ISSUES AND PERSPECTIVES OF HOTEL ASSET MANAGEMENT POST PANDEMIC

HOTEL & LODGING FINANCIAL ADVISORY SERVICES UPDATE | JULY 2023

CAPSTONE PARTNERS

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Hotel & Lodging

Issues and Perspectives of Hotel Asset Management Post Pandemic

KEY SECTOR TAKEAWAYS

Capstone Partners' Financial Advisory Services (FAS) Group is pleased to share its perspective on hotel asset management in the aftermath of the COVID-19 pandemic. Through our extensive experience advising clients in the Hotel & Lodging sector and our ongoing analysis of macroeconomic trends, we have identified several key takeaways below, followed by an in-depth overview of sector dynamics.

1. The pandemic and its enormous global impact has clearly demonstrated the latent volatility of hospitality real estate.
2. The Hotel & Lodging sector is perhaps the most labor-intensive segment of the Real Estate industry and has unequivocally been stressed by both the pandemic as well as more recent volatility in the Domestic and International markets.
3. Capital structure and working capital are increasingly critical to day-to-day operations and asset management for the Hotel & Lodging sector.
4. Technology advancements have and are expected to create efficiencies for the travelers, yet the cost to the sector must be managed.

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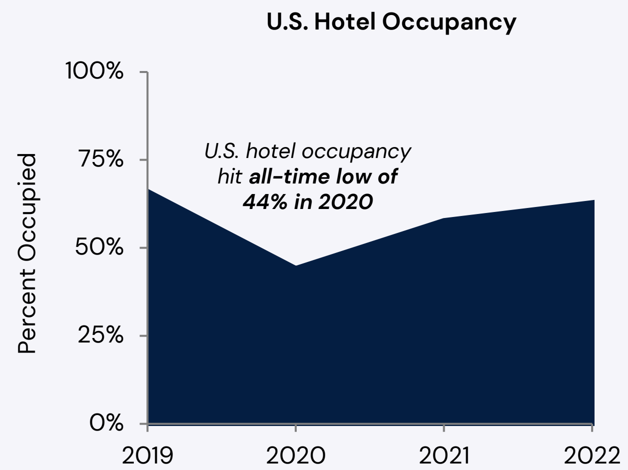
HISTORICAL PERFORMANCE PRE-COVID

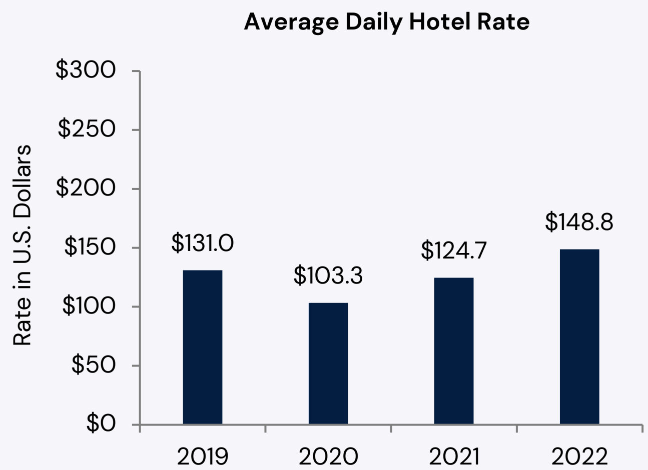
Those in the Hotel & Lodging sector will likely need to determine new valuation parameters for this asset class, including owners, investors, franchisors, trade partners, lenders, management companies and, most importantly, employees. The pandemic has forced owners to examine their agreements and contracts with trade partners and lenders to survive and thrive post-COVID. In this high interest rate and exacerbated inflation environment, proactive asset management of short- and long-term strategies is critical.

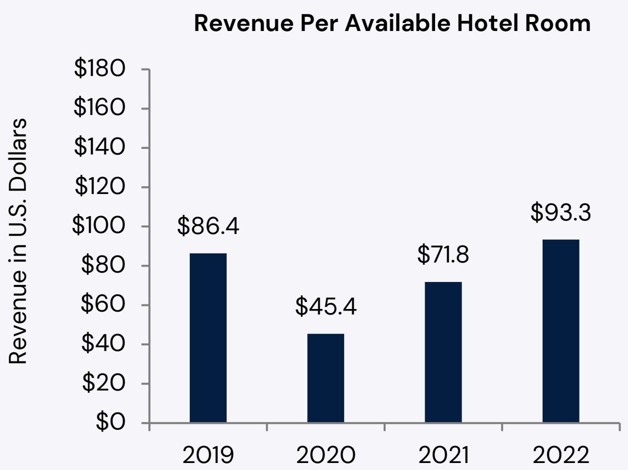
Understanding the overall root causes and the probable trajectory of the fate of this sector has proven to be critical to formulating a plan to manage through the current turmoil. Since 2012, national U.S. hotel occupancy has been historically consistent, with occupancy percentages generally staying in the mid-60% range, according to Smith Travel Research (STR).[1] This range changed during the COVID-19 pandemic, and in early 2020 national hotel occupancy fell to an all-time low of 44%.

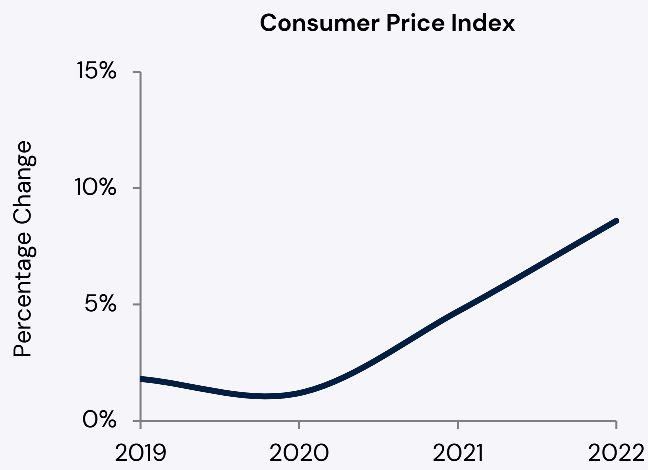
Hotel & Lodging Sector Continues to Rebound from Pandemic Low

While the Hotel & Lodging sector has continued to rebound following the aftermath of the COVID-19 pandemic, rising costs due to inflationary pricing, worker shortages, and cost of capital have continued to suppress earnings in the Hotel & Lodging sector and have caused a ripple effect of stress and distress throughout the sector.









Source: Smith Travel Research, Federal Reserve Bank of Minneapolis, and Capstone Partners

POST-COVID RECOVERY: 2021 AND 2022

The year 2021 showed signs of a recovery that was bolstered by pent-up demand. Additionally, growing optimism around COVID vaccines and treatments emerged, driving last-minute bookings at a pace never before seen in the sector. Yet the current recovery has been stressed by macro elements of supply chain issues, global political environment, high wages, inflation, and high interest rates. Although occupancy has yet to fully recover, average daily rate (ADR) growth has been favorable. As of year-end 2022, revenue per available room (RevPAR) has tracked back to 2019 levels and has surpassed CPI (Consumer Price Index) growth, according to STR[2]. But will it hold?

This recovery has been at the expense of the leisure traveler. U.S. hotel leisure travel revenue is projected to end 2022 14% above 2019 levels, while hotel business travel revenue is expected to come within 1% of 2019 levels, according to the American Hotel & Lodging Association.[3] Business and group travel has still been lagging, particularly in the major gateway markets. Virtual meetings continue to replace corporate travel and firms have been budgeting travel and perks more closely.

The perception of hotels as a viable investment class has continued to be tested. CMBS' (Commercial Mortgage-Backed Securities) delinquencies and special remittances have continued to be prevalent for hotel real estate, according to Fitch Ratings (see table below).[4] The Hotel segment has recovered quickly, yet continues to be in the top three segments for special remittance, following Retail and Regional Malls.

Hotels have proven to be the only segment in the Hotel & Lodging sector where on-going business and real estate value need to be balanced. Hotels rely on short-term "leases"—which must be adjusted daily based upon local market supply and demand, making day-to-day operations critical. Still, hotels are underwritten similarly to other forms of real estate, with secured debt and common metrics of loan-to-value, debt service coverage ratios, and capitalization rates. Owners and investors often have to adjust their metric of returns for the day-to-day operations in comparison to lenders, even at risk of negative equity. Hence, short- and long-term proactive asset management is crucial.

U.S. Commercial Mortgage-Backed Securities Special Servicing Remittance

Date	Regional Malls	Hotel	Retail	Office	Student Housing	Multifamily	Mixed Use	Industrial
Feb-23	8.41%	4.06%	5.25%	1.41%	1.58%	0.54%	1.74%	0.45%
Dec-22	8.23%	4.30%	5.33%	1.18%	1.30%	0.55%	1.62%	0.44%
Dec-21	11.60%	9.43%	6.92%	1.23%	3.00%	0.44%	2.93%	0.16%
Sep-21	14.53%	11.05%	8.22%	1.26%	4.72%	0.50%	3.09%	0.17%
Year End 2020	19.97%	18.38%	10.98%	1.70%	5.05%	0.58%	4.06%	0.42%

Source: Fitch Ratings and Capstone Partners

DISPARATE PRESSURES CONVERGE ON SECTOR

Working Capital and Financing Needs

Honesty and transparency have shown to be the best strategies when communicating with lenders. Generally, lenders do not want to assume responsibility for managing a human capital-intensive business. Lenders and owners must determine long-term strategies while considering average rate changes on a daily basis and seasonality of demand on a weekly/monthly basis. The impact of COVID has only educated loan officers and bank asset managers about daily operational variables. Being transparent with cash flow, accounts payables, and payroll only helps with the forbearance agreements and negotiations of revised terms.

Lenders had no fiduciary pressure from governmental agencies in terms of compliance during the height of COVID. The moratorium on foreclosures, coupled with government assistance such as the CARES (Coronavirus Aid, Relief, and Economic Security) Act, PPP (Patient Protection Program), and EIDLs (Economic Injury Disaster Loans), allowed owners and lenders flexibility, but were short-term crutches. Impending maturity dates in the next few years are expected to be a challenge. The Federal Reserve's (Fed's) interest rate increases have led banks to be more cautious in their underwriting and risk assessment (demonstrated by the demise of Silicon Valley Bank and Signature Bank). A proactive understanding of the business' liquidity and projected cash needs to be assessed not only quarterly, but on a monthly/weekly basis.

Management and Employee Retention

The massive disruption of the Hospitality workforce has been the single most important issue facing stakeholders, including guests. When the world shut down in 2020, hotels in the U.S. laid off approximately 6.2 million employees, according to the U.S. Bureau of Labor Statistics.[5] Prior to the pandemic, direct travel jobs accounted for 6% of the total workforce, and travel-supported jobs accounted for 11%, according to the U.S. Travel Association (USTA).[6] But in 2020, direct travel jobs accounted for a disproportionate 35% of jobs lost, and total travel-support jobs accounted for a staggering 65% (USTA).[7] Despite the tight labor market, more than 1.5 million jobs in the Travel sector need to be filled (USTA).[8] The PPP rescue served as only a temporary fix for owners and has been coupled with the high cost of human capital. Capstone has found that employee-related expenses generally range from 30% to 40% of revenue. Raising wages is not a simple solution when cash flow is tight. Many veteran hotel managers and employees have had the opportunity to reevaluate the work, life, and health balance of the Service sector. There is no easy solution. Yet all industry leaders have had to recognize the vital importance of fully engaging the workforce into the Hotel & Lodging sector.

Franchise and Online Travel Agencies

While legally a franchisor is not a partner, brand fees in the range of 10% to 15% of revenue have often left owners feeling like they are giving franchisors a partner-sized share of their profits. Managers have often had to comply with operational standards that are not ideal, especially during the pandemic. Similar to lenders, franchisors were lenient by deferring fees and capital expenditure (CapEx) requirements during 2020. The pandemic has presented an opportunity to reevaluate brand values and potentially renegotiate such terms as fees, license terms, and product-involvement plans (PIPs) that are mutually beneficial for long-term prosperity.

Other often "forgotten trade partners" are online travel agencies (OTAs) such as Expedia Group (Nasdaq:EXPE) and Booking.com. Reportedly, more than 82% of U.S. travel reservations were made without human interaction in 2018, via websites or applications, according to Stratos Jet Charters.[9] The pandemic has renewed concerns from hotels and airlines about fees charged by third parties, which can reach 25%. The large hotel chains can negotiate lower fees and have the advantage of loyalty and incentive programs. Group and corporate travel have been virtually nonexistent in 2020 and 2021, and OTAs have reportedly delivered a large share of the relatively sparse bookings, according to Morning Consult.[10] Nevertheless, OTAs will likely continue to provide the majority of bookings. Operators must closely watch room inventory provided to third parties. The "heads in beds" occupancy model has not necessarily proven to be an effective economic strategy. Net ADR has been more important to the bottom line. This should be the time to reconsider contracts and guarantees with all third parties.

LOOKING INTO THE FUTURE

Global Supply Markets & Consumer Confidence

The pandemic has stressed the global supply chain ecosystem. Supply costs and freight, coupled with the increased cost of labor and oil, have impacted operations daily. Hotel companies and owners have been seeing freight times expand to two or three times longer than what they were pre-COVID. This encourages hoteliers to be creative in their purchasing processes, including finding new domestic and international supply sources. Being preemptive has proven to be essential for owners and managers.

Despite the increase in vaccinations, consumer confidence in travel has continued to be an issue. Most brands have installed health and safety protocols. Educating guests and highlighting cleanliness and health standards has been imperative to sell rooms. Using third-party accreditations and the recent requirement of vaccine passports may help. The guest experience is always evolving, and COVID-19 has added a high degree of complexity to the mix.

Valuation

Hotel valuations have been generally measured by cash flow and various multiples (capitalization rate, discount rate, room revenue multiple), as well as construction costs and implicit value. The short-term impact has been obvious, as hotel sales transactions were limited in 2020, excluding the large hotel portfolios and REIT transactions. There were opportunities in 2021 in the Hotel & Lodging sector as interest rates were low and investors and lenders were optimistic to discard 2020 in their underwriting and valuation. The lack of pressure from government agencies and Fed rate policy slowly reopened financing markets in mid-2021. As a part of the CARES Act late last year, even the SBA (Small Business Administration) offered incentives for new loans, including waiving three months of P&I (principal & interest) payments and all loan fees. The CMBS market has also been revived in 2021, albeit cautiously. A slew of new lenders also entered in 2021: regional banks, insurance companies, and debt funds, all once hesitant of lodging assets, have reconsidered the economics.

The Fed's antidote to inflation—consistent interest rate hikes since early-2022—has, in 2023, constrained both lenders' and investors' appetite for all commercial property. The rate hikes have led to wider spreads and more conservative loan-to-values (LTVs) which will not bode well for the sector. The increase in rates may also create distress for borrowers needing to refinance low-coupon loans; maturity defaults may be inevitable.

Outlook

The volatility of the day-to-day operations of lodging real estate has been perceived as a disadvantage to inherent land and real estate value. Yet, in this post pandemic period, the daily variability of the Hotel & Lodging sector has only sustained value, as demonstrated by the recovery of revenue per available room to 2019 levels. This will likely continue to be tested by national and global economic forces, compelling owners and investors and their trade partners (employees, franchisors, and third parties) and lenders to collectively work together toward a common goal of maintaining and improving cash flow, valuations, and liquidity.

Sabena Arora
Senior Advisor, Hotel & Lodging Sector

"The volatility of the day-to-day operations of lodging real estate has been perceived as a disadvantage to inherent land and real estate value. Yet, in this post pandemic period, the daily variability of the Hotel & Lodging sector has only sustained value, as demonstrated by the recovery of Revenue Per Available room to 2019 levels."

CAPSTONE CASE STUDY

The client, a commercial real estate developer with multiple properties throughout downtown Boston, was experiencing insolvency and engaged in a bankruptcy-related restructuring process.

Its portfolio included a premium luxury hotel, which spanned 123 luxury condominiums, spa, and themed bar and restaurant. It also included four Class B office buildings which combined street-level retail—including a Nike (NYSE:NKE) flagship store—with commercial office space and four parking facilities. Total appraised value for the properties (excluding the hotel) was approximately $400 million.

Capstone's FAS Group was engaged to assist with restructuring the debt of the hotel property which was subsequently sold in bankruptcy and provided ongoing accounting and finance support for the office properties.

Additionally, a member of the FAS Group acted as an on-site advisor to the operational team responsible for the office buildings during the restructuring.

Ultimately, the underperforming hotel property was sold, and the other properties were returned to profitability and turned back over to the client for continued operation.

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FINANCIAL ADVISORY SERVICES

CAPSTONE SERVICES PROVIDED

- **Restructured debt with business stakeholders and lender**
- **Provided accounting, finance, and interim operational support during turnaround process**
- **Acted as financial advisor during the sale of underperforming assets and restoration of remaining business to profitability**

Capstone's Financial Advisory Services Group

Transaction Advisory Services

- Buy- and Sell-side Transaction Support
- Financial & Operational Due Diligence
- Quality of Earnings Review
- Valuation Services
- Post-merger Integration

Business Advisory Services

- Business Performance Improvement
- Project Management
- Accounting & Audit Support
- Public Company Readiness
- Public-to-Private Planning
- Interim Management Advisory Services

Turnaround & Restructuring

- Turnaround Advisory
- Crisis Management
- Restructuring Advisory
- Debtor & Creditor Advisor Services

Special Situations Investment Banking

- Strategic Alternatives
- Contingency Planning
- Buy- and Sell-side Distressed M&A
- Debt & Equity Capital Markets
- Balance Sheet Restructuring

Bankruptcy Services

- Debtor & Creditor Representation
- Chief Restructuring Officer
- Chapter 11 Plan of Reorganization
- Chapter 11 Liquidation
- Chapter 7 Liquidation
- Section 363 Asset Sale

HOTEL & LODGING ADVISORY SERVICES SPECIALISTS

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Sabena Arora has more than 25 years of hospitality real estate experience. In addition to serving as a Senior Industry Advisor on Capstone's Financial Advisory Services (FAS) Group, she is also the founder of Acadia Lodging Brokers and Advisors. Previously, she spent six years with Highgate Holdings, specializing in acquisitions and investment analysis. During that time, she was responsible for evaluating more than $50 billion in national and international hotel investments and transacting hotels totaling more than 12,000 rooms. She has extensive experience with all aspects of lodging investment transactions including full service and select-service portfolios, resorts, timeshare, mixed use projects, REITs, and casinos.

Brian Davies
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Brian is the Managing Partner of Capstone Partners' FAS Group. He has more than 25 years of professional experience working extensively in the fields of post-merger integration, business reorganization and interim management services. He has provided financial advisory services to lenders, debtors, creditors' committees, trustees and equity holders in bankruptcy matters and out-of-court restructurings. Brian has provided assistance to under-performing businesses, potential acquirers of distressed assets/entities, and advised clients on general business issues. He has advised and worked with financially distressed companies to develop cost containment and asset rationalization plans, improve liquidity, re-engineer financial and other back-office functions, and enhance cash flow. His industry experience includes Retail, Security, E-Commerce, Real-Estate and Housing, Manufacturing, Distribution, Automotive, Construction, Hospitality, Environmental Testing Laboratories, Aviation, Food/Beverage, Mining and Healthcare.

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Matt Hart is a Managing Director in Capstone Partners' FAS Group, primarily focused on Special Situations Investment Banking. He has more than twenty years of experience advising, financing and investing in companies in transition, and has worked more broadly in finance since 1996. Matt has advised on nearly 100 transactions totaling over $180 billion, including debt raises and restructurings, special situations mergers and acquisitions, liability management transactions, and public and private equity raises. Clients have included companies and their owners, lenders and bondholders, statutory committees, and other parties-in-interest. His experience has included most major industries and ranged from private, lower middle market companies to publicly traded, household names such as Lehman Brothers, General Motors, Chrysler, American Airlines, and Kodak.

FIRM TRACK RECORD

Capstone has represented numerous companies in the Hotel & Lodging sector and has has the extensive industry knowledge needed to help owners and stakeholders address challenges and capitalize on opportunities. Below is a sample of our engagements in the space.

Hilton Garden Inn PHOENIX FINANCIAL ADVISOR TO THE SENIOR SECURED LENDER	Howard Johnson YUMA FINANCIAL ADVISOR TO THE SENIOR SECURED LENDER	WESTIN HOTELS & RESORTS TRANSWEST RESORT PROPERTIES, INC. FINANCIAL ADVISOR TO THE BORROWER	MARRIOTT DETROIT METRO AIRPORT FINANCIAL ADVISOR TO THE SPECIAL SERVICER
WATERFRONT LUXURY HOTEL TRANSACTION ADVISORY SERVICES	COURTYARD BY MARRIOTT TRANSACTION ADVISORY SERVICES	WESTIN HOTELS & RESORTS FINANCIAL ADVISORY SERVICES	PCNY PRINCETON CLUB New York FINANCIAL ADVISORY SERVICES

2023 CHAPTER 11 RESTRUCTURING THE M&A ADVISOR TURNAROUND AWARDS	**2022** DISTRESSED DEALMAKER THE M&A ADVISOR TURNAROUND AWARDS	**2022** SPECIAL SITUATIONS TURNAROUND ATLAS AWARDS COVAIL	**2022** CHAPTER 11 RESTRUCTURING TURNAROUND ATLAS AWARDS BEAMABLE	**2020** CORPORATE RESTRUCTURING FIRM OF THE YEAR ACQ5 Global Awards 2020

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Market Presence

With a long-established U.S. footprint, together with an international partner platform, we provide clients with broad expertise and access to key market relationships on a global basis. Our presence is backed by ~200 professionals in the U.S. with 450+ professionals across 41 countries.

242
M&A transactions completed in 2022

$26B
aggregate transaction value

26%
of our deals are cross-border

8th
globally ranked for deals under $500m

450+
team of IMAP professionals worldwide

15
industry verticals with global expertise

2,200
historical completed transactions

United States

~200 professionals
11 offices

Boston · Chicago · Dallas · Denver · Detroit · Los Angeles · New York · Orange County · Philadelphia · San Diego · Tampa

International

450+ professionals
60+ offices in 43 countries

Asia: China · India · Japan · Thailand
Africa: Congo · Egypt · Ghana · Ivory Coast · Mauritius · Morocco · Nigeria · Senegal · South Africa
Americas: Toronto · Vancouver · Argentina · Brazil · Chile · Colombia · Mexico · Panama & Central America · Peru
Europe: Belgium · Bosnia & Herzegovina · Croatia · Czech Republic · Finland · France · Germany · Hungary · Ireland
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