JF CAPITAL ADVISORS

# JF CAPITAL THOUGHTS: CHANGES IN THE HOTEL INDUSTRY

The impact of the COVID-19 pandemic will drive numerous future changes in the hotel industry. Some of these changes will occur in the short term and others will take longer to phase in. In thinking through numerous operational, financial, legal, safety and valuation related challenges, I can offer thoughts for consideration. Here is what I have been thinking about:

## Reopening of Hotels

- Even when hotels are cleared for reopening from a health, safety, and social distancing perspective, there will be lingering health concerns which will create meaningful headwinds and will slow any recovery.
- New safety standards will be introduced by brands and some municipalities including operating protocols and cleanliness/safety standards. These will require incremental training, incremental staff, and operating expenses.
- Leisure (first) and business transient (second) will benefit from some pent-up demand, although will return slowly and in a muted fashion due to lingering health issues, as well as financial concerns.
- Group (especially large groups) will be the last segment to recover and will recover slowly. Various state and city regulations and restrictions will likely limit events and gatherings up to certain sizes.
- Domestic travel will recover substantially quicker than international travel.
- Some large big-box group hotels, especially in union heavy markets, may take a long time to reopen (if they reopen at all) as they have been historically reliant on large meetings, banquets and catering.

## Operating and Fixed Cost Reserves

- Owners and lenders will spend more time considering the amount of necessary working capital, seasonality, as well as funded cash reserves, in order to address cash flow shortfalls and to withstand future demand shocks.

## Increased Use of Technology

- Historically, the hotel industry has been slow to adopt new technology.
- Owners and operators will be very focused on increasing the use of technology in order to reduce labor costs and preserve operating margins.
- Technology improvements will come in many different areas including front desk, housekeeping, restaurant service, and kitchen staffing.

- Substantially more guest communication will be done via mobile device with little direct interaction.
- Front desk activities are likely to move towards the airline model where check-in will be primarily via mobile device or electronic kiosk; this is already happening with mobile check-ins but the use of technology for check-in and check-out will increase substantially.
- More housekeeping and cleaning functions will be done by robots.
- Some kitchen preparation and food functions such as ordering and delivery, as well as restaurant service (in non-luxury hotels) will become automated.

**Removal or Relaxation of Unnecessary Brand Standards**

Over the years, each hotel brand has introduced numerous operating and physical standards. This has led to what is referred to as brand or amenity creep. These increased operating service standards, as well as FF&E and OS&E standards, introduce meaningful incremental labor and capital expenses.

- **Daily Housekeeping:** Daily housekeeping is one of the most obvious examples of this. Most customers do not have daily housekeeping at home and use a towel, washcloth, or bedsheet more than once. Daily housekeeping is one of the most expensive items that burdens a hotel P&L and is not meaningfully appreciated or even wanted by hotel guests. If brands allowed hotels to offer housekeeping on a fee basis, that would allow for a meaningful increase in profitability and require significantly less staffing.
- **Room Service:** Brands that require room service will have increasing amounts of pressure to remove this money losing offering while maintaining an efficient grab-and-go operation. However, in the shorter term while COVID-19 concerns remain, room service may need to take the place of hotel restaurant and bar dining.

**Brands Should Drive Rooms Revenue!**

Over the last few years, the major brands have had an increased focus on direct bookings through Brand.com. Despite this brand effort which has helped on the margin, there has not been a material or meaningful reduction in highly expensive OTA business. Right now, brands receive their full fees (including management and/or royalty fees) on all OTA produced room nights, so for the brands and their own revenue generation, OTA's are simply another booking channel. For owners who are paying OTA fees of 11%-20% and then brand fees of 11%-15% (for franchised hotels), this is extremely painful. In a fair world, brands should not be receiving royalty fees for OTA driven room nights. It is also questionable whether brands should be receiving any of the marketing/system/program fees for OTA driven room nights.

Similarly, business driven from group meeting planning agents such as HelmsBriscoe, which come with 7.0%-10.0% commissions, are important for driving group business. However, these commissions, combined with full brand fees of 11%-15%, severely impair profitability. In a fair world, brands should not be receiving royalty fees for meeting planner driven room nights.

**Health and Sanitary Precautions**

Owners and operators will need to evaluate, create, and maintain a sanitization and safety program for front/back of house and guestrooms. Brand standards and industry operating standards and regulations will evolve and will surely impose incremental financial costs on owners and operators. This will involve incremental hours, additional product cost, and training for all staff. For the foreseeable future both owners and operators will need to create protocols and plans to address any future coronavirus infections of employees and guests. Municipalities are likely to create some of their own standards as well.

**Insurance Policies Will Be Revisited**

There will be a renewed focus on business interruption insurance coverage and what specific events or issues trigger such insurance. Substantial amounts of focus will be placed on clear definitions of force majeure, physical damage, and civil authority provisions. There will be a focus on pandemic insurance coverage, though without a federal backstop or provision, similar to terrorism insurance, it will likely be cost prohibitive to purchase. There will be a significant number of lawsuits related to business interruption insurance that will take years to resolve.

The COVID-19 pandemic and the damage it has caused may trigger an increase in health insurance premia for employees as policies renew.

## Loan Agreement Provisions Will Be Reconsidered

There will be a greater focus on debt service reserves, operating and seasonality reserves and built-in temporary forbearance and covenant waivers in the event of a shutdown of hotels or meaningful portions of the economy. This will have a direct negative impact on equity returns, value, loan proceeds and pricing of debt.

CMBS debt and its inflexibility will be reconsidered. Many of the structural flaws of CMBS will be highlighted as they cause slower response times to borrowers and limited ability to make material loan modifications.

## Hotel Risk Premia Will Be Reconsidered

Investors and lenders will once again focus on the appropriate risk premium for hotel investments vs. other asset classes. This focus on the inherent riskiness of an operating service business with high fixed costs and rents that re-price daily will drive hotel valuations lower as both discount rates and cap rates, versus other real estate asset classes, are likely to increase.

## Hotel FF&E and CapEx Buildout Spending Will Be Reconsidered

Far greater thought will be given to room layouts, design, and all products in the guestrooms. Products in the guestrooms will be reconsidered in terms of what guests really want and what they really need. Some of this focus will be on surfaces and products that are easier to clean. This will be necessary in order to manage future development and operating costs and to generate financial returns.

## Other Technologies Will Receive Greater Focus

The current crisis will trigger a reset of thinking with respect to the future of hospitality and how people meet and interact. This will impact many hotel design and operating considerations including:

- Driverless cars and impact on room night usage, arrival/departure sequences, and availability of parking affiliated needs (battery charging stations, parking spaces, porte-cochere space for pickup and drop-off).
- Size and technology capabilities of meeting spaces in order to accommodate off-site meeting attendees.
- Ability to efficiently and economically serve many people without buffets.
- Significant automation of restaurant operations.

## Restaurant Operations

Other than in high end destination restaurants, food and beverage options will be seriously reconsidered. Numerous issues will need to be evaluated including:

- Need for full-service restaurants in urban environments.
- Streamlined menus requiring less labor, kitchen preparation and service time.
- Need for hotel restaurants to leverage their fixed costs by providing substantially more offsite catering, delivery, take-out, etc.
- Cooking technology with less reliance on a large kitchen and service staff.
- Significant reduction in brand mandated F&B operating standards.

## Rooms Booking Technology

The hotel industry is fairly antiquated in the selling and pricing of guestrooms. New technologies will need to be addressed.

- Individuals and travel agents book rooms that are “rented” daily with a check-in time of 3pm-4pm and a checkout time of 11am-12pm.
- Therefore, as an industry, we are selling rooms in 20-hour time blocks simply because this is how the GDS and PMS systems are set to work, despite it not being what customers actually want.

If you would like to discuss any of these topics and how they relate to your current or contemplated hotel debt or equity investments, I can be reached at jonathan@jfcap.com or at (917) 238-6917.

Stay Safe!

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