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Q2 2017
LODGING INVESTMENT ROADMAP

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To our clients and industry friends:

In the first five months of 2017, we've seen promising signs of growth in the lodging investment arena. Values continue to climb and deals continue to be transacted at a healthy pace. We believe that will be very evident at the upcoming NYU Hospitality Investment Conference. In this issue of the Lodging Investment Roadmap, we share our answers to some of the questions we've received from clients and peers over the last quarter. We welcome the opportunity to discuss your thoughts and questions on lodging investments. Please contact us anytime.

What have been the economic effects of the Trump presidency?

In our last issue looked at what the lodging industry might expect from the Trump administration, and recently the news stream in the U.S. has been awash with happenings in Washington over the course of President Trump's first 100+ days in office. Some of that news has affected the financial world, but generally the markets have remained on the solid footing rebuilt over the last several years. In fact, U.S. stocks have rallied since the U.S. presidential election and have now advanced for eight straight calendar years. 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.

Thus far, real estate investors have responded positively to the possibility of less government regulation, fiscal stimuli (including infrastructure spending) and tax reform. All in all, there are few signs, if any, of evident speed bumps in the foreseeable future that would pose challenges to the current economic growth trend.

The Trump presidency seems to be having a positive effect on international markets as well. According to the World Bank's latest Global Economic Prospects report, the global economy is expected to expand 2.7% this year, recovering from a post-crisis low in 2016, thanks to rising commodity prices and announced stimulus plans in key major economies.

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Are other factors driving the stock market rally?

Solid corporate fundamentals, rather than the 2016 election results, may be what is actually driving the positive stock market rally. U.S. corporate profits have rebounded strongly since last November's presidential election, although the lodging industry has yet to experience any meaningful flow-through of those profits to its bottom line. Company coffers are cash rich, and could benefit further from changes in tax policy that would allow repatriation of overseas profits.

Hoteliers expect that corporate transient travel and corporate meetings will grow as U.S. companies get back to the business of growing their businesses. The operators we speak with feel confident about the second half of 2017, with both corporate group and corporate transient indicators in the green. Recent public company earnings calls validate this upbeat perspective.

Thus far this year, RevPAR continues to grow across most markets, albeit at a much more subdued pace than the same period last year. Almost all of the growth in RevPAR has come from ADR increases, with occupancy levels remaining virtually flat or dropping. If transient and group demand from the corporate segment accelerates for the balance of 2017, as expected, hotel profits will benefit dramatically. Higher-end hotels, especially those in STR's Luxury and Upper Upscale sectors, will likely be the greatest beneficiary.

The types of hotels that are struggling most right now seem to be resort properties and those in heavy leisure destinations. The strong dollar and border controls may be to blame. Foreign travelers may not be able to afford their annual trek to the U.S., while Americans are taking advantage of the "bargains" found in many overseas markets. This dynamic has certainly impacted heavy leisure destinations such as Florida and California in early 2017. Further, there is anecdotal evidence that some groups are relocating their conventions to non-U.S. venues out of concern for their international attendees. This is mainly impacting major gateway markets such as New York, Los Angeles and Miami. In total, international visitors presently account for about 6% of total U.S. room demand.

What will the impact of rising interest rates be?

Confidence levels at the Federal Reserve Bank have been buoyed significantly in the past 12 months, notwithstanding global challenges. Consumer confidence has improved in the U.S., resulting in steady growth in retail sales. The labor market has also tightened, providing further support to the notion that the nation's economy is on solid footing. The Fed's rate increases have definitely impacted commercial real estate transactions, particularly the lodging sector. But for now, at least, investor valuations seem unaffected, as historic inflow of capital and excellent market liquidity has supported strong property valuations. While there is a high correlation between interest rates and cap rates, our review of larger transactions for the past 18 months shows a very stable trend in cap rates, virtually untouched by the Fed's actions.

We expect at least two more rate increases by the Federal Reserve Bank in 2017. Strong confidence in the economy, combined with rising fiscal stimuli and tax cuts, could accelerate economic expansion and cause the Fed to yet raise rates more aggressively. Players in the commercial real estate arena are already factoring further bumps in interest rates into their underwriting. We expect transaction volume to pick up in the second half of 2017, once there is more clarity from Washington on the administration's fiscal and tax policies.

Have challenges in the labor market changed?

Even before November election, there has been a lot of conversation about the impact of deportation threats across the lodging sector. Employees are naturally nervous – concerned that agents may show up at the workplace to deport them. To date, however, the industry's challenges with filling staffing needs has not gotten any worse, although marked slowdown of inbound foreign nationals to the U.S. may not yet have manifested itself. The challenges faced by operators to fill housekeeping and F&B positions have not changed much since the election, nor have hiring practices. Hopefully, the message has gotten through to Washington that these are valued employees who are needed to keep the nation's hotels and other businesses running. Interestingly, one seasoned operator commented that this is one of those rare occurrences when being a union hotel may actually be a benefit to owners and operators, since the unions tend to support the hiring of legal workers.

The age-old question: is it a buyer's or seller's market?

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Real estate investment funds faced a serious challenge with their investment goals in 2016, and it has carried into this year. According to *The Wall Street Journal*, major U.S. private equity houses had nearly $240B of dry powder set aside for investment purposes last year, but virtually no place to put it. Their dilemma becomes even more acute as a larger number of sovereign wealth funds and foreign pension funds continue to seek U.S. hard assets. Their flight to quality and safety means a significant amount this foreign capital is being invested directly or through private equity proxies. *The Financial Times* reports that last year alone, investors from abroad acquired $48.5B of U.S. real estate, an increase of nearly 8.0% from the last peak in 2007. Nearly 50% of those funds went into hotel acquisitions. With so much capital coming into the U.S., there continues to be a dearth of big-dollar, quality hotel assets available for acquisition. Any owner of a hotel in a Top 25 market, especially one where an investor can place $75M or $100M in equity, will be sure to draw top tier investors and pricing. We believe the pendulum has shifted; it is now definitely a seller's market.

Is new supply a concern?

The lodging industry is going through a period of supply expansion at the moment, but that growth in inventory is fairly conservative in comparison to previous cycles. At the peak of the last cycle, in 2009, new rooms were being added at an annual rate equal to 2.8% of the then-existing available inventory. Demand for rooms at that time was a negative 6.2%! According to PwC, supply is expected to peak at 2.0% in 2017, while demand growth is expected to increase by 2.1%. Much of the new room supply has been added in the select service segment where properties are much more easily financed, often by local or regional lenders. There are literally hundreds of new hotel projects on the drawing boards across the U.S.; however, most will not come to fruition any time soon. The majority of these new developments have not been funded or financed. On the debt side, in particular, we see lenders growing much more conservative given the new Basel III bank reserve requirements. Additionally, CMBS risk retention requirements, imposed by the Dodd–Frank Wall Street Reform and Consumer Protection Act, went into effect in 2016 and will continue to affect the industry.

What should I know about investing in Cuba?

As the Obama administration opened the doors to Cuba last summer, the expectation was that U.S. dollars would soon be flowing freely into the long-forbidden destination. Now, U.S. airlines that had recently jostled for limited flight routes into the island have dramatically pulled back. Bloomberg reported that American Airlines cut its daily flights to Cuba by 25% and switched to smaller jets on many routes. JetBlue also downsized its planes due to lower-than-expected demand. Silver Airways has now suspended all its Cuba service while Frontier Airlines is canceling its Miami-Havana route due to higher-than-anticipated costs and lower-than-expected demand. "Market conditions have failed to materialize there, and excess capacity has been allocated to the Florida-Cuba market," the airline reported.

The renewed interest in Cuba led to immediate inflation (as much as 400 percent) for the island's state-run hotels, ground transportation services and even local *paladares*, the private, family-run restaurants that dot the island.

Why is the Cuban rum not flowing so freely? American visitors are realizing that "normalization" may only be one-sided. U.S. tourists visiting the island with high hopes have found that the infrastructure they expect just isn't up to par. The renewed interest in Cuba led to immediate inflation (as much as 400%) for the island's state-run hotels, ground transportation services and even local *paladares*, the private, family-run restaurants that dot the island. Hotel rooms in Cuba are now running at prices comparable to those during U.N. Week in New York City!

Many Americans have quickly learned, in whispered conversations with their humble Cuban hosts, that freedom of expression and self-determination come at a high price – and continue to be considered crimes against the state. Prices and politics have become the main deterrents to a promising and well-intentioned venture. In an effort to make a statement to the Castro regime, it is likely that the Trump administration will soon wipe away many of the one-sided Obama initiatives. There is a plethora of other welcoming Caribbean venues, such as the Dominican Republic, the U.S.- and British Virgin Islands, where freedom and democracy are as reasonable as the lodging rates. For now, Cuba remains as distant as ever on the competitive landscape.

Lodging Investment Roadmap Summary

The only constant is change is an adage that holds true today, and we expect that to continue to be the case in the coming months. We've observed REITs reentering the market with purchases of trophy assets in some cases, which is an indicator that the lodging investment sector stands on solid footing. While dynamics will continue to shift within individual geographic markets, we expect strong performance generally through the second half of 2017.

For those attending the NYU conference next week, we look forward to seeing you there. Please contact a member of our team if you'd like to discuss your portfolio or select investment opportunities while we're in New York.

Otherwise, we're pleased to of service to institutional and independent investors alike when it comes to helping them achieve their goals, whether it means leading a disposition, acquisition, financing or refinancing, asset management or strategic consulting. We wish you all the best through the summer months and into what promises to be an exciting second half of the year!

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