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Challenges in the Hotel Investment Market and the Strive for Independence

All-Cash Investors Put More Pressure on Industry

By Patrick Adamle
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Many hotel projects that were feasible in past years are no longer today due to changing market conditions.

Much of this is attributable to the fact that required returns with reasonable rents can no longer be earned and there exists the high burden of more equity for bank financing.

Due to rising construction costs and a smaller number of fixed lease offers, developments are almost impossible to calculate. In addition, the shortage of building materials and labor are resulting in a declining number of developments. Without new-construction projects, investors are "forced" to focus on existing properties first.

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As a result, the pressure on purchase pricing increases.

Under current market conditions, borrowing is becoming more costly for investors, so that the investor market is subsequently reduced and concentrated on equity-driven investors. Borrowing at higher rates is becoming a challenge in a low-profit environment, especially as rents will not be able to rise equivalently due to rising operating costs.

I think alarm bells are ringing at banks when they hear the word "hotel," and they are thus demanding high risk premiums.

Whereas in the past an investor had to bring maybe 25% equity capital, the banks now demand closer to 50%.

Now, all-cash investors are coming in and taking equity out.

These investors have high interest expectations on their invested capital, but these are hard to earn with hotels.

Market Movements

Investment activity in the hotel market, which came to an almost complete standstill during the pandemic, has become active again as restrictions faded and travel behavior picked up.

A more dynamic investor interest and rising confidence can be noticed within the hotel real estate market, both in the urban and leisure industry.

With higher yield expectations, investors must shift into the value-add asset classes.

These are hotels where a change of operator is necessary or a conversion is pending.

It is currently difficult to find a new tenant for locations outside the city center, and conversions are currently expensive and difficult to calculate.

In general, it is not easy to find a new tenant now because only a small number of operators are able to provide the necessary bank guarantee.

In this situation, it is easier for investors who do not need a lease contract but can also work with a pure management contract. Some major hotel brand companies work in this way.

High Guarantees

Institutional investors are willing to invest but have difficulties finding operators who can meet the high guarantee requirements.

The selection of the right operator is more difficult than ever before.

Which operators are still able to invest and provide the necessary guarantees when subsidies expire?

Liabilities built up in recent years must be repaid in a market environment that remains weak.

State aid has not yet put operating companies under pressure, and as a result fire sales have been rare. The suspension of the obligation to file for insolvency kept hotels “alive” until now, but there are fears of a postponed wave of insolvencies.

Strive for Independence

The operator black-box situation is causing development companies to rethink maintaining the value of the hotel developments and to guarantee their ability to be sold.

The value of fixed lease contracts is doubted, and guarantees are not given. The trend in the market is to bring parts of the value chain back in-house. It can be observed that development companies are building up and further strengthening their own operator platforms, which offers the desired flexibility.

Also, management and franchise contracts continue to gain momentum. Management contracts with a professional manager provide more security than a lease agreement which does not appear to be reliable.

Management and franchise platforms, as well as interim manager and asset managers, will be even more in demand in the future.

Despite changing market conditions, interest in hotel real estate will continue.

Attractive projects — based on location, financing and the operator — will prevail.

The focus will be on value-add properties and trophy assets. Core properties will have a harder time, except for those that can keep demand high despite reduced travel budgets and declining consumption behavior of guests.

Banks will become even more selective. However, it is not clear whether such behavior will persist overall. Ultimately and despite everything, tourism is a global growth industry and will recover in the medium term.

Patrick Adamle is managing partner at MRP Hotels, a business consultancy based in Vienna with offices in Berlin and Munich.