SPRING 2018

LODGING INVESTMENT ROADMAP

April 18, 2018

To our clients and industry friends:

In our last *Roadmap*, issued in the Fall of 2017, we commented on the highly anticipated tax reform package that was winding its way through Congress. Once the package passed, there seemed to be a clearer path to continued profitability for the U.S. hospitality industry, only to be muddied by the Trump administration's latest position on proposed tariffs on imported aluminum and steel. The lodging sector continues its "slow but steady" positive trend well into 2018. Hotel owners and operators have now had the pleasure of experiencing eight consecutive years of uninterrupted RevPAR growth. The industry is currently experiencing its highest occupancy levels since 1981. All signs currently point to this trend continuing for the foreseeable future, and the pace may actually pick up as the industry benefits from the tax stimulus and improving economy.

We invite you to continue reading for more of The Plasencia Group's perspective on where things stand in the lodging investment environment.

How is the broader economy impacting hotels?

Economists expect the recently enacted tax cuts and the spending bill to give a significant boost to the gross domestic product growth rate, particularly for the next two years. The tax reform means businesses and consumers will keep more profits. This, in turn, is anticipated to spur demand for equipment and other goods, as well as manufacturing and R&D. Many expect the stimulus to generate increased room nights as companies ramp up their related marketing and travel spending. Economists widely expect that the long-awaited tax package could permanently raise the economy's supply capacity by increasing the number of workers and their productivity. As an example, Apple announced it would be creating twenty thousand new jobs in the U.S., and it is being joined by many other companies such as Boeing, Caterpillar, and others.

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The *Wall Street Journal* reports that the decrease in the corporate tax rate will also prompt investment and hiring by businesses. Factors such as lower individual tax rates and fewer breaks for households that are designed make the economy more efficient will put more money into people's pockets. Additionally, the changes in tax laws governing profits earned abroad should let U.S. corporations repatriate funds they have thus far kept in overseas accounts, virtually eliminating the need for the inversions we have read so much about over the last decade.

The economic momentum resulting from the changes in the U.S. tax system last December and the recently passed Congressional spending bill may now be muted by the recently announced plans to impose trade tariffs. For the most part, however, it seems one of the world's most stringent tax codes still has the potential to become one of the most stimulating.

What does the scene look like for lodging operating performance in early 2018?

The wage increases, bonuses, and tax cuts that have made their way into Americans' wallets have had an almost immediate effect on the lodging sector. The greatest impact has been to the Leisure Transient segment which has meaningfully boosted room night demand. The effect of the tax reform package has been more sluggish when impacting demand in the Corporate segment, but it is expected to pick up in the second half of 2018. Additionally, the national defense spending package that was also approved by Congress is expected to generate increased demand for hotels from defense-related companies.

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The one area in which hotel operators have been stymied is that of increasing expense loads. A clear majority of hotels across the U.S. are experiencing surging labor and insurance costs, as well increasing property tax assessments. With the improving national economy, profit margins will continue to increase, but revenue is flowing less freely to the bottom line as revenue dollars are having to percolate through the filter of mostly "uncontrollable" expenses.

Has there been much change in the debt markets?

We have previously written quite a bit about the availability of debt flowing into the lodging sector. At present, investors seeking to place senior mortgages on acquisitions are finding an ample supply of lenders offering reasonable interest rates and terms. Providers of debt have raised huge sums of capital, but are having difficulty putting it out as deal volume remains subdued. Many veteran hotel investors believe there has never been a better time to be a borrower, in virtually any segment of the hotel industry.

We continue to see low rates for acquisition financing, ranging from 4.50% to 5.25%, depending on the strength of the sponsor and the condition of the asset. However, officials at the Federal Reserve Bank have signaled that the enacted tax cut may be boosting demand without increasing the economy's supply capacity. As such, we could see the Fed raise interest rates more aggressively than planned to avoid a substantial pickup in inflation. The economic backdrop already has the market projecting three or four Fed rate bumps in 2018.

While a lender may be aggressive in placing acquisition and refinancing debt for existing properties, it won't be as easy for a developer to secure debt funding for new-build hotels unless that developer already has a strong relationship with a financier. Further, most construction lenders won't touch a hotel unless it is affiliated with one of the major lodging brands. Coupled with construction costs that are up 25% to 30% over just a few years ago, tight construction financing will continue to keep the possibility of rampant new inventory in check for the foreseeable future.

How would we describe the lodging investment arena?

A number of investors that have previously been on the sidelines having been coming off the bench in 2018. In past cycles, REITs and Private Equity firms have been the most aggressive buyers. Today, REITs remain active, but in a much more measured way. Private Equity is taking a much less active posture with lodging. Hotel investments by PE firms are nowhere near the pace seen in prior expanding cycles. Most are worried that "late in the cycle" investments are not wise. With 96 months of continued RevPAR growth as of the end of February, their challenge may be that "late in the cycle" has proven to not be so late. Those who passed on investment opportunities two years ago because they thought they were late to the game are now lamenting that decision. The longest RevPAR growth stretch was 111 months, from the early 90s through the early 2000s. While we are quickly approaching that milestone, few see anything on the horizon that would keep the industry from surpassing that benchmark.

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While REIT and Private Equity investment in hotels and resorts has been more muted of late, we have been surprised at the makeup of buyers entering the hotel investment arena, many for the first time. Since late in 2017, and now continuing into 2018, more and more private, high-net-worth, and family office investors have seen the benefits of placing their equity in hotels and resorts. Newcomers to the hotel investment arena are typically seeking predictability, which is harder to find in other investment vehicles. They find that comfort and consistency they're looking for in financial performance when reviewing stable historical hotel P&Ls. They view this as great time to enter the lodging sector, believing they can get stronger risk-adjusted yield out of a hotel than an apartment building or from the stock market. The strength of the economy is allowing newer hotels to ramp up and stabilize at a faster pace, making hotels even more attractive to first-time lodging investors.

While some first-time investors are daring enough to take on the challenge of managing themselves, or hiring their own management teams, most have brought in professional management firms or, as is more and more often the case, they are acquiring brand-managed hotels and resorts.

Looking back, single-asset transactions were up year-over-year in 2017. Thus far in 2018, pricing for hotels has been strong and we expect interest in single-asset deals to continue to grow. Cap rates remain flat, although with increasing interest rates, cap rates will soon follow. Thus far, the bumps in interest rates have not impacted cap rates. We are often seeing buyers hit or exceed sellers' strike prices, especially for hotels delivering consistently strong yields. Cash-on-cash yield is what most of these private investors are seeking, especially since they haven't been able to find it in other investment vehicles. An asset's time on the market has also been shorter of late. For the more complicated deals, our Investment Sales Division is completing disposition processes in about four to five months from beginning to end, although some efforts have been shorter. We're also proud to report that in the past 18 months alone we have closed over 90% of engagements we have taken on.

DID YOU KNOW?

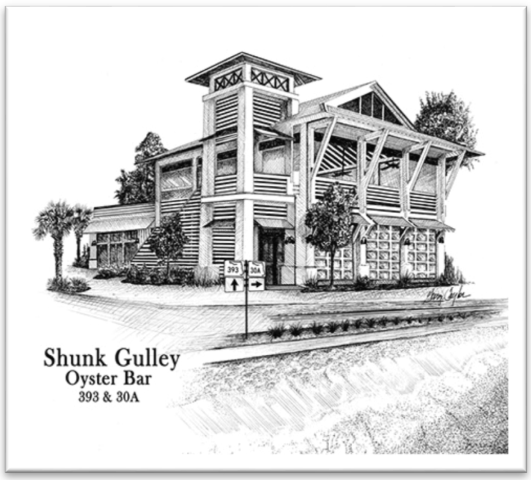
The Plasencia Group has closed over 90% of the engagements we have taken on in the past 18 months.

On the Road: Shunk Gulley

1875 South Highway 393, Santa Rosa Beach, FL 32459 | shunkgulley.com | (850) 622-2733

After the first bite, you'll understand why the locals hope this place remains as much of a secret as the fishing reef it's named after.

What to Order: You can't visit this place without trying the oysters, whether you order them raw, chargrilled, or fried. There's even a bacon cheddar jalapeño option for the more adventurous tasters. You can't go wrong with the Gulf fish sandwich with a side of duck fat fries with truffle oil and garlic aioli. And if you're a cole slaw fan, be sure to get some on the side or on your sandwich. For those who don't enjoy seafood, the fried sweet tea brined chicken is a favorite of the locals as well. Finish the meal with an order of the beignet fries while you sip on a cold beverage and enjoy the stunning view of Santa Rosa Beach.



Suggested by:
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***On the Road** is a collection of some of our favorite places we have visited as we travel the country.*
Our recommendations, and those of friends of the firm, may be found at **tpghotels.com/on-the-road**.

Lodging Investment Roadmap Summary

As you assess your hotels' performance figures through the first quarter, adjust budgets, and examine your investment strategies, you may find that you want to consider a disposition or refinancing of a single asset or even a portfolio. We welcome the opportunity to evaluate your lodging investment portfolio alongside you, and to have a dialogue about your options.

Best wishes from the entire team at The Plasencia Group!

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