ALTERNATIVES

Time to Book an Extended Stay in the Hotel Sector?

Jim O'Shaughnessy
Managing Director & Hotel Group Leader, Barings Real Estate

BARINGS INSIGHTS

The hotel sector has been particularly hard hit by the global pandemic given its reliance on corporate and leisure travel, which all but came to a stop over the past year. As a result, both borrowers and owners of hotel assets have, in many cases, found themselves in need of financing solutions to bridge the gap to recovery. For investors, this period of stress may provide the opportunity to deploy capital at attractive entry points across the capital structure, often in high-quality assets with long-term, structural tailwinds.

Hotels and retail properties have borne much of the global pandemic's brunt since the spring of 2020 with COVID-19 ravaging the U.S. economy and dramatically altering consumer behaviors.

And while the challenges facing the retail sector are as much about structural change as they are about cyclical weakness, the story is notably different in the hotel sector, which remains underpinned by long-term structural growth drivers.

That doesn't mean the picture for hotels has been a rosy one. In fact, as a result of the global pandemic, U.S. hotels saw their largest-ever decline in demand in 2020—with RevPAR (revenue per available room) down some 47.5% vs. 2019[1]. And even this striking statistic doesn't tell the full story, as it wasn't until March 2020 that the virus started to truly weigh on demand in the U.S.

The impact has also been uneven. Upper-upscale hotels have been hit particularly hard—with year-over-year RevPAR down roughly 62%. The fall has been even more dramatic for properties in gateway urban cities with large exposures to international travel and/or convention business.

While there are some similarities to prior periods of crisis, the comparable impact following both September 11th (-10.4%) and the Global Financial Crisis (-16.8%) pale in comparison to what we have witnessed from COVID over the last year. Perhaps the most obvious drivers of this are the duration of the pandemic and its global nature, which have resulted in an unprecedented drop in travel of all types.

Where There is Crisis, There is Opportunity

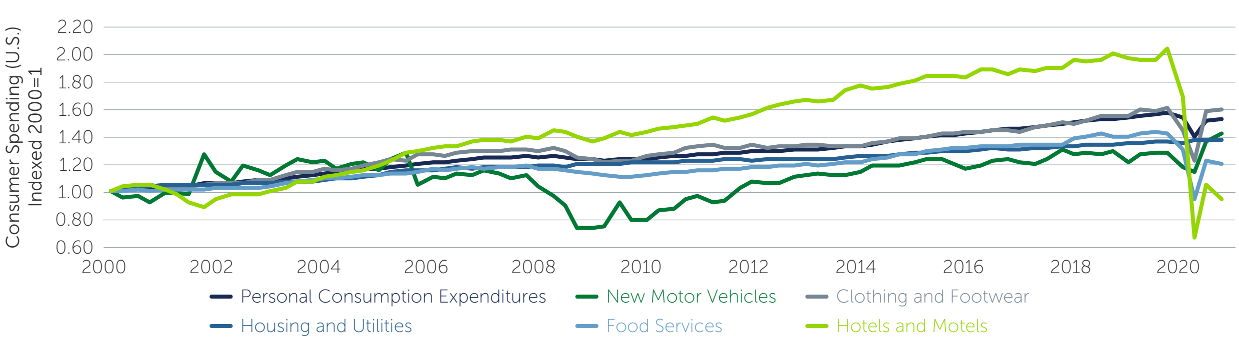
Even with all of this doom and gloom, if we use past cycles as a guide, there will be opportunities emerging in the pandemic's wake. Today, these opportunities are beginning to come into view.

The key to capitalizing on them will be to understand where the underlying structural trends that have been in place long before COVID will intersect with the coming cyclical recovery, which will inevitably be uneven across the hotel sector and tied to factors like location and property attributes.

Long-Term Tailwinds

If we zoom out from the current crisis, we can see the long-term trend toward more experiential leisure—taking the trip vs. buying the jewelry, for instance. This a powerful force that cuts across today's largest population cohorts—most notably, Gen-Z, Millennials and Baby Boomers. While COVID has interrupted the trend for the time being, there is reason to believe that lodging will continue to gain wallet share as a percentage of consumer spending. Indeed, as the Millennial and Gen-Z cohorts enter their prime earning years, much of their leisure spend is likely to go toward travel. Similarly, the last wave of Baby Boomers will enter their retirement years over the next decade, likely also spurring growth in travel spend.

FIGURE 1: A Short-Term Interruption to a Long-Term Trend?



SOURCES: Barings Real Estate Research; STR; BEA. As of December 31, 2020.

1. Source: Smith Travel Research. As of December 2020.

A Multi-Speed Recovery

In order for this structural trend to resume, an inflection point will need to be reached cyclically. And in order for that to happen, people need to feel that it is reasonably safe to travel. The question, then, is: When will this happen?

The answer is complicated, but it seems reasonably clear that two things are true: 1) there is broad, pent-up demand across all traveler groups—from consumer to corporate; and 2) different segments of the market are likely recover on notably different timelines.

For instance, as a greater and greater percentage of the population is vaccinated over the coming three to six months, **drive-to leisure destinations** are likely to be among the first to rebound. Even destinations requiring only short-haul flights should begin to rebound sooner than later with consumers viewing them as safer than long-haul journeys.

In fact, we are already seeing this. A Southwest Florida beachfront resort in Barings Real Estate's portfolio, for instance, has maintained occupancy >60% in recent months and the asset itself has generated significant positive cash flow over the last year—even in the face of the pandemic.

These trends favor resort destinations like Napa Valley, the desert Southwest and South Florida and select urban areas with strong leisure demand such as Tampa and Los Angeles. Interestingly, the "work-from-anywhere" trend has also driven demand to these and similar locations as workers with location flexibility have been attracted by resort-style amenities and warmer climates.

On the flip side, **corporate travel** will be slower to come back. The widely recognized success of the great work-from-home experiment will inevitably leave businesses hesitant to immediately return to pre-COVID levels of travel spend. That said, the pent-up demand for travel in corporate America is palpable. After little to no in-person meetings for a year or more, sales people and executives across all major industries are clamoring for face time. Indeed, the hypothesis that business travel is dead likely looks far too pessimistic. At Barings, while we estimate that 2021 corporate (transient) travel spend will likely only reach 30% of 2019 levels, we expect that to accelerate in the back half of the year, getting back to 70% and 90% of 2019 levels in 2022 and 2023, respectively.

Some areas of the market will inevitably remain challenged for several years. For instance, we expect the **convention business** to only get back to 50% and 80% of 2019 levels in 2022 and 2023, respectively. But even here, for large organizations like the *American Medical Association*, for instance, the pent-up demand to get back to in-person, annual meetings will be strong.

International travel may face the most uncertain outlook of all given restrictions and rules that vary from country to country and the likely uneven rollout of the vaccine across the globe. This will continue to weigh on hotels that cater to international travelers—which tend to be disproportionately urban and higher-end hotels.

"Many of the properties facing short-term distress are the same ones that look set to benefit from the long-term structural growth in experiential leisure from Baby Boomers, Millennials and Gen Z."

Investing in the Different Phases of Recovery

Given the multi-speed trajectory that different segments of the hotel market appear to be on, it's reasonable to anticipate that the opportunity for investors in hotels will come in phases as well.

Initially, opportunities are likely to emerge from properties that face some sort of distress. The collapse in market demand and associated temporary hotel closures have resulted in negative cash flows and operating losses for the owners of certain properties. Additionally, borrowers who had been given lifelines in the form of short-term forbearance measures will in many cases see those expire soon.

These factors have resulted in a **liquidity crunch**—or a need for near-term capital—that looks likely to present opportunities for investors willing to assume some of the recovery risk. Each transaction will be structured uniquely to its own situation, but opportunities are beginning to emerge across various parts of the capital structure—and at various points on the risk/potential return spectrum, including:

- **Structured Debt:** Typically structured as high loan-to-value mezzanine debt, this type of instrument is being used to help owners and borrowers bridge short-term (12 to 36-month) liquidity needs.
- **Preferred Equity:** Similar to structured debt, these investments enable asset owners to fund short-term operating and capex needs while retaining most of the upside coming from medium-term asset price appreciation. For investors, the opportunity is to potentially earn an attractive yield on an impaired but otherwise high-quality asset—and to potentially gain exposure to asset price appreciation.
- **Asset Purchases or Assuming Debt from Distressed Holders:** For various reasons, asset owners or the holders of debt may look to sell in the current environment. This can present opportunities for investors/managers with some appetite for risk and deep, in-house hotel asset management capabilities to take over ownership (or responsibility for the debt) and actively manage the asset to recovery.

Many of the properties facing short-term distress are the same ones that look set to benefit from the long-term structural growth in experiential leisure from Baby Boomers, Millennials and Gen Z. By providing capital in the current environment, not only can investors potentially earn an attractive return, but they can help these properties to keep the proverbial (or in some cases, literal) lights on, in the form of amenities that remain open, and a staff that remains employed. Some of these properties, especially on the debt side, include so-called "trophy" assets, for which opportunities to invest have traditionally been few and far between.

In addition to the near-term need for capital, a likely **second investible phase of the recovery** will come from markets that showed strong demographic tailwinds pre-COVID but which were particularly hard-hit by the pandemic. Markets such as Nashville, Orange County and Atlanta may offer particularly compelling opportunities due to severe COVID-related RevPAR declines.

Time to Check in?

Many institutional investors are under-allocated to hotels. This is likely due to a) the heightened cyclicality of the sector, and b) the relatively small percentage that hotels represent in the most followed private real estate indexes, most notably the NCREIF benchmark, which today has an exposure to hotels of only 0.3%.[2]

If history is a guide, the time to invest in hotels is when things look bleak. This appears to be one of those times. Understandably, investors may be cautious allocating capital to this space given the cyclical challenges that COVID has introduced. As in every real estate sector, prudent risk management is absolutely critical to long-term success. To capture potential opportunity while also managing risk, investors may want to consider:

- Diversifying hotel exposure across geographies and points in the capital structure to avoid being overly concentrated in any one or two segments of the market
- Investing with managers with cycle-tested asset management capabilities. This factor is as important in hotels as any real estate sector given the many value creation levers to potentially exercise, from restructuring contracts to choosing new brands or property managers.
- Entering investments armed with adequate liquidity and a broad enough time horizon to adapt to potential changes in the industry recovery pattern.

The COVID crisis has left much destruction in its wake—and hit the hotel sector particularly hard. For investors willing to provide hotels with a bridge to recovery, the current period of weakness may ultimately prove to be an attractive entry point.

"Given the multi-speed trajectory that different segments of the hotel market appear to be on, it's reasonable to anticipate that the opportunity for investors in hotels will come in phases as well."

2. Source: National Council of Real Estate Investment Fiduciaries. As of Q4 2020.

Barings is a $345 billion global investment manager sourcing differentiated opportunities and building long-term portfolios across public and private fixed income, real estate and specialist equity markets. With investment professionals based in North America, Europe and Asia Pacific, the firm, a subsidiary of MassMutual, aims to serve its clients, communities and employees, and is committed to sustainable practices and responsible investment.*

LEARN MORE AT BARINGS.COM

**As of December 31, 2020*

21-1522553