top three chain categories — luxury through upscale — have seen overall demand growth every month in 2023, and group demand in luxury and upscale-class hotels in October was its highest for a single month since October 2018.

"We're starting to come out of the imbalances that were caused by COVID," said Ari Tenzer, a managing partner at Miami law firm TA PLLC who specializes in hospitality transactions. "I think that's all starting to smooth out."

This year, a return of widespread travel to Europe and reopening of more international destinations caused U.S. and Caribbean hotels to see some flattening in RevPAR and ADR growth, but Alessandro Colantonio, chief investment officer for Gencom, a leading developer and investor in hotels, said that was anticipated — and he thinks U.S. destinations are still due to see a larger benefit "coming from the other direction" with foreign visits here still rebounding.

Corporate travel and especially group travel have both improved, with existing convention hotels in popular markets such as Las Vegas, Nashville and Washington, D.C., seeing "great recovery in 2023," according to Samantha Ahuja, co-chair of the hospitality practice at Greenberg Traurig LLP.

"Everybody thought group business would be dead for a long time," TA's Tenzer added. He said that mentality started to change in 2022, and he described 2023 as a transition year, given the advanced time needed for group bookings.

Colantonio echoed that sentiment, saying Gencom's large resorts from Miami to Costa Rica are also seeing a strong group pace going into 2024.

"That's encouraging because I think getting that group demand back is really what's going to help you get the balance between ADR and occupancy, which might not have been there over the last couple of years," he said.

Colantonio said there are also "strong signs" coming from a number of more business-centric urban markets, which he suggested might have even more potential upside than resorts in the next year or two.

He noted that Gencom has made recent acquisitions in Chicago, Seattle and Portland, adding that Miami's urban core has also looked strong with continued migration of financial firms to the city. New York has also exhibited promising numbers, according to several sources.

Capital Complications

With strong fundamentals from a hotelier's perspective, development or acquisitions of hotels would appear justified, but activity slowed significantly on both fronts in 2023 in the face of a complex financial environment driven by interest rate hikes, inflation, and high construction and labor costs.

"Hotel valuations [maybe are] becoming soft, particularly in certain markets and segments, softer anyway from roaring highs, but performance is still pretty good," said Matthew Norton, who leads the real estate practice group at K&L Gates and specializes in hotel and resort work.

Prior to 2023, there were many portfolio buyers in the market, including large REITs, that would buy multiple hotels at a time, but they are now mostly on the sidelines — either deterred by the cost of capital or in triage mode dealing with capital issues in their existing portfolios, including on loans that are coming due, BH3's Freedman said.

In contrast, asset-light brands or newly formed groups and funds that are seeking opportunities in the market and don't have those legacy issues from prior deals have the chance to do well because of their capacity to "play offense," Freedman added.

Following several years of high demand for hotels, however, 2023 tended to see a wider gap between would-be sellers' asking prices and what the market would bear, Norton and others said. Owners who held on during the pandemic have been rewarded, and with solid revenue flow, many may look to hold on for a couple more years until the economy hopefully stabilizes and becomes more favorable.

"I think sellers that feel like they can protect their equity, they'll find ways to keep their hotels," Norton said. "They're not going to want to just sell their hotels unless they feel like they really need to."

The increased cost of capital presents a serious challenge for those owners with loans maturing or who need additional capital for improvements or rehabilitation.

Fortunately, unlike during the global financial crisis in 2007 to 2009, there is a lot of liquidity out there.

Although banks and other traditional lenders have pulled back significantly, limiting themselves mostly to very specific opportunities and sponsors with whom they have a relationship or well-established track record, that has hastened a growing shift toward more private lenders who will offer or accept more creative terms, Liam Krahe, managing attorney at Miami-based Cohen Property Law Group PLLC, said.

Preferred equity agreements have been an increasingly popular option on the private side, Krahe added. While offering similar features to debt, typically including a term and payment schedule, the investor's position above common equity holders reduces their risk and gives them greater control over the project than a loan, while the seller gains flexibility, including perhaps a delay to the start of the repayment.

These deals could also take the form of the owner selling the project but retaining an interest by becoming the preferred equity provider, essentially subordinating their equity to the new investor.

"It allows the seller the potential to still receive that asking price but receive it in a different way over time, instead of in a lump sum on day one," Krahe said.

When capital and deals will start flowing again is anyone's guess, but K&L Gates' Norton and others said they think 2024 is likely to see more activity as a result of both more loans coming due and resulting distress forcing sales on some properties, as well as what they hope will be a more stabilized interest rate environment.

"We're going to be at a higher interest rate level, and therefore, you're going to need to find higher yields to make all the numbers work. But at least we've got certainty now. I don't think investors are going to be as concerned about continuing interest rate increases," Norton said.

Developing Experiences

On the development side, Freedman and others said they do not expect to see many new hotel-only projects come out of the ground in 2024. Instead, the vast majority of new hotel development will feature a residential component.

Multiple sources brought up this rise of "branded residential" as something to watch, noting that it offers several advantages from a business perspective and also addresses a trend of hotel guests gravitating to experiences when picking hotels, whether related to health and wellness amenities, adventure activities, food and wine offerings, or concerts and other events.

"That's an interesting trend, in my view, because of where a developer sits and where the brand sits and what the customer wants," Greenberg Traurig's Ahuja said.

From a development standpoint, having a "for sale" residential component gives the developer a great opportunity to offset construction costs in this challenging environment. It then also provides flexibility on the operations side, as these units are often available for hotel use when not occupied, potentially adding hundreds of additional premium rooms, said Gencom's Colantonio.

The spread of standalone branded residential projects also reflects the perceived strength of this consumer preference.

"They want that 'experience' even when they're not staying at a hotel," Ahuja said. "I think that's very interesting and again part of that experiential story."

While "branded residences" started at the top end of the luxury hotel market — with brands like Ritz-Carlton, St. Regis and Four Seasons and in vacation destinations like Miami — Ahuja said she is seeing the trend expand into other market levels.

An increasing number of retail brands — such as fashion houses Bulgari, Armani and Fendi, as well as automakers Porsche and Bentley — have also looked to capitalize on the concept by providing their names and design touches to components of residential projects.

"The question is how that translates in other markets and with other brands, but I think, based on what I've seen, we're seeing success in it in many areas," Ahuja said. "So I think that's going to be a growing market, and it's very responsive to the economic market as well."

--Editing by Philip Shea and Kelly Duncan.
