Q1 2016

LODGING INVESTMENT ROADMAP

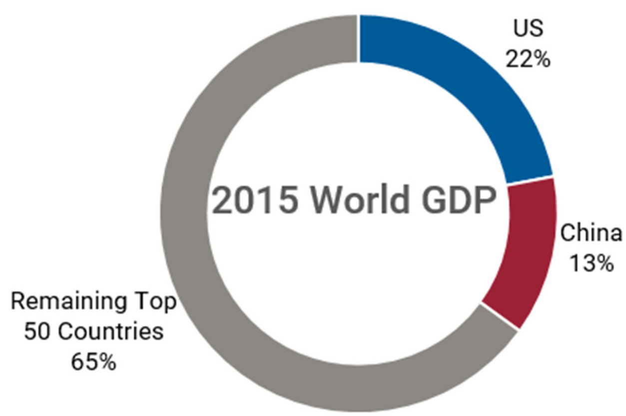
February 2, 2016

To our industry friends:

As we departed the Americas Lodging Investment Summit in Los Angeles, we thought it would be helpful to our clients and friends to provide an anecdotal synopsis of what we learned at the conference, as well as our firm's macro- to micro-perspectives on what's ahead for the lodging investment environment.

What is the effect of the global economy, and China in particular, on the US lodging industry?

The new year began with a shock to the stock markets, with big drops in early January. Investors may have been overly optimistic about China's impact on the global economy, and now reality is coming home to roost, but we believe investors may have also underestimated the resilience of the U.S. economy. China is clearly going through a slow-down, but it is not all doom and gloom. According to the World Bank, today China represents 13% of the of world's GDP; the U.S. accounts for 22%. The Chinese economy is expected to continue to grow, but at much more "normalized" rates of five to six percent GDP growth.



Source: World Bank

We see a much safer investment environment in this cycle, and so do foreign investors. Levels of property debt are down dramatically. The positive elements of this up-cycle continue to drive global companies and investors to the U.S. More than ever, they are attracted by the rule of law, traditionally safe investment vehicles, transparency in accounting, strong credit, success in dealing with major economic challenges, resiliency and diversity, an entrepreneurially-oriented economy, and the continued flight of like-minded investor capital to our borders. These investors seek experienced domestic investment partners to help them place their capital, with only a few investing directly. Hotels are particularly attractive since they are much more attractive and accessible than industrial buildings or apartments, and also offer EB-5 benefits. The volatility being spurred by China may be affecting the investment markets, but we urge investors to "tune out" the current noise.

Will the Fed's rate increases and the CMBS markets affect hotel investments?

We view the recent Federal Reserve Bank's rate increase as a good thing, and the fact that they did so before inflation mandated an increase was actually a prudent move. While the Fed opted to leave short-term rates alone at its January FOMC meeting, officials also suggested they would likely continue with plans for gradual rate increases as early as their next meeting in March. Interest rates for commercial real estate investments remain near all-time lows, and they are expected to stay low for the foreseeable future.

We don't see many signs in the economy that would cause interest rates to grow quickly. As such, we also expect capitalization rates to remain fairly stable. We do expect the availability of construction financing to continue to be tight as lenders move their available capital instead into refinancing CMBS maturities later this year and next. In fact, several lenders have told us that they plan to keep their powder dry until the latter half of the year. This could translate to higher debt costs early in 2016, but overall, we see credit conditions remaining fairly loose for acquisition financing.

There is one other item flying under the industry's radar that we believe warrants mentioning. Late last year, an SEC rule (Regulation AB) took effect, stipulating that a senior executive of a lending institution (think J.P. Morgan, Bank of America, Deutsche Bank, etc.) must sign a one-page form saying that he or she has personally reviewed the prospectus of any securitization transaction being offered and is familiar "in all material aspects" with the collateral assets, the deal's structure and "all material underlying transaction agreements." The form goes on to say that the signee certifies that the prospectus and supporting documents don't contain untrue statements or omit material information. We have yet to see the full impact of this regulation, but we suspect it is causing quite a bit of trepidation in the executive suites of many CMBS bankers.

Are U.S. businesses again playing a role in the resurgence of the hotel industry?

Following the last recession, hotels were stung badly as corporate travel and conferences were curtailed. Today, major American companies are hiring again and they have also ramped up their investment in research and development and in manufacturing. The U.S. lodging industry stands to benefit greatly from continued corporate financial strengthening. Geopolitical issues are significant, and we are only a few years removed from a global financial crisis. The next 12 to 18 months will bring some volatility and apprehension to corporate CEOs due to U.S. political uncertainty and the impact of a new administration on tax policy, the regulatory environment, etc. However, we suggest taking a much longer view. Prospects for corporate growth in the U.S. are very positive for the next ten years. Moreover, according to the Harvard Business Review, over 80% of the companies in the U.S. were created in the two- to three-year period just after recessions, with entrepreneurs taking advantage of opportunity. These businesses are just now beginning to impact hotel revenues.

Continued economic growth will be slow and steady. This is the tortoise economy, as compared to the hare economy seen in the fever pitch days of the last cycle. Economies go through periods of natural refreshing, and a down-cycle is inevitable, but we expect more running room in this cycle, with hotels being supported greatly by large and small businesses alike.

Is this cycle over for the lodging sector?

Hardly. Sellers continue to sell and buyers continue to buy. The financial markets may be down at the moment, but they are not massively volatile, and there have not been any pervasive downdrafts. Wages are ticking up and the dollar continues to strengthen. The latter is now at a 12-year high, which is a net positive over the long-haul that will contribute to positive economic growth and positive job growth. Current investor return expectations are moderating and we see little chance of another recession at the moment.

The lodging sector is now approaching 75 straight months of RevPAR growth. By all measures and barring a catastrophic event, both average daily rate and occupancy should continue to grow through late 2017, albeit at a more moderate pace. Most of that RevPAR growth will be in ADR meaning improved flow-through to the NOI line. Sellers are actively putting performing assets on the market and buyers are showing up!

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Is new room supply a threat again?

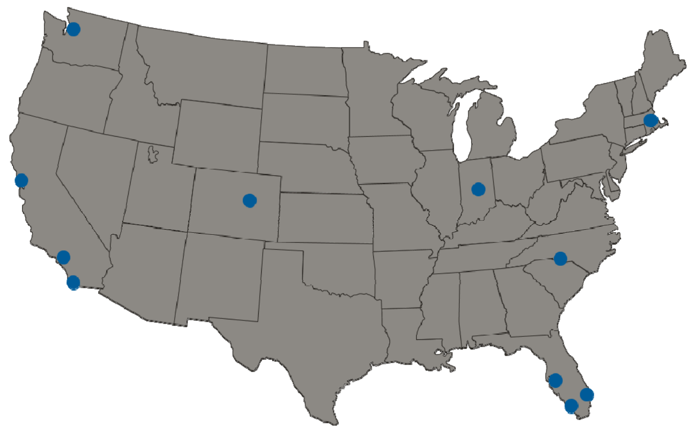
There has been a lot of commentary recently with respect to the number of new hotel rooms in the pipeline. However, we see no real threat on the supply side in the immediate future. There are certainly challenges on the horizon for cities such as New York, Pittsburgh, Chicago, Houston and New Orleans, but the overall level of supply across the U.S. remains well below where it stood during the last peak. While room supply is definitely expanding, we believe it will begin to moderate in 2017.

We suggest that there are also a number of key markets that offer excellent development dynamics, especially for new full service product.

These markets include:

- Boston, MA
- Charlotte, NC
- Tampa/St. Petersburg, FL
- Broward County, FL
- Naples/Ft. Myers, FL
- Indianapolis, IN
- Denver, CO
- San Diego, CA (northern suburbs)
- Los Angeles, CA (northern suburbs)
- Seattle, WA
- San Francisco Bay Area, CA

Key Full Service Hotel Development Markets



Who will be the primary sellers and buyers of hotels?

A number of traditionally active players in hospitality are now exiting. Many investors wanted to sell in the last cycle but were prevented from doing so by the Great Recession. They were forced to hold their properties for an extra cycle, but they, too, are now active sellers. Private equity firms are also exiting those investments they acquired early in this cycle, five to seven years ago. But perhaps the greatest source of hotel acquisition opportunities in the next year will come from public lodging REITs. The REITs are, for all intents and purposes, out of the acquisition market for at least the next 18 to 24 months. As REITs face declining stock prices, property dispositions at loftier private market prices and stock repurchases will become more common. Many REIT portfolio transactions marketed in 2015 did not materialize. Today we see several REITs executing more direct, off-market deals in an effort to mitigate any negative publicity that could result from a failed open marketing process. Most of these players are selling mainly full service hotels. According to HVS, in 2015, the bulk of transaction volume was in full service hotels and resorts, and we expect to see the same dynamic in 2016.

As public REIT investment slowed to a crawl in late 2015, the profile of buyers also shifted. Private equity players are now taking a much more active buying role in the market. These firms have been active investors in both down- and up-cycles. PE firms are raising funds at an unparalleled pace, and these are dollars that will flow into the lodging sector in 2016 and 2017. Non-traded REITs, life insurance companies and other institutional investors, as well as high-net-worth investors, round out the most active buyers. Sovereign wealth funds represented a very small portion of the direct buyer market in 2015 as a percentage of total investments, and similar offshore investors have focused mainly on five or six coastal markets. We expect foreign investment to rise in the coming year, partnering with established U.S.-based partners.

What are the trends in hotel pricing?

Compared to a decade ago, hotels are now accepted as mainstream real estate investments. In fact, like interest rates, hotel cap rates are at historic lows, and the spread in capitalization rates has narrowed dramatically when compared to other asset classes. Hotel cap rates are about 200 bps above those of office and multifamily real estate, and with the REITs on the sidelines, there seem to be fewer firms competing for lodging product, making it a more attractive vehicle.

Growing ADR, subdued supply growth, and low interest rates will all assist in supporting strong hotel asset appreciation. Perhaps the factor that had the greatest influence on transaction pricing in 2015 was the fact that REITs were out of the market late in the year. As a result, the cap rate compression we had been experiencing since 2012 quickly ceased. Nevertheless, for renovated and well-situated full service hotels in the top 25 or 30 markets (excluding primary gateway markets like New York or San Francisco), we expect capitalization rates will hover between 6.5% and 8.0%.

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The most active investors we are dealing with today are pricing properties using a number of factors. They seek levered internal rates of return in the mid- to high-teens, cap rates in the seven to eight percent range, and prices per key that are at least 25% to 40% below replacement cost. We don't believe the "sellers' market" is over by any means. In fact, we are still seeing strong pricing throughout the country, particularly in certain regions and for specific asset types. The better hotels in secondary markets, in terms of prominence and physical condition, remain very attractive especially if they can provide high-teen returns to investors. Our experience with luxury and resort hotels has also been very positive. The high cost to construct, along with challenging loan parameters have insulated these properties, trading today at cap rates in the low- to mid-single digit range.

While hotel values flattened out a bit in the last half of 2015, we expect that they will continue to grow as a result of the massive availability of investment capital, low interest rates and improved bottom line profits. Barring a black swan event, we expect values to increase, albeit at a more modest pace, through 2018.

What are some prudent pieces of advice for hotel owners and investors at this point in the cycle?

It appears we are entering a more mature stage of the current economic cycle. More and more industry experts say that hotel asset appreciation reached their peak in 2015. Clearly, the easy money has been made, and great deals will now require a much more surgical approach, on the buy side as well as the sell side.

Sellers still have great leverage today, should they decide to exit. We would argue that it would be best to get out on top, while the indicators are still in the green, rather than timing the market and missing out. As we noted above, there is plenty of equity chasing deals, and we hear from many lenders that they still have an open ear when it comes to hotel loans. However, if the CMBS markets fully dry up and debt should become more difficult to obtain, the transaction market will be immediately negatively impacted.

Owners should also consider several other factors that are having a growing impact on their properties. These include more aggressive tactics by property assessors seeking higher real estate taxes, increases in wages and benefit costs, competition from Airbnb, and brand mergers, to name just a few. In fact, in the past few weeks, we have been fielding more and more questions regarding the announced Marriott/Starwood merger. We will be commenting on that transaction soon in a separate piece.

The lodging industry is enjoying one of the strongest and longest periods of growth on record. Owners and lenders have not taken this for granted. Tighter operating efficiencies, continued stringent loan underwriting standards, and a fairly muted pace of new hotel construction have all contributed to this remarkable period of success. The memories of 2008 and 2009 are still very fresh, but we remain cautiously optimistic, notwithstanding the stock market's up and down performance over the past few weeks. Nevertheless, we suggest that buyers of hotels will need to moderate return expectations and look more to the secondary markets for acquisitions generating higher returns.

Underlying fundamentals have not changed enough to justify any running for the exits, but we do encourage diversification and redeployment of capital, especially for assets that have matured. We expect more sellers than buyers this year, as firms that have now held assets for a while heed the lessons learned from recessions past. As for our team, we plan to tune out the noise, remain vigilant, provide good counsel and stay the course.

If you'd like to discuss any of the topics presented here, or would like The Plasencia Group to evaluate your lodging investment and consulting needs, please contact us at (813) 932-1234. We wish you much success throughout 2016 and beyond and sincerely look forward to the opportunity of working with you.

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