The Plasencia Group
Passion. Access. Certainty.

## SUMMER 2016

# LODGING INVESTMENT ROADMAP

*May 17, 2016*

To our industry friends:

Many of us will soon be heading to New York for the NYU International Hospitality Industry Investment Conference, where the main topic of conversation will likely center on whether the industry has already hit its peak or will soon trend downward. Others will argue that this cycle still has legs. Through the end of 2015, an interesting disconnect was developing, with hotel operators experiencing continued growth in top line performance, while Wall Street began raising warning flags. But as challenged first quarter operating statistics came in, operators in some markets had to temper their expectations. Most industry pundits now believe operating performance is likely to improve for the balance of 2016, and there is little evidence to suggest that the U.S. economy is near a recession. In this issue of our Lodging Investment Roadmap we hope to provide our clients, partners and friends with our current perspective of the state of affairs of lodging investments as well as our firm's outlook for what's ahead.

### What is the state of the lodging market now?

Obviously, it is always difficult to call a "peak" in any market until you've actually passed it and have the benefit of hindsight. Looking back now, it is clear that the hotel industry experienced its most recent peak in investment deal volume and pricing in the third quarter of 2015. Cap rates for stabilized assets primarily located in STR's Top 25 markets have risen by as much as 50 to 100 basis points since then.

The U.S. lodging market recently experienced its 73rd consecutive month of positive, albeit decelerating, growth in RevPAR. Historically, the longest period of RevPAR growth occurred from late 1991 through 1998, with 80 months of growth.


Source: Smith Travel Research

While nine of the Top 25 STR markets experienced declines in RevPAR in the first quarter of 2016, STR nevertheless reports national RevPAR is still up 2.7%. If you exclude the two most challenged markets, New York and Houston, that national number skews upward to 3.5%. Several areas continue to benefit from strong performance, mainly in ADR. For example, in the southeast, markets such as Atlanta, Orlando and Tampa can still boast RevPAR growth levels in the 6.5% to 7.5%. Still, many public hotel companies and REITs, particularly those that are heavily weighted in the northeast, have recently provided revised guidance, reducing their 2016 annual RevPAR growth projections. They now suggest year-end RevPAR growth for their portfolios will be in the range of 3.0% to 5.0%. Industry prognosticator STR is projecting RevPAR growth at 5.0% this year, down 1.2% from 2015.

| | 2015 Actual | 2016 Forecast |
|---|---|---|
| **Supply** | 1.1% | 1.7% |
| **Demand** | 2.2% | 2.3% |
| **Occupancy** | 1.7% | 0.6% |
| **ADR** | 4.4% | 4.4% |
| **RevPAR** | 6.2% | 5.0% |

Source: Smith Travel Research

Owners and operators are now rightly concerned about property performance with declining RevPAR growth in some key markets. And when you couple the potential drop in top line revenues with increasing expense loads brought on by opportunistic property tax assessments, roiling wage markets and the like, there seems to be some cause for concern. All agree, however, that the down-cycle we could be heading into clearly will not be as deep or as long as the two previous recessionary periods. The industry is certainly well-positioned to react to any signs of inflation. And when comparing lodging to other asset classes, the major real estate owners we speak with don't seem to be overly concerned about the current state of the hotels in their broader portfolios.

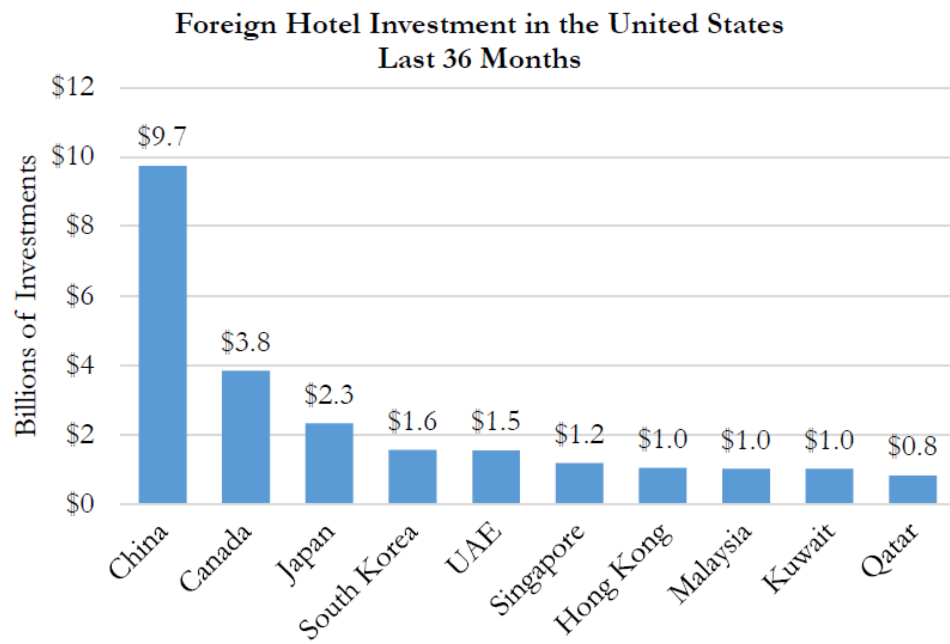
Still, a limited number of investors have begun executing defensive moves by shortening their investment horizons. They are also moving down the leverage scale to conserve capital. While this approach could prove to be prudent, the more aggressive investors would argue that their conservative brethren are leaving money on the table since the economy is still in a growth mode.

## How are hotel investment dynamics changing?

As we approach the more mature portion of this economic cycle, the way buyers are underwriting transactions is definitely changing. We are also seeing a change in investor profiles. Below are some of the adjustments we have experienced in the recent evolution of lodging investments:

- Deal volume through the first quarter of 2016 is about half of what it was for the same period a year ago, due in large part to fewer portfolio sales. That said, the level of disposition activity we see going into the NYU Conference is substantial and the pace of deal closings will definitely increase in the second half of the year. REITs, private equity firms and private individuals are all taking assets to market right now.
- Excluding New York, Houston and a few other markets, we expect hotel values across the rest of the country this year will be flat or slightly ahead of 2015.
- REITs will continue to dispose of "non-core" assets in 2016 on a more profitable one-off basis as opposed to bulk sales.

- High-net-worth investors and family offices are actively back in the market now that they have fewer competitors and pricing has "normalized." They will be a major source of acquisition capital in 2016.
- While foreign investment activity has heretofore been focused mainly on bi-coastal markets, more and more international buyers are moving into secondary markets. These international sources of capital continue to chase yield and have increased their U.S. allocations. Most foreign investors continue to partner with established domestic players or operators who can provide local insight and strategic guidance throughout the acquisition process.

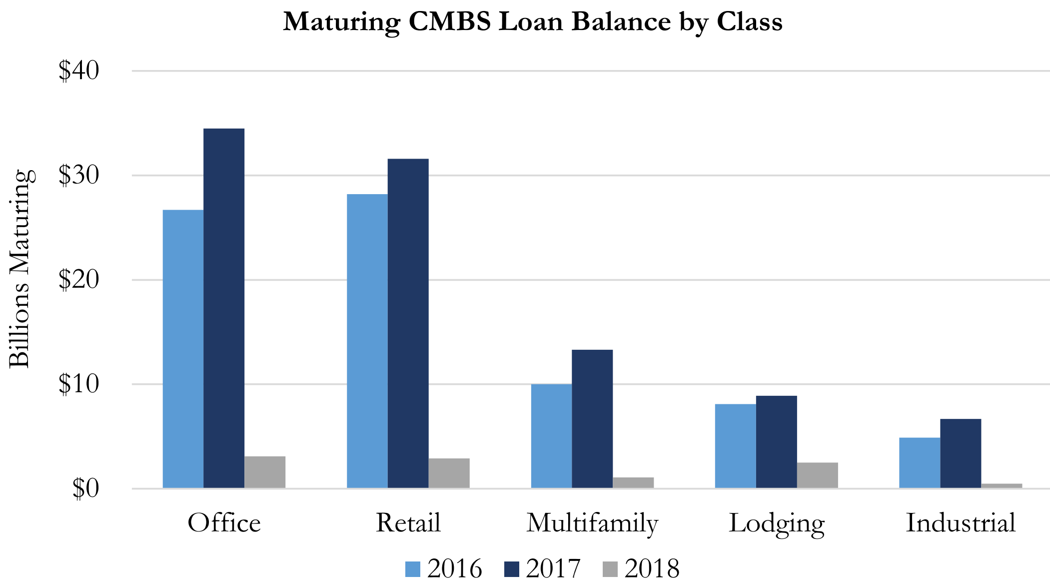



Source: Real Capital Analytics

- Buyer underwriting is focusing more and more on "trailing-twelve" numbers versus future performance. Further, many opportunistic investors are now back to more of a price-per-key and discount to replacement strategy, especially if an asset's top line revenues are attractive but NOI margins are currently below industry norms.
- Loan-to-value metrics have changed, with buyers able to borrow 5% to 10% less now than they were at the same time last year. LTV levels have shifted to roughly 60% today, compared to 65% to 70% a year ago.

### Will debt continue to tighten, and if so, how will it affect lodging investment activity?

Lenders are taking a more conservative, if not idle, approach at the moment. Conversations with senior executives at several traditional hospitality lenders lead us to believe that debt will be more plentiful in the second half of the year, although much of it will be earmarked for refinancings. With over $16 billion in CMBS hotel loans alone maturing by the end of 2017, borrowers are certain to require gap financing from the lending community. Many traditional lenders are hoping to cash in on refinancing stable assets and historically solid borrowers rather than taking risk on new debt issuance.



Source: Trepp, LLC

Loans made seven to ten years ago are now terming out. The current market for CMBS issuance, loans that have long been a great source of financing for the hotel industry, has been very quiet of late. The CMBS market peaked at over $200 billion in 2007, but fell below $50 billion in 2015. New risk retention rules for conduit loans are also making it even more difficult for the CMBS markets to pick back up in a significant way.

This will put greater stress on capital available through traditional lenders, making it more difficult for borrowers to find money, likely leading to increased costs for financing. There is also an expectation that the Federal Reserve Bank will raise interest rates further in 2016. Institutional investors have commented to us that they would actually welcome such an increase as a sign by the nation's central bank that the economy is strong enough to absorb such a rate hike.

The constriction in the debt markets will invariably result in decreased transaction activity. While mezzanine debt will help get sales across the finish line, it also leads to an increase in the cost of capital, making it more difficult for larger deals to get done. We expect there to be great opportunities for transactions in the $40 million to $60 million range, but fewer $100+ million deals.

## What's in the construction pipeline?

In the past 12 to 18 months, construction activity has ramped up dramatically, especially in several major markets such as New York, Chicago, Houston and Los Angeles. Supply in such markets is coming in mainly at the full-service level, with properties of 300 rooms and up, with meaningful amounts of meeting space. New supply has also been a factor in other, smaller cities, but new rooms in secondary and tertiary venues come mainly in the form of select service assets of less than 200 keys and little meeting space. STR reports that of the roughly 103,000 rooms now under construction in the U.S., 67% are select service hotels.

In the past, low interest rates coupled with unaccommodated demand have been the impetus for new construction. Thankfully, the industry is now coming more into balance, as construction debt has all but dried up, making it difficult for deals to pencil. This lender driven self-regulation of hotel construction should allow fundamentals to continue to improve in most of the country's markets. It is also important to note that demand for guest rooms continues to exceed new supply across all chain segments. Full-service occupancies are expected to remain above 70% for the foreseeable future.

## What extraneous factors are affecting hotel profitability?

- Wage hikes will continue to squeeze profits. Labor unions have increased their influence during the past several years. Further, several cities across the U.S. are enacting living wage or minimum wage legislation which, in many cases, will lead to increased costs or to layoffs.
- Property tax hikes continue as assessors in many markets have taken a much more aggressive posture of late. Boston, Chicago, New Orleans and Orlando, in particular, are experiencing large tax increases.
- Airbnb and other accommodation-sharing sites have become stealthy disruptors to ADR and occupancy. These services are also often unfairly benefitting by not paying their fair share of sales taxes and bed taxes.
- PIP overreach is hurting investor returns. Hotel brands are delivering challenging PIPs on changes of ownership, with renovations often ranging from $35,000 to $40,000 per key on full service assets.
- Foreign travel continues to drive demand in the U.S., mainly in East and West Coast markets. As airlines increase as seat capacity, more and more visitors from Europe and Asia are spending time here. Brazil may be down for a bit, affecting the Florida leisure market, but they are not out. The results of the Presidential election may yet have an unforeseen impact as well.
- Reduced energy prices have been one of the few welcome surprises to property P&L statements. These lower utility costs are expected to remain with us at least through the end of the year.

## What do you make of hotel investments in Cuba?

While Marriott and Starwood recently announced limited initiatives on the northern end of the island, we believe hotel investment activity in Cuba by U.S. brands will be muted, at best. There are simply better and safer options than Cuba for hotel investors to place their money. The fact that the perceived thaw in diplomatic relations has been one-sided, mainly from the U.S., coupled with the inherent risks of doing business with a communist regime, may continue to render Cuba off-limits for the U.S. hotel industry. There will be more one-off developments or renovations in Cuba but for the most part, investments in other Caribbean nations or on our own soil, present much better opportunities.

## What immediate advice does The Plasencia Group offer to hotel owners and investors?

We expect that the pace of transactions will increase considerably for the balance of the year. What will be missing, in our opinion, are the numerous large portfolio transactions that contributed to the $40 billion in deals recorded in 2015. This will result in lower year-over-year deal volumes at year end. Lack of acquisition financing won't help matters either. Pricing, however, will remain at or above current levels as cap rates plateau.

If you're considering selling a hotel asset because of its non-core profile, fund life issues or simply because you want to get out while the getting is still good, now is a definitely a great time to execute.

While the public markets remain soft, private capital has filled the void nicely. Private equity, which is having difficulty finding yield in other sectors, is turning to the lodging space for their investments.

If you are a buyer, we recommend focusing on two arenas: hotels with historically stable cash-on-cash returns and properties that can be acquired at large discounts to replacement cost. In cycle after cycle, those who acquired low-risk, low-return properties did well over the long-haul. But those who acquired hotels at prices well below replacement fared even better. We can point to dozens of transactions that improved in value by 50% to 100% with this strategy. Additionally, for the trophy buyer with a long term investment horizon, acquiring and retaining an iconic hotel or resort is a sure way to maximize asset preservation. Keep in mind, however, that without a deep pocket or a relationship lender, it may be difficult to finance a large acquisition and repositioning.

## Summary

Investors are not ignoring the risks associated with fluctuating market conditions and tightening debt markets. The recent sluggishness does give pause for concern, but this cycle is a bit different from the last two, at least thus far, as evidenced by the still fairly stable operating performance across the lodging horizon.

We are approaching a murky period where pragmatism and sensible investment strategies carry the day. We encourage investors to maximize their cash positions with timely hotel dispositions. On the buy side, early movers on acquisitions have historically been the biggest winners. At this stage of the real estate cycle, we believe The Plasencia Group can truly add value by employing our laser-focused approach to sourcing capital and relying on decades-long relationships with owners and investors. Do let us know if we may be of assistance with any of your hospitality investment needs, be it a disposition, acquisition, refinancing or asset management.

Finally, we encourage you to write us and let us know what you think about the contents of our Lodging Investment Roadmap. It is always helpful to hear from you on what information is useful, and on which topics we might expound in future issues. Feel free to drop me a note at lplasencia@tpghotels.com. All the best!

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