FALL 2016

LODGING INVESTMENT ROADMAP

September 14, 2016

To our industry friends:

As summer draws to a close, many of us are returning to our daily tasks refreshed, with recent and fond memories of time spent with family and friends over vacation. And as we work toward meeting year-end goals, we again provide our Lodging Investment Roadmap where, in addition to regular commentary on the economy and investment environment, we'll explore how college towns and other cities anchored by universities can prove to be opportune markets for lodging investments.

We hope that the information presented here proves useful to you and your team, and we welcome the opportunity to work with you soon.

What changes are we seeing in economy today?

Since the beginning of 2016, we have experienced a roller coaster ride in stock market swings, erratic data from China, conflicting signals from Federal Reserve Bank regarding rate hikes, and the United Kingdom's vote to leave the European Union. Despite the confusing message from the global economic markets, the U.S. economy has remained resilient. The S&P 500 Index has hit its tenth record high this year, and the Dow Jones Industrial its ninth peak.

In a recent report, PwC quotes Oxford Economics' data which shows that real GDP will increase approximately 1.8 percent for the full 2016 year. As we all know, there is a high correlation between GDP and hotel average daily rates. GDP would be higher were it not for global economic issues such as the United Kingdom's referendum to exit the European Union, the slowdown in China, the continued strength of the U.S. dollar, and continued uncertainty surrounding the upcoming U.S. Presidential election.

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Many economists and analysts are suggesting that the Federal Reserve Bank is moving more confidently toward raising interest rates, possibly as early as this month. And Chair Janet Yellen's recent public comments give credence to that possibility. Given the positive domestic economic momentum, it seems more and more likely that there will be an increase at least before the end of this year. This possible increase in rates, the first since the 25-basis-point hike in December of 2015, would come as the U.S. economy shows signs of stability and as global financial markets have calmed down quite a bit following the United Kingdom's vote to exit the European Union. Yet every time the Fed has raised rates, it has triggered other global economic challenges.

The Fed's efforts are being suppressed by market forces beyond their control. We posit that if the Fed does force up its target interest rate, it could be a temporary move before year end, and it would be symbolically nominal. This bodes well for commercial real estate and for the hospitality sector, as it allows investors to continue to acquire properties with the cost of capital hovering at near all-time lows.

Where are we in this cycle?

One of the comments often heard at lodging industry conferences revolves around the end of this current cycle. Whether the reference is to baseball innings, or a comparison to another sport, especially for those challenged by the nine-inning limit, the fact is that cycles do have beginnings and ends, or we wouldn't have cycles! Based on the conversations we have had with economists, CEOs and CFOs of major global firms, and our tracking of the vast writings on the subject, we believe that a recession is not too far away. However, the question we should probably be asking is: how deep will the next recession be?

At the "end" of the past two up-cycles, the peak rapidly dropped into a deep trough resulting from the 9-11 attacks and, in 2008, by the global financial crisis. These two cycles differed greatly from "natural" cycles, in that they were impacted by external events. The current positive phase of this cycle has lasted nearly 80 months, so it is human nature to expect that things will only get worse, not better, from here. It is our view that this up-cycle is indeed coming to an end, although any trough will be short-lived, and the next upswing is not too far away, likely beginning shortly after a new administration is fully installed in Washington.

We believe that the current growth in room inventory is unlikely to cause any major nation-wide disruption, as has been the case in previous cycles. Simply put, the current increase in new construction has, in large part, been limited to the select service arena, and to a limited number of markets. Further, the number of new hotels being built across the U.S. with more than 50 square feet of meeting space per room is down to a handful. Further, Smith Travel Research projects that supply growth across the country will peak at 2.5% in 2018. This represents far fewer new rooms than in past cycles. Markets with strong operation fundamentals should weather the new supply storm fairly easily.

But perhaps the factor that will most come into play in keeping supply in check is the lack of available construction financing. Learning from past mistakes, lenders have been very cautious with the amount of funds they have allocated to new-builds, and their underwriting criteria has been rigorous. Some developers resorted to using EB-5 funding to finance their projects, but even this source has now all but dried up.

These factors, coupled with significant increases in the cost of construction labor, have made it extremely difficult to justify any major hotel or resort developments. So long as new supply remains muted, and interest rates remain low, the lodging industry will continue to perform well. The landscape for hotel investments continues to be positive for the time being. With the supply pipeline still below previous cycles, and displaying strong fundamentals buoyed by the consumer and business sectors, the lodging industry appears well poised to weather any potential downturn.

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What is happening in the lodging transaction arena?

Transaction volume for individual sales thus far this year is down when compared to the same period in 2015. While overall volume is down, sale prices, on a per-key basis, have held up fairly well as compared to the same time last year. Capitalization rates have remained flat or even higher in some markets, especially those with heavy additions to supply. So as net operating incomes have continued to rise in many cities, sale pricing has not matched that pace, resulting in flat to increased cap rates. Unless the Fed hits the market with a hefty increase in interest rates, we expect that trend to change slightly, with improvement in deal volume and possibly a decrease in cap rates as the year progresses.

We base our opinion on the fact that the number of markets that have experienced negative RevPAR growth remains much lower than the number in decline in previous cycles. Further, domestic private equity firms as well as foreign sources of capital continue to invest in the higher-yielding lodging sector, having a positive impact on transaction metrics. These two sources of investment capital have accounted for the vast majority of hotel transactions thus far in 2016. With the economic and political turmoil in many overseas markets, foreign capital will likely continue to flow unabated into U.S. commercial real estate. We have also seen a slight increase in acquisition activity from the REIT sector, although we do not expect any meaningful return of REIT capital to the marketplace in the foreseeable future. The one element that continues to be missing from this portion of the cycle is the lack of major portfolio transactions. Unlike previous phases of the typical economic rotation, this cycle has experienced a dearth of larger multi-property transactions that have traditionally served to boost deal volume statistics.

What challenges and opportunities lie ahead?

We are often asked our opinion on those markets which present the most challenges as well as the ones offering the best opportunities in which to invest. Here are our top five in each category:

Challenged Markets
Nothing new here. Most of these markets suffer from the greatest number of new rooms being added to inventory. In the case of Houston and Miami, they have experienced a "double whammy" of energy declines and Zika, respectively.

1. **Houston** – The decline of the energy sector and an inordinate increase in room inventory continue to haunt the city's progressive remake.
2. **Miami** – The inbound flow of capital from Latin American investors has slowed dramatically, while Zika virus cases have increased.
3. **Chicago** – New supply and safety concerns have captured the headlines. Many expect local property owners will see exorbitant increases in property taxes as Mayor Emanuel's administration looks for ways to address the city's financial morass.
4. **New York** – Significant declines in RevPAR, resulting mainly from significant increases in the number of new rooms, have taken their toll on what has historically been a very resilient market.
5. **Los Angeles** – Several submarkets in the Los Angeles Basin are seeing new rooms enter the market, but none more than the downtown area which will see over 3,000 new rooms in the near term. Other than Beverly Hills, most submarkets have been challenged to grow rate and occupancy.

Opportunistic Markets
Several markets continue to see excellent increases in rate growth and supply remains muted. Investors will find the greatest upside in these areas.

1. **Tampa/St. Petersburg** – The Tampa Bay region consistently continues to claim some of the highest RevPAR numbers in the country. Demand continues to increase while supply growth has thus far been muted.
2. **Boston** – Solid demand growth and comparatively few new rooms have allowed Boston and most of its submarkets to regularly remain at or near the top of STR's performance tables.
3. **Seattle** – While the market has seen its share of new rooms, construction has now slowed while rate and demand continue to rise. The performance of Seattle's CBD is particularly strong. Transaction pricing remains solid.
4. **Charlotte** – With its access from several key markets, Southern charm, and controlled supply growth, Charlotte continues to attract a strong leisure and business base. The city's international hub airport provides an attribute that is hard to match.
5. **Savannah** – Very strong weekend occupancy, virtually year-round, and a romantic and walkable historic district, Savannah is poised for strong growth now in its group segment.

What can be done to minimize the effects of Zika virus on the industry?

The media's reporting on the Zika virus evokes memories of SARS or the bird flu, although its effects have thus far been very contained. Here are some interesting facts about the Zika virus:

Zika Virus Facts

- According to the *Wall Street Journal*, **Zika was identified in Uganda in 1947**. It spread into Latin America since its arrival in Brazil in 2014 before making its way north.
- As of August 24th, the Centers for Disease Control's (CDC) narrow travel notice advises women who are pregnant or couples thinking of becoming pregnant to **avoid unnecessary travel only to the 0.5-square-mile section of the Wynwood neighborhood** north of downtown Miami and a one-square-mile section of the Greater Miami area.
- Dr. Tom Frieden, Director of the CDC, recently stated that, **"At the present time, there is no need for the travel advisory to be broader than this specific Zika-affected area."** The virus spreads most easily in crowded settings where people don't have access to air conditioning or window screens, and where there are large numbers of Aedes aegypti mosquitoes.
- Frieden also stated that the **Zika-carrying mosquito only travels less than 200 yards in its lifetime**, and its lifespan is typically about 40 days.
- In an August 21st interview, Dr. Anthony Fauci, Director of the National Institute of Allergy and Infectious Diseases, said "**I do not think, although we need to be prepared for it, that we're going to see a diffuse, broad outbreak in the United States** because of a number of issues, particularly the conditions in our country ... that would not really make that a very likely happening."
- Researchers at the University of Florida recently questioned 828 people nationwide about the Zika virus. All had already planned to visit the state within the next six months. **Most of the visitors to Florida seem undeterred by Zika**, as more than 70 percent said they were concerned about the virus, but less than 10 percent of those with concerns changed their travel plans.

We provide the following proactive suggestions to hoteliers and hotel owners, particularly those with hotels in Florida, in an effort to create awareness among guests, and also to protect themselves:

- Take proactive measures to cover or eliminate containers or areas that would normally collect or retain water and serve as mosquito breeding areas. Abatement is the first step.
- Make insect repellent freely available to guests, should they want it.
- Direct guests and employees to information such as that found on the CDC website, to help to build protective behaviors.
- Verify and strengthen barriers such as screen doors, positive air pressure and other preventive impediments to keep insects from entering buildings.
- History tells us that United States, and Florida in particular, is uniquely equipped and experienced to successfully manage difficult situations, from natural disasters to public health challenges such as Zika. Fortunately, the rainy season is almost over for the southeastern U.S. The damp humid days of summer will soon give way to cooler, insectless days and nights. The more pleasant weather will go a long way to relieving Zika fears.

What should you know about ad valorem property tax assessments?

Our experience as asset managers of hotels from California to Florida tells us that more and more municipalities around the country will continue to shift the brunt of local ad valorem property tax assessments to commercial properties (typically owned by out of town entities). Many in the hotel industry are talking about ad valorem taxes becoming one of the greatest challenges creeping up on owners and operators with more regularity. Typically, in the third quarter of each year, owners will receive proposed reassessments to their hotels' valuation from local tax assessors. With very few exceptions in cities such as New York and Houston, we expect a continued trend of increases in assessments as cities cope with major budget deficits.

Any owner contemplating a sale or refinancing will likely be impacted and buyer or lender underwriting will be affected. For transactions on the horizon for 2017, owners should keep in mind the possible increase in assessed values at change of ownership. There are ways to mitigate increases in assessments, including the obvious appeal process or the allocation of personal property (vs. real estate) as a greater portion of the hotel's value. Additionally, cost segregation studies, where certain costs previously classified as subject to a 39-year depreciable life can instead be classified as personal property or land improvements, thereby allowing a possible switch to accelerated depreciation methods. Being alert to such ad valorem tax increases has allowed us to successfully appeal increased assessments in property taxes – a critical effort especially when hotels and resorts change hands.

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COLLEGE TOWN, U.S.A.

We are frequently asked by the hospitality investment community for our take on which hospitality markets make for sound investments. Of course, there are a wide variety of such locations, our hometown of Tampa among them, but we have found that one particular type of market checks many of the boxes for investors today: hotels located in college or university anchored markets. For hoteliers, proximity to a college campus offers much more than idyllic memories of glory days gone by:

- **College markets are growth markets.** By 2025, the U.S. Department of Education projects total undergraduate enrollment of 19.8 million, an increase of 50% since 2000. Universities have grown commensurately to satisfy this increased demand, in part by increasing their physical footprint and expanding faculty. Hoteliers in such markets will continue to benefit not only from the direct population growth, but also from the indirect growth in the market spun off by a university's presence.
- **College markets generate consistent demand.** From student move-ins at the beginning of the academic year to graduations and reunions at the end of it, colleges originate a wide variety of room night-generating events. Sporting events in particular can justify room night minimums and sky-high ADRs at 100% occupancy levels. These events are usually scheduled well in advance and occur on a consistent basis, providing for clarity in the budgeting process. Due to the proliferation of summer classes and programs, demand is often relatively consistent year round. Campus-related demand generators have the added benefit of being unusually well insulated from the vagaries of broader economic cycles.

- **College markets foster strong culture.** These markets are known for their culture, arts and diversity, and they typically radiate a strong sense of place. These vibrant settings, with their restaurants, nightlife and walkability, are ideal locations for hotels, and they allow prudent hoteliers to seamlessly combine the surrounding community's unique feel with that of their property.
- **College markets catalyze innovation in a strong workforce.** Lured by educated workforces, high levels of on-campus R&D and a strong quality of life, industry is making a home in college markets now more than ever. The accompanying infusion of private capital and talent are a boon to the local economy and create quantifiable demand for hotel room product.
- **College markets capture public investment.** Investment from both state governments and the federal government also makes its way to college markets, predominantly in the form of financial aid, subsidies and grants. This steady and significant flow of dollars provides stability during periods of slow economic growth and complements private investment during periods of prosperity. As a result, hotels in university markets are viewed as less susceptible to national or even regional economic downturns.

Our firm has recently facilitated hotel transactions in college-oriented locales such as Gainesville, Florida; Columbus, Ohio; Baton Rouge, Louisiana; and Richmond, Virginia, among others. These markets are diverse geographically, but across the board we found strong interest from the entire spectrum of the hospitality investment universe. As a result of this strong demand, we were able to generate attractive offers on each asset.

If you are considering buying or selling an asset in a college market, please call on us. We are in constant communication with the key players for these assets, and we are confident in our ability to achieve a successful outcome on your behalf.

Lodging Investment Roadmap 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 seems a bit different from the last two, at least thus far, as evidenced by the still fairly stable operating performance of hotels, across the entire 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 with a disposition, acquisition, refinancing or asset management situation.

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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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