Q1 2019

MARKET FOCUS: WASHINGTON, D.C. METRO

January 17, 2019

The District of Columbia market continues to be one of the most solid bets any lodging investor can make these days. While only time will tell what the effects of the record-breaking federal government shutdown will ultimately be, we believe in the resilience of the market for a number of compelling reasons. Limited increases in room supply and extremely high barriers to entry are key factors when considering an investment in the Washington, D.C. metro area. While there almost always seems to be solid investor interest in the market, challenges exist that current and potential owners and investors should consider as they evaluate their lodging portfolio strategy for 2019 and beyond.

This issue in our *Market Focus* series offers insights to our clients and friends who may have an interest in investing in the area, already own lodging assets in the market, or both. We include commentary on the Washington, D.C., area lodging landscape, including our own take on perceptions from various industry experts, hotel owners and investors.

Whether your interest in the D.C. market is as a current owner or future investor, we hope the information contained in this *Market Focus* proves helpful. As always, we welcome the opportunity to speak with you to discuss your hotel and resort holdings, whether in the D.C. area or elsewhere.

Operating metrics: What do the numbers really indicate?

While the year-to-date operating metrics of the D.C. market may appear challenged, the numbers alone do not tell the full story. Market performance in January 2017 was inflated by the Presidential Inauguration and Women's March, creating an extraordinary month that hotels could not hope to match in 2018. When removing January from 2017 numbers and comparing 2017 to last year, 2018 actually shows a healthy increase in demand. Even when January 2018 numbers are included, Washington, D.C. has sold more hotel rooms in 2018 than in 2017, and the sole explanation for the weaker occupancy numbers is an increase in supply. Visitor spending generated by conventions increased 6% in the past year, totaling $378 million, a point of proof in the market's relative strength.

The growth trend in D.C. hotel demand is poised to continue, tying its record of 21 citywide conventions in 2018. The record should be broken this year, with 23 conventions projected.

Demand drivers in the metro area are among the most stable in the nation, which is why the D.C. hotel market has such great long-term appeal to most investors. As long as the Federal Government is based there, demand will emanate from lobbyists, the military, their vendors, and countless other related sources.

The Washington office market's strength also bolsters lodging demand. Over four million square feet of primarily Class-A office space were constructed in 2018 alone. The office pipeline consists of an additional 7.6 million square feet now under construction, with 56% preleased. Further, a total of $6 billion in new investment in Class-A office, hotels, retail, housing, Metro rail and other infrastructure is coming to the D.C. metro in the next three years. D.C.'s economy is also diversified. The region is home to over 1,000 tech start-ups, and with the addition of Amazon's HQ2 campus, the area will become home to a substantial technology workforce.

November 2018 YTD Operating Metrics

Ranked by RevPAR

Market	RevPAR	% Change	ADR	% Change	Occ.	% Change
New York	$225.55	3.7%	$258.31	2.7%	87.3%	1.0%
San Francisco	$203.56	4.2%	$245.23	6.3%	83.0%	(1.1%)
Oahu Island	$197.69	2.6%	$235.31	2.3%	84.0%	0.4%
Boston	$156.51	3.5%	$202.31	1.0%	77.4%	2.0%
Miami	$148.83	6.8%	$193.97	7.0%	76.7%	0.4%
Los Angeles/Long Beach	$146.09	1.9%	$181.49	2.3%	80.5%	(0.4%)
San Diego	$134.32	5.0%	$168.00	2.9%	80.0%	1.8%
Seattle	$128.37	0.6%	$167.64	3.1%	76.6%	(2.3%)
Anaheim/Santa Ana	$126.74	2.9%	$162.39	3.8%	78.0%	(0.4%)
Washington, D.C.	$115.22	(3.7%)	$158.10	(2.3%)	72.9%	(1.4%)
Nashville	$110.82	2.6%	$148.39	3.4%	74.7%	(0.8%)
Chicago	$107.39	5.4%	$151.56	4.5%	70.9%	1.5%
New Orleans	$107.27	4.7%	$152.28	2.9%	70.4%	2.5%
Denver	$99.99	0.1%	$133.30	0.6%	75.0%	(0.1%)
Orlando	$98.98	3.4%	$127.08	5.3%	77.9%	(1.6%)
Philadelphia	$96.98	6.4%	$133.78	2.3%	72.5%	4.1%
Tampa/St. Petersburg	$94.33	0.9%	$131.25	2.7%	71.9%	(1.6%)
Phoenix	$92.70	5.4%	$131.35	2.1%	70.6%	3.1%
Minneapolis/St. Paul	$85.70	7.4%	$123.93	6.6%	69.2%	1.2%
Atlanta	$78.86	3.9%	$110.76	3.4%	71.2%	0.5%
Dallas	$76.04	0.6%	$109.59	2.9%	69.4%	(2.0%)
Detroit	$72.36	4.5%	$105.21	2.6%	68.8%	1.9%
St. Louis	$70.26	–	$105.95	0.5%	66.3%	(0.4%)
Houston	$68.26	(6.6%)	$106.30	(1.7%)	64.2%	(4.5%)
Norfolk/Virginia Beach	$67.26	3.7%	$104.50	2.0%	64.4%	1.7%
Top 25 Markets	**$118.13**	**2.7%**	**$158.36**	**2.9%**	**74.6%**	**–**
All Other Markets	**$73.30**	**3.0%**	**$114.69**	**2.3%**	**63.9%**	**0.8%**
Total United States	**$87.71**	**3.0%**	**$130.23**	**2.6%**	**67.3%**	**0.5%**

Source: Smith Travel Research

How quickly will incoming supply be absorbed?

New guestroom supply in the region has increased by approximately 6.5% over the last 18 months. This new inventory is forecasted to be absorbed within two and a half years. The number of new rooms is expected to grow by an additional 1.7% this year, but the demand for those rooms is anticipated to far exceed supply. Given the vitality of the D.C. market, demand has increased at a compounded growth rate of 2.2% over the last four years alone. The District's RevPAR performance is expected to decline as a result of the new rooms in the region, but only briefly as the market absorbs the additional supply. It is important to call attention to the fact that the majority new room development has occurred outside of the District due to the limited availability of development sites within it.

Hotel Projects Under Construction in D.C. Metro

Hotel	Developer	Rooms	Open Date
Home2 Suites Potomac Mills	Kalyan Hospitality LLC	126	Q1 2019
Hyatt Centric Alexandria Old Town	Magna Hospitality Group	124	Q1 2020
Home2 Suites Silver Spring	The Duffie Companies	100	Q2 2019
Homewood Suites Largo	Frontier Development	116	Q2 2019
Bethesda Marriott at Marriott HQ	The Bernstein Companies	246	Q2 2020
Residence Inn Ritchie Station Marketplace	Dakota Legacy Group	112	Q1 2020
citizenM Washington DC Southwest	Potomac Inv./City Partners	252	Q4 2019
Conrad at CityCenterDC	Hines	370	Q1 2019
Hilton Washington DC National Mall	Stanford Hotels	367	Q3 2019
Thompson DC at The Yards	JW Capital/Geolo Capital	225	Q2 2020
AC Hotel Washington Northwest	OTO Development	219	Q4 2019
Total		2,257	

Sources: Lodging Development, local news

What does D.C. transaction activity suggest?

Gross transaction volume was modestly ahead of 2017 in the D.C. metro area last year. The combined acquisition and renovation costs in the District have exceeded or are close to exceeding replacement costs depending on the location, though that has moderated slightly. The bid-ask spread remains significant for upscale, full-service hotels, so investor focus may be shifting to easier-to-acquire select-service properties. The barriers to entry and expansion, such as a lack of available land in the District and the 130-foot building height limit, have increased the value of existing hotels.

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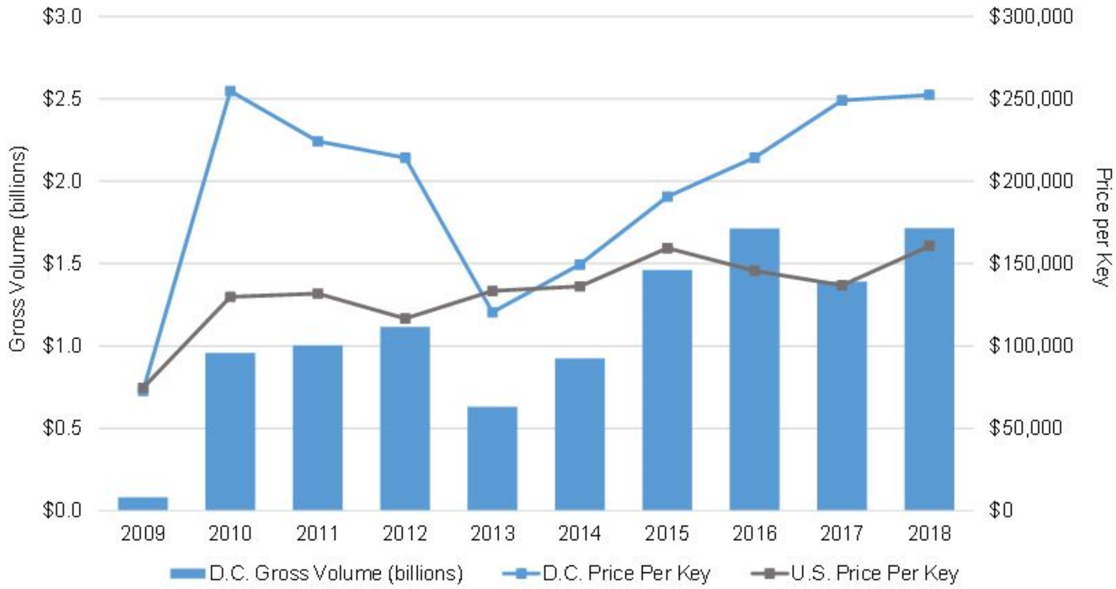
Lodging Transaction Trends



Source: Real Capital Analytics

While fewer properties may be changing hands within the District itself, many more notable properties in the wider metropolitan area saw new owners in 2018.

Alexandria, in particular, has seen its share of investor interest, with the Hilton trading in excess of $400,000 per key, followed closely by several other properties within the District trading in the high-300s to 400s per key. Arlington is another submarket that has attracted meaningful activity in the last year.

D.C. Market Major Lodging Sales – Last 12 Months

Date	Property Name	City	State	Keys	Year Built	Price	Per Key	Qualifier
Jun-18	Hilton Alexandria Old Town	Alexandria	VA	252	2000	$111,000,000	$440,476	confm'd
Nov-18	Hilton Garden Inn Washington DC Downtown	Washington	DC	300	2000	$128,000,000	$426,667	confm'd
Oct-18	Courtyard Washington DC Dupont Circle	Washington	DC	148	1969	$54,100,000	$365,541	confm'd
Dec-18	The Darcy	Washington	DC	226	1960	$81,762,000	$361,779	approx
Jan-18	Key Bridge Marriott	Arlington	VA	583	1959	$186,000,000	$319,039	confm'd
Jan-18	Westin Alexandria	Alexandria	VA	319	2007	$101,592,357	$318,471	alloc'd
Dec-18	Kimpton Carlyle Hotel Dupont Circle	Washington	DC	198	1940	$59,372,900	$299,863	confm'd
Jan-18	Chevy Chase Pavilion	Washington	DC	198	1990	$58,500,000	$295,455	confm'd
Feb-18	Beacon Hotel	Washington	DC	199	1963	$58,000,000	$291,457	confm'd
Mar-18	Hyatt Centric Arlington	Arlington	VA	317	1976	$81,000,000	$255,521	confm'd
Mar-18	Westin Washington National Harbor	Oxon Hill	MD	195	2008	$44,400,000	$227,692	confm'd
Jun-18	Hyatt Dulles Airport	Fairfax	VA	316	1989	$51,000,000	$161,392	confm'd
Dec-18	Hilton Embassy Row	Washington	DC	231	1970	$36,000,000	$155,844	approx
Feb-18	Westin Tysons Corner	Fairfax	VA	407	1975	$62,000,000	$152,334	confm'd
Aug-18	Residence Inn Chantilly Dulles South	Chantilly	VA	123	2005	$17,500,000	$142,276	approx
Feb-18	Hyatt House Gaithersburg	Gaithersburg	MD	140	1998	$19,000,000	$135,714	confm'd
Jun-18	SpringHill Suites Fairfax Fair Oaks	Fair Oaks	VA	140	2009	$18,250,000	$130,357	confm'd
Mar-18	Sheraton Reston	Reston	VA	298	1973	$26,999,999	$90,604	approx
Aug-18	Marriott Greenbelt	Greenbelt	MD	284	1985	$18,031,000	$63,489	approx

Sales $10 million or greater; sorted by price per key
Source: Real Capital Analytics

Opportunities and Challenges Ahead

Although the forseeable future for D.C.-area hotel and resort investments continues to be promising, it's worthy to include a few notes of caution:

- Property taxes will continue to increase at a rate higher than inflation due to the newly implemented independent statutory funding for Metro projects underwritten by all three area state governments (Virginia, Maryland, and D.C.). It is also important to note that the commercial real estate tax base in D.C. is comprised of only 40% of all buildings located within the District. The other 60% of District facilities are owned by tax-exempt entities (i.e. government, military, education, religious, not-for profit, etc.).
- Demand growth from international visitors has waned since the 2017 inauguration.
- Utility expenses, including gas, water, sewer and electric, will continue to increase at a pace greater than inflation due to residential exemptions.
- Gross operating profit margins may have peaked as increased wages, healthcare costs, reduced productivity and cost of sales have combined to take their toll on profits.
- Cap rates in the market are at historic lows and are expected to rise as interest rates climb.

Despite some potential challenges for the market, there is ample opportunity ahead for D.C. lodging investors and operators:

- Amazon's HQ2, announced for Crystal City, near Reagan National Airport (now called "National Landing"), will create compression to the surrounding areas, particularly within the District. Amazon's business partners will follow, exacerbating that effect.
- Significant barriers to entry are defining factors for the District. Investments in the region are likely "winners" in the long-term as most real estate investments in the District have proven over time to be quite resilient.
- Demand growth in the District over the next year is projected to continue at a pace that will only slightly lag supply growth (+1.3% vs. +1.7%, respectively).
- Opportunity zones have been be created within the District in areas where land is available, lowering the cost of entry for a select few investors.
- Change in control of the House of Representatives will likely bring new business to the District as the lobbying scene changes.

Summary

There's no arguing that the dynamics of lodging investments in the Washington, D.C. metropolitan area are unique. And, like the other markets in which we work across the country, we find that there are local factors that will always impact investment decisions depending on the submarket, location, property type, and so on. Whether you're keeping up with general trends, or studying the details carefully to prepare for a sale, purchase, or another capital event, don't hesitate to contact our team of advisors if we may be of assistance to you.

We wish you all the best through this year, and we look forward to speaking with you soon!

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