Steady rates 'a relief' for US hotel owners, but cost of debt still elevated

Hoteliers continue to operate in higher-for-longer environment

U.S. Federal Reserve Chair Kevin Warsh explains during an Oct. 28 news conference the Federal Open Markets Committee's vote to hold interest rates steady. (Getty Images)

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That the Federal Reserve did not raise interest rates again came as welcome news to U.S. hotel industry players, but rates remain higher than they'd like.

The Federal Open Markets Committee voted 10-2 on Wednesday to hold the federal funds rate at 3.75% to 4%, having raised the rate at its last meeting. Fed Chair Kevin Warsh said during a news conference that economic activity is expanding at a strong pace.

“While uncertainty remains, owing in part to geopolitical developments, domestic spending has been resilient, productivity growth is strong and capital investment robust,” he said. “Job gains have kept pace with the workforce, and the unemployment rate has changed little, but inflation remains elevated.”

The Fed's pause is "a relief" for hotel and commercial real estate owners, but the hospitality industry is still at the top end of the rate range it's been in for the last four years, said Greg Porter, managing director of capital markets/mortgage brokerage at Hospitality Real Estate Counselors, via email. Plus, the high end of that range could continue to go up, he added.

"The Fed is tilting hawkish, and that means more pain and an acceleration of forced sales in 2027," he said.

Hospitality industry response

The hotel industry, and commercial real estate market at large, continues to suffer from the indigestion of higher rates, Porter said. Hotel owners who bought their properties five years ago sit on fixed-rate loans tied to a 1% Five-Year Treasury, and that provides no incentive to meet today's pricing reality.

"That legacy debt is the main driver of the wide bid-ask spread in the market," he said. "Sellers are clinging to valuations supported by their expiring cheap debt, while buyers must underwrite to today’s rates."

As owners of debt originating in 2021 and 2022 refinance their five-year, fixed-rate loans at today's rates, they're forced to bring cash to the table to right-size the loan to new debt service coverage ratio and loan-to-value realities, he said. The alternative is to sell.

Lenders are losing patience, and hotel owners' sale decisions are increasingly the result of pressure from lenders, Porter added.

"I expect this trend to accelerate transactions and forced sales in 2027," he said.

At the same time, most large investors have been patiently waiting on the sidelines, either prudently waiting for deals to pencil or managing their own balance sheets, he said.

The Fed is leaning toward raising rates — possibly as earlier as the committee's next meeting in December — as evidenced by the two dissenters who voted to raise today, Porter said.

"There is no rate relief in sight, and even if the Fed cut rates by, say, 50 basis points in 2027, it would be insufficient to shield the market from the rate shocks, forced paydowns or forced sales as loans come to maturity," he said.

The Fed's decision to hold rates steady was expected, said Jordan Kirkbride, senior vice president of capital markets at Driftwood Capital, by email. However, the decision doesn't materially change the picture for hotel owners weighing acquisitions, sales or refinancings, he added.

"The market is underwriting rates staying elevated, with inflation pressuring both financing costs and operating expenses," he said.

In this environment, basis, operating execution, revenue diversity and physical product quality matter most, Kirkbride said. Recently built or renovated hotels with multiple demand drivers and limited near-term capital expenditures are best positioned to absorb these higher carrying costs.

Driftwood's credit platform is focused on high-quality hotels with attractive bases, durable demand and limited CapEx risk, Kirkbride said. These assets are operationally intensive, which creates real barriers to entry. The company's in-

house management, development and investment platforms let Driftwood identify and underwrite them across both credit and equity.

Fed comments

Economic growth has strengthened, and the gross domestic product increase in the first half of this year was revised up from an earlier estimate of 1.8% to 2.4%, Warsh said. The third quarter of this year appears to have brought even more rapid advances, led by healthy consumer spending likely running above 3% growth and business investment likely rising at about a double-digit pace.

“Capital expenditures are at a historically high share of GDP,” he said. “High-tech investment is leading the acceleration, but there’s also been a broadening in other categories, and these trends bear watching.”

The jobless rate is lower than it was a year ago, and payroll growth is above last year’s pace, he added.

Americans continue to deal with inflation, which has been running above the FOMC’s 2% objective for nearly six years, Warsh said. In September, the annual inflation rate amounted to 3.7%.

As it is the FOMC’s responsibility to bring down inflation, the committee’s discussion has focused on price stability, he said. Since it raised the federal funds rate in September, the committee members have observed changes in financial and credit conditions.

“They have tightened for some businesses and households, much as we would expect,” he said. “Market participants are becoming somewhat more discerning in their capital allocations, and while overall financial conditions are tighter, I'm unwilling and unable to call them tight. But broadly, these developments go in the direction of achieving a longer, more durable period of economic growth and price stability.”

As the committee widens its frame to survey the broad economic and financial picture, real activity is pointing in the right direction, Warsh said.

“That’s good news, but inflation is too high,” he said.

Energy and related prices have moved higher again in recent weeks, and it’s the FOMC’s job to ensure the relative price changes in some sectors don’t broaden across the economy, he said.

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