Hotel upgrades

The lodging sector is one of the few bright spots in the US CMBS landscape. **Kenny Wastell** uncovers the reasons why.

The US lodging sector has enjoyed an uplift in fortunes over the past 18 months, with pent-up demand from holiday-makers driving a post-Covid recovery. Despite a slight uptick in delinquencies in recent months, sector-specific metrics suggest hotels provide snug shelter for investors, while other areas of CMBS are hit hard by macroeconomic headwinds.

Hotel delinquency rates in Fitch's US CMBS universe reached 3.57% in September, according to data released by the agency in October. While this is an increase on the 3.53% rate in August and well above the pre-pandemic rate of 1.4% in March 2020, it remains significantly lower than the 4.9% in October 2022 and pandemic peak of 18.4%.

Similarly, Darrell Wheeler, head of CMBS research at Moody's, says that the agency saw hotel-related delinquency rates in US-focused multi-loan pools reach as high as 20% at one point in 2020, falling to 7.6% in August 2022 and 5.2% in August 2023. A key driver behind this improvement is strong global growth in revenue ▶

Darrell Wheeler, Moody's

per available room (RevPAR) within the hotel sector, explains Ramzi Kattan, a senior real estate analyst in Moody's corporate finance team. This figure is calculated by multiplying occupancy rates by average daily rates (ADR).

"When you look at these three metrics [RevPAR, ADR and occupancy], they are up year-to-date by 15% to 20% [globally] on 2022 and mostly up on 2019, which is the pre-Covid year," says Kattan. "We expect that growth to be sustained, although perhaps not quite at the rate we've seen over the past 18 months."

This global increase in RevPAR has been reflected in the US market and consequently fuelled an improvement in the performance of multi-loan pools. "The performance on the underlying loans has been much stronger than people might have expected out of Covid," explains Wheeler.

In a recent CBRE webinar, Lawrence Britvan, president and vice chair of the firm's institutional hotels debt and structured finance team, also hailed the post-Covid performance of the hotel sector as being unprecedented. Lodging typically underperforms in downturns with a strong correlation to retail, but that has not been the case in the aftermath of the pandemic, he said.

"It's been a strange coincidence of hotels overperforming, while other asset classes have hit struggles that they've never hit before because of the pandemic," said Britvan. The result is that hotel owners have enjoyed greater accessibility to debt. Lenders, he added, are more comfortable lending into an asset class that has strong fundamentals compared with its commercial real estate peers.

Projections also anticipate ongoing RevPAR growth over the coming 10 years, partly because new hotel room supply has been lower than historical norms. Britvan primarily attributes this lack of new development to increased costs of capital.

"The debt financing is there on the construction side, just like it is in every other part of the hotel space," he noted. "It's the equity dollars that are harder to come by to get the returns you need, with the increased costs associated with the debt." This is further compounded, he explained, by increased costs of building supplies.

Normalised growth

Naturally, the scale of improved performance can only be viewed within the context of the cliff edge brought about by global lockdowns, as EJ Park, vp and senior credit officer in Moody's commercial real estate finance team, stresses. Nonetheless, she says that ratings have held relatively stable due to strong fundamentals. Referencing STR data, Park says the lodging sector went through a decade of expansion and peaked in 2019 prior to the Covid pandemic, followed by a 48% decline in RevPAR in 2020.

"In 2021, RevPAR recovered by almost 60% from 2020 and then in 2022, it recovered by another 30% from 2021," says Park. "That artificial cap early in the pandemic is why you see these big numbers and percentage changes. Putting all that aside, if you compare 2022 to 2019, it effectively grew about 8%."

She continues: "Year-to-date through September, 2023 is up about 13% compared to the same period in 2019. So now you're seeing normalised growth of single-digit numbers compared to 2022."

> "THE DEBT FINANCING IS THERE ON THE CONSTRUCTION SIDE, JUST LIKE IT IS IN EVERY OTHER PART OF THE HOTEL SPACE"

Some types of travel – notably business travel – have taken longer to recover than others, meaning there is still runway for improved performance in multi-loan pools with exposure to the lodging space. "Of course, at a certain stage in the recovery, that growth in RevPAR begins to peter out naturally," says Wheeler. "But there are several markets we continue to follow – primarily gateway cities – that haven't fully recovered, and they are still continuing to benefit."

CBRE's Britvan agrees. "The overall general trend after the initial shock of Covid has been hotels overperforming in terms of resorts and

EJ Park, Moody's

score of 40 for 2Q23 – an improvement of 17 points compared with the same period in 2022 – San Francisco was given a red score of zero. New Orleans and Austin also received scores of zero, behind Miami and San Jose, at four and five respectively.

Nevertheless, Park stresses that Moody's is careful to take a longer-term approach to markets that had been performing well prior to 2020. "Overall in the US, for the year-to-date through September, RevPAR compared to the same period in 2019 is up around 13%, whereas San Francisco is down 27%," she says. "Las Vegas, by comparison, is up 29%, so you have a very wide-ranging pattern of recovery."

Florida, where there's real risk from hurricanes and so forth."

Indeed, another recent report by Moody's Analytics found that hotels in Fort Lauderdale, just north of Miami, had the highest average insurance costs of US$1,436 per unit in 2022, a compound annual growth rate of 8.1% since 2017. Yet the rise in insurance costs is not exclusive to the US's most hurricane-hit state.

"We've seen [insurance] go up 30% to 70% in markets like Denver that historically do not have big losses," Britvan noted. This, he believes, is due to insurance companies attempting to counter-balance anticipated losses elsewhere.

Despite these challenges, the overriding story

drive-to leisure initially. Now we've seen a massive recovery in business and group travel as well, that's led to great recovery in the urban markets too."

This pattern of recovery is another that Moody's Park says has been unconventional compared with other recoveries. In previous economic shocks, she says, large urban gateway cities such as San Francisco and New York were typically the first to recover. Due to the nature of the pandemic, it was smaller markets that first showed signs of recovery, as holidaymakers were reluctant to fly and opted for more local and drivable destinations.

Hotel California

While the recovery in New York started in late 2021 through to 2022, Park says, San Francisco is an example of a gateway city that is still lagging. A recent US-focused CMBS report by Moody's outlines the scale of San Francisco's challenges.

The RYG quarterly assessment scores the short-term supply and demand characteristics of various property types and markets, assigning a red, yellow or green score of 0-100. While the New York hotel sector was given a yellow

> "DO I THINK HOTELS IN SAN FRANCISCO ARE JUST GOING TO GO AWAY AND WE'LL NEVER SEE THEM AGAIN? NO"

She adds: "Do I think hotels in San Francisco are just going to go away and we'll never see them again? No. Markets tend to go through cycles of expansion and contractions. This just happens to be the part of the cycle that San Francisco is in right now."

CBRE's Britvan suggests that the biggest risk to the hotel space is a decrease in cashflow that would accompany any potential recession. With ADR driving RevPAR growth, there is a possibility that the industry will not be able to sustain the price rises seen recently, as above-target inflation persists.

"The other big risk that's out there," Britvan observes, "is the cost of insurance. We've seen that cost double – even triple – in markets like

in US hotel CMBS currently appears to be a positive one, with performance likely to continue improving. "For most of the other big urban gateway cities, they all seem to be recovering very nicely, which is good," says Moody's Park. "Barring another unexpected shock, lodging should continue to perform well in the foreseeable future. That's the one bright spot in commercial real estate right now."

SCI's Premium Content offers regular in-depth analysis of trends and developments across the securitisation market, in addition to our usual news output. To upgrade your subscription to access all Premium Content for a year or for further information, email ***ta@structuredcreditinvestor.com****.*