THE PLASENCIA GROUP
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Q1 2017

LODGING INVESTMENT ROADMAP

January 31, 2017

To our clients and industry friends:

The U.S. economy generally and the lodging sector specifically closed out 2016 on firm footing. While a number of challenges remain, we head into 2017 with a positive, bullish outlook. We hope that you will find the information and commentary on the economy and lodging investment environment in this issue useful. Should you have any questions or feedback, please don't hesitate to contact us.

What can the lodging industry expect from the new Trump administration?

The effects of the presidential election on the lodging industry are still playing out, but many executives in the real estate community believe that having a hotel developer and one of their own as president is a good thing. Usually, at past hotel industry conferences such as ALIS or NYU, a phrase often heard has been "cautious optimism." That is again the case, coming away from the ALIS conference in Los Angeles. No matter which side of the aisle one may be on, the capriciousness exhibited by the new Trump administration, and indeed by the president himself, is causing many to tread cautiously. That said, most real estate and hotel executives with whom we have had candid conversations feel the country's economy is moving in the right direction given the emphasis on growing domestic manufacturing, easing the regulatory environment, and addressing those issues that have taken their toll on labor costs.

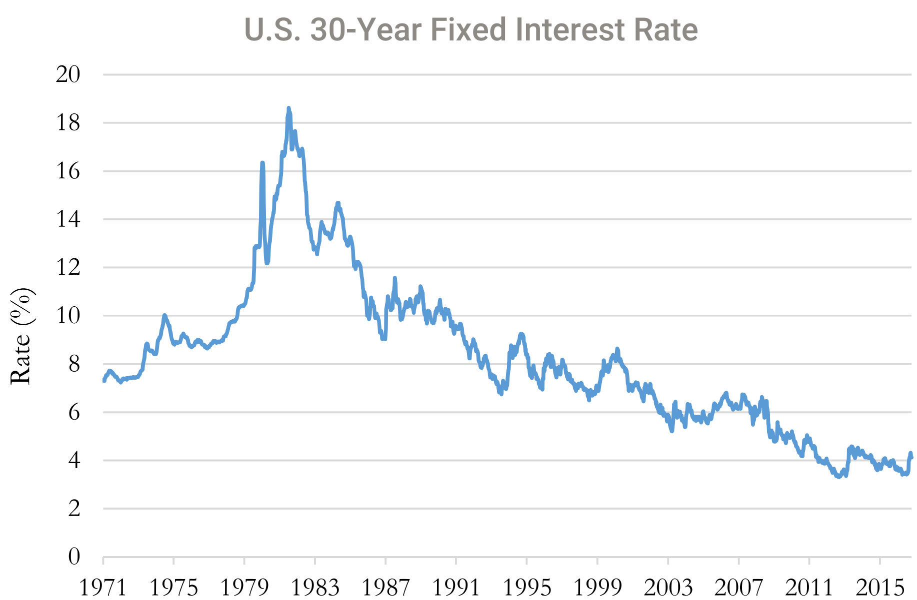
Several factors are contributing to the new buoyancy. U.S. stocks have now advanced for eight straight calendar years and have rallied since the presidential election. Bond prices have dropped in recent months, and yields have risen amid the anticipation of faster economic growth, higher inflation, and further hikes in short-term rates by the Federal Reserve. Moreover, company fundamentals, rather than election results, may be the more influential factor driving the positive stock market rally. Corporate coffers are cash rich and could benefit further from changes in tax policy that would allow repatriation of overseas profits. These companies are now aggressively hiring new employees. All in all, there are few signs, if any, of speed bumps in the foreseeable future that would pose challenges to the current economic growth trend. In fact, we may have already waived off a recessionary period altogether in this cycle. If the U.S. does experience two quarters of negative economic growth, the landing should be soft.

We believe most commercial real estate investors will continue to respond positively to the notion of less government regulation, fiscal stimulus through infrastructure spending and long-awaited tax reform. In general, we find the industry's mood to be more optimistic than a year ago, notwithstanding the more overt cautious sentiment.

Most real estate and hotel executives feel the economy is moving in the right direction given the emphasis on growing manufacturing, the easing of the regulatory environment, and taking on those factors that have taken their toll on labor costs.

What do increasing interest rates mean for the economy?

The Federal Reserve Bank has suggested it will raise the federal funds rate three times in 2017. This prediction also calls for three more rate bumps in both 2018 and 2019. These increases accompany the rate hike that already took place in December 2016. The Fed's stance on raising rates now and into the near future is a signal that the U.S. economy is improving, and no longer needs the central bank to support below-average interest rates. Increases in the federal funds rate however, likely mean an eventual increase in short-term interest rates. We also expect hotel development in the U.S. to become more difficult to finance as higher rates impact investor returns and add to project cost. And based on history, the rate increases by the Fed will inevitably impact other countries negatively.



How will new room supply affect hotel performance in 2017?

The introduction of new supply, coupled with slowing demand growth, will have a downward effect on occupancy throughout 2017.

The lodging industry is becoming more resigned to the fact that supply growth will grow beyond the long-term industry average of about 2.0%, at least through 2018. This would represent the highest level of supply growth since 2009. The introduction of new supply, coupled with slowing demand growth, will invariably have a downward effect on occupancy throughout 2017 and into 2018. The decrease in occupancy will be most pronounced in suburban markets that are suffering from abnormally high increases in supply due to lower development costs. These increases in inventory may also result in very weak RevPAR growth, driven almost entirely by demand.

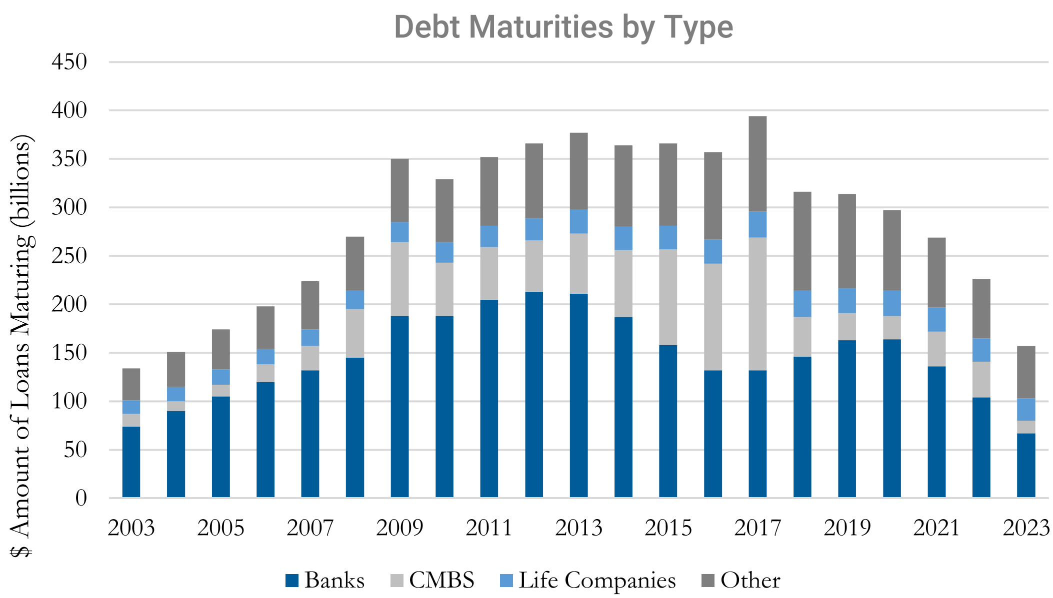
There will be several markets such as Chicago, Dallas, Houston and New York, that will continue to be challenged by new hotel additions. However, the good news is that supply growth is expected to slow down by 2018 at or near the long-term average. This deceleration in growth will help to avoid a spike in inventory similar to the previous cycle in 2009, when supply growth reached a dangerous level of 2.8%. Elevated labor costs for developers, increases in the cost of capital, and "stealth" supply from Airbnb will combine to keep supply in check.

What will be the impact of the record amount of CMBS debt set to mature this year?

An item to keep an eye on through the beginning of 2017 is the so-called "Wall of Maturities." This wall has been created in large part by the $230 billion of CMBS loans that were originated beginning in 2007, with a large part of these being 10-year loans. Approximately $262 billion of non-bank issued commercial real estate loans are scheduled to mature in 2017. Over half of this debt is of the CMBS variety.

This increase in CMBS debt maturing in 2017 will create an above normal rate of maturity defaults. Of the $262 billion in maturities, approximately 10% percent consists of hotel loans. Despite an increased default rate, we expect that there will continue to be enough liquidity in the market to accommodate the refinancing of the remaining performing loans. Additionally, it is estimated that there will be between $65 billion and $75 billion of new CMBS debt being issued in 2017.

With newfound ease in performing a disposition, we believe there will be an increase in properties on the market by this time next year.



Loans with very low loan-to-value (LTV) ratios will be refinanced with new allocations from life insurance companies as well as by banks seeking to earn more than the federal funds rate. Loans with higher LTVs will be refinanced with the aid of mezzanine financing. Those with even higher LTVs that cannot be refinanced at par, but still have a LTV of less than 100%, will receive equity infusions or will be sold. We believe there will be a modest increase in the number of hotels on the market by this time next year resulting from CMBS defaults.

How will risk retention policies affect CMBS lending?

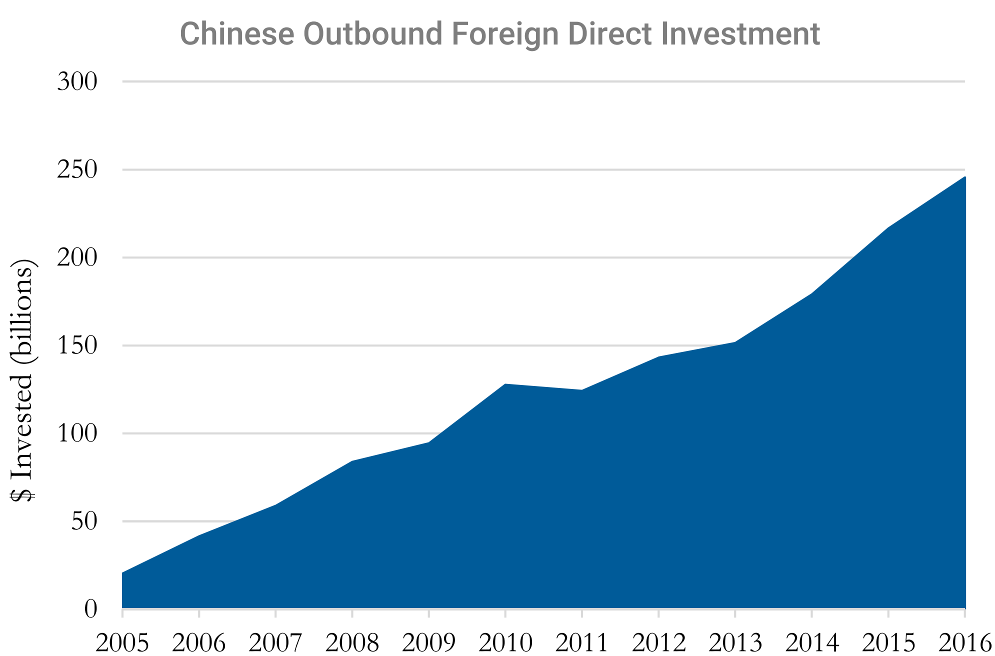
On December 24, 2016, the new CMBS risk retention policies associated with Dodd-Frank kicked in for domestic lenders, while foreign capital sources will be subject to Basel III. Lenders will now have to retain a meaningful portion of the credit risk of any debt they issue. This risk can be apportioned in different ways, but despite this, it is expected that the new retention practices will result in CMBS spreads rising by 20-50 basis points.

Lenders are expected to have higher loan quality now that they have skin in the game, but there is a concern among investors that lending capacity will not meet demand. As an example, having to retain a 5% strip in every CMBS loan issued will inevitably cause downward pressure on the volume of CMBS loans that are originated. This is an issue with the largest year for CMBS maturities, 2017, starting a week after this new requirement was instated. As a result of the implementation of "RegAB" at the beginning of this year (requiring executives to be personally liable for CMBS disclosures) and new risk retention requirements, approximately 20-25% of the securitized lenders that were open at the beginning of 2016 are now closed.

Not being able to adequately meet CMBS refinancing demands will cause capacity pressure on non-CMBS loans, which in turn may create capital shortages in the next year or two. These capital shortages may hinder commercial development, as well as create upward pressure on the number of hotels and other commercial properties for sale.

What is the outlook for Chinese investment in U.S. real estate?

Chinese investment in hotels for 2017 looks to be weaker, in comparison to 2016. Last year Chinese foreign outbound direct investment was nearly $250 billion. With over a decade of increasing foreign outbound direct investment, China's State Council, the country's most powerful government body, sent a notice in December to all departments of the government, likely resulting from the many high-profile hospitality transactions that took place in 2016. The government will now need to directly approve all foreign acquisitions over a certain size. This edict immediately caused a decline in investment activity. The notice also required each department to cease foreign real estate purchases of more than $1 billion using state-owned enterprises. This is not the first time these rules have been put into place, but it is believed by many that they will be more strongly enforced going forward. Economists at the Chinese Academy of Social Sciences, a research organization affiliated with China's State Council, believe that China's outbound foreign direct investment will drop to 2015 levels due to these regulations.



The stepped-up oversight comes as China is seeking to clamp down on the outflow of capital from the country, which hit a new high in October 2016. However, Chinese investors and companies continue to push for overseas diversification into other currencies, and the lodging sector will remain a huge beneficiary of this flow of Chinese capital.

What does the lodging investment landscape look like?

Hotel REITs started out 2016 with a whimper but finished the year with a bang, posting a healthy 25 percent total return for the year. Lodging REITs well outperformed other asset class REITs, with a quarter-over-quarter increase of over 15 percent while the broader REIT sector dropped 0.5 percent. Hotel REITs have historically been viewed more favorably when there is an increase in interest rates. Additionally, lodging REITs tend to be more sensitive to fluctuations in the equity markets and are highly favored by real estate investors with exposure to interest-rate risk in their portfolios. Stock valuations for public hotel companies portend a significant rebound in fundamentals for 2017. REITs are already very active buyers early in the year, with several properties under contract. This bodes well for sellers of hotels, as REITs have historically had a major impact in setting pricing velocity in previous cycles.

At this point in time, there are certainly more buyers than sellers, with abundant capital flows seeking everything from stabilized properties to deep turn-around opportunities. There seem to be various "buckets of money" ready to flow into virtually all types of investments. Life insurers, private equity and high-net-worth investors are all active. Sourcing debt for acquisitions has not been a problem, which is not the case for new construction. The bid-ask gap is closing as sellers recognize the opportunity to sell late in the cycle. Although interest rates have gone up, the increase has not affected cap rates as they remain flat across most markets and hotel segments.

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Where do we see opportunities?

The contrarian play is to acquire in markets that have had strong supply growth, but which have already experienced absorption. Examples of such markets include New York City, Houston and Miami. We suggest proceeding with caution as these markets still have a way to go. Several other markets present excellent prospects. These include:

- Louisville, Kentucky
- Charlotte, North Carolina
- Boston, Massachusetts
- Washington, D.C.
- Tampa/St. Petersburg, Florida

Perhaps the greatest opportunities are the failed transactions and "busted deals" of 2016. Several REITs and private equity firms attempted to sell assets last year but were unsuccessful. Those properties remain on their disposition horizon and will be the first to go in 2017. Full service hotels, especially those offering a repositioning opportunity, offer tremendous potential for patient investors.

Lodging Investment Roadmap Summary

As we've commentated over the past few quarters, this market cycle has been different from the last two, with lodging investors enjoying relatively stable operating performance despite fluctuating market conditions and tightening debt parameters. The presidential election has undoubtedly infused a dose of confidence into the lodging sector and indeed commercial real estate as a whole. We expect transaction activity to pick up during the first half of 2017.

Should you consider a hotel disposition or refinancing, we welcome the opportunity to assist you. We are pleased to say that The Plasencia Group completed almost nine out of ten engagements successfully in 2016, resulting in one of the highest closing ratios in the industry. Similarly, if you seek to generate incremental value from an asset you intend to hold, our asset management team has proven its ability to pay for itself by quickly delivering meaningful bottom line returns.

When it comes to the buy side, bid processes have been more competitive given that there are fewer quality assets on the market today. Nevertheless, we continue to be approached by a number of foreign and domestic capital sources seeking to immediately acquire hotels. We can add value to the sale of your lodging assets by attracting capital utilizing our relationships with these investors and lenders.

As always, please do give us a call if we may be of assistance in implementing your investment strategy this year, whether it be with a disposition, acquisition, financing or refinancing, or consulting. We wish you and your firm all the best through the remainder of the first quarter and beyond, and we welcome the opportunity to work with you soon!

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