Hotel Business

CONFIDENCE INCREASES AS FUNDAMENTALS REMAIN STABLE

By Nicole Carlino

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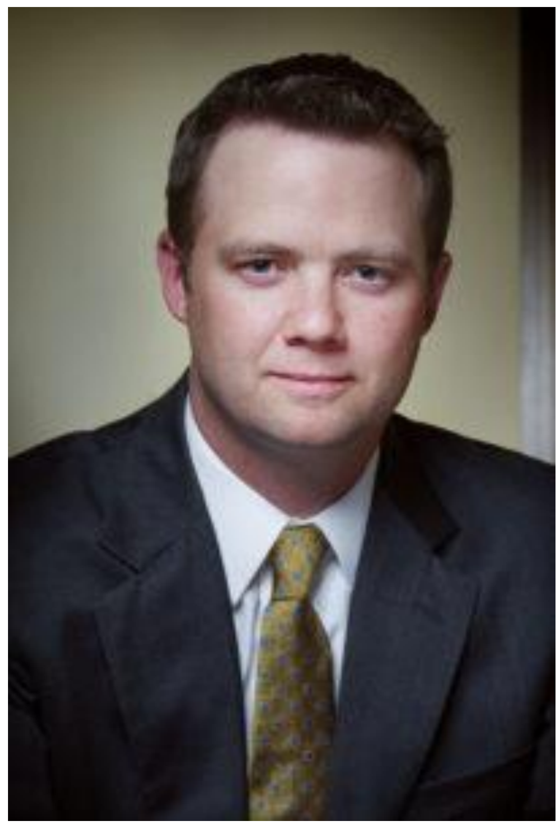
NATIONAL REPORT—How are lodging REITs faring in today's market, and what can we expect from 2019? Hotel Business spoke to industry experts to get their take on the current—and future—landscape.

"The best way to describe hotel fundamentals today is stable and good—not great," said Michael Bellisario, senior research analyst, hotel REITs and C-corps, Robert W. Baird & Co. "RevPAR continues to remain in this lowish single-digit range, costs continue to increase, operators have a challenging time pushing rate, and bottom-line growth is modest at best. Overall, those in the industry are optimistic that growth will continue and potentially reaccelerate further. Our view is yes, that is certainly possible—the macroeconomic indicators point to RevPAR growth being better than it is, but those indicators have been pointing toward that for several years now.

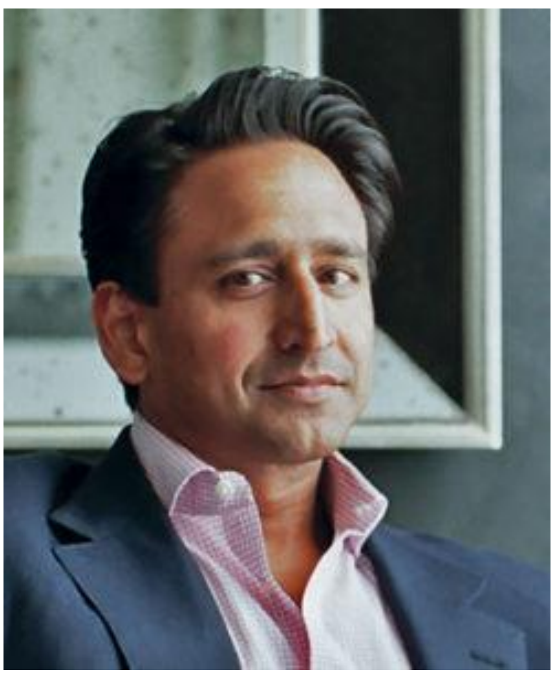


Rob Hays
Ashford Inc

"We've already lapped the election in terms of the optimism around that, consumer confidence is at or near record levels, and it's the same with employment," he continued. "Now, we have the benefit of tax reform; we know there's a lag for that to work its way through. Our view is maybe it boosts RevPAR a little, but we're going to continue to remain in this lower-for-longer environment where we're not going to get back to 2012-2014 levels of RevPAR growth."

For his part, Neil Shah, president/COO, Hersha Hospitality Trust, agrees that the industry is in a good place. “On an absolute basis, the lodging industry is in very good shape and we continue to break occupancy records every month,” he said. “Nationally, the environment is quite good. In many major markets, new hotel supply and even shadow supply (Airbnb, VRBO, etc.) has peaked and is now decelerating while macro indicators like GDP, corporate profits, employment and international travel are accelerating, leading to increased travel. We believe these accelerations will be a near-term tailwind for the sector, but we are staying vigilant with our asset management and expense control plans as we remain in a low to mid single-digit RevPAR growth environment with nearly offsetting expense growth.”

Rob Hays, co-president/chief strategy officer, Ashford Inc., added, “I would describe the landscape as ‘confident.’ Prior to this year, the industry landscape was ‘cautiously optimistic,’ but that was due to the uncertainty around where we were in the cycle. This sentiment has changed considerably since last year, and it is because of the reacceleration in industry fundamentals due to stronger economic growth. Fortunately, this growth seems stable for the foreseeable future.



Neil Shah
Hersha Hospitality Trust

“Lodging demand has continued to outpace supply; occupancies remain at record levels and owners have been somewhat successful in pushing rates higher due to stronger leisure and business travel,” he continued. “I think we can thank the unprecedented 18-year record low of unemployment, which currently stands at around 3.8%. Higher real income has given rise to strong consumer sentiment and we have seen the added spending benefit across our hotels.”

Still, the biggest concern for lodging REITs right now is cost pressure. Bellisario said, “Some 40-60% of your cost structure might be labor and benefits, property taxes are going up, insurance is going up, utility costs are going up; there’s only so many costs you can take out of the operating model… It’s very difficult when RevPAR growth is 2-3% and costs are going up by that amount or more, depending on the market. It’s also something that these guys can only control around the edges. They can't control where property taxes are going—they can fight them, appeal them, buy in more favorable jurisdictions, but property taxes are going up. It's the same with utility costs."

Hays agreed about costs going up. "While the industry is still experiencing positive RevPAR growth, the growth is in the low single digits. At the same time, we are seeing labor costs and property taxes grow at rates higher than revenue growth, which puts serious pressure on holding margins," he said. "This has forced owners to try and find alternative and creative ways to grow revenues and, at the same time, look for other aggressive cost-cutting measures at the properties."

New supply is also an issue. "Many markets across the country are still facing significant new supply, which can quickly end rate growth in a particular market," Shah said. "In this cycle, the gateway urban markets absorbed a lot of supply in the beginning and middle of the cycle, while the suburban markets are trying to absorb it now. If tariff-related issues slow down corporate growth that would clearly be cause for concern. Inflation is inevitable, and lodging is uniquely positioned to drive rates accordingly and immediately. And yes, we continue to hope that current events do not impact the long-term attraction of inbound international travelers to the U.S."

Paul Titcher, a partner in the Los Angeles office of Cox, Castle & Nicholson LLP, echoed Shah's sentiments on supply. "For example, some reporting indicates that there are more than 5,000 hotel rooms currently under construction in Los Angeles County, many of which are in Downtown L.A. Keep in mind that this does not include hotels that are currently in the planning stage," he said. "While people have been saying for years that Downtown L.A. needs more hotel rooms to handle convention traffic, this level of construction is extraordinary. Cautious investors may consider waiting to see how these units will be digested before jumping into this market at this time."

Paul Titcher
Cox, Castle & Nicholson LLP

In terms of buying and selling, Bellisario described the market as hopeful. “You have a lot of different buckets of strategies,” he said. “The overarching theme is balance sheets are in a much better position; REITs and their investors in the stocks feel better about the fundamental outlook, stock prices are higher, and capital deployment for acquisitions is higher on the to-do list than it has been in the last couple of years. It’s competitive; everyone wants to buy. There’s a lot of cheaper cost capital out there, high-net-worth individuals, foreign capital, private equity that can use leverage, and there’s not a lot for sale; when you think about the supply and demand of getting a transaction done, you have to look at a lot of deals to get one across the finish line. That’s why I said hopeful: They’d like to buy, but I think they acknowledge it is very difficult because a seller doesn’t have to sell. Many can simply refinance; it’s more efficient, you continue to own the asset and you can push pricing a little bit more. It’s a viable alternative today where it really wasn’t 36 months ago. The debt market, to an extent, is one of the biggest competitors from an acquisition standpoint.”

“Most REITs are always looking for deals regardless of market conditions,” Titcher said. “With valuations where they are today, most REITs are a bit more cautious on the acquisition side and are passing on deals that don’t make sense. At the same time, they’d be a bit more willing to part with an asset if presented with a generous offer.”

Titcher noted that he’s been working on a lot of dispositions recently, particularly as it relates to changing strategies. “Some REITs are looking to take advantage of values to dispose of assets that may not fit with their core focus. For example, if your core focus is 4- or 5-star hotels in urban centers and you currently hold a few extended-stay hotels in suburban areas that may have been acquired in a portfolio transaction, now may be the time to unload those properties at today’s strong valuations,” he said.

Bellisario added that the prospect of trophy properties is also something many in the industry are considering. “There’s speculation around the Strategic portfolio and what Anbang does with it, as well as other big trophy assets potentially being marketed for sale,” he said. “Maybe something happens, maybe it doesn’t, but I think people in the industry are waiting for these big transactions to occur to either have the REITs deploy some capital or we get more M&A. The companies are positioned for that to occur, but it might not occur.”

As for 2019, Hays said, “We are quite bullish on the industry and lodging REITs over the next couple of years. We have great economic tailwinds behind us: positive GDP growth, strong consumer sentiment, growing corporate profits and increasing corporate spending. If those trends continue, the lodging REITs will do well. In addition, to the extent that the Federal Reserve is comfortable allowing inflation to tick a bit above its 2% target, that would be a benefit to hotel REITs as we may be able to push average daily rates a bit more aggressively."

"Lodging REITs have performed well thus far in 2018, but improving sentiment for the sector may have lifted all boats," Shah said. "I think you might see some more separation as the year comes to an end and 2019 outlooks are shared. We suspect the third quarter will be challenging for the space with July 4th falling during the middle of the week and both Rosh Hashanah and Yom Kippur taking place during September. The fourth quarter should yield more robust performance; however, those companies with a high concentration of hotels in Houston and South Florida will face a difficult comparison to the post-hurricane boost the industry experienced in the fourth quarter of 2017. We remain bullish on continued growth in our industry for 2019, but some markets will be challenged by new supply and wage growth."

"We think 2019 will look similar to 2018," Bellisario said. "The one thing that's changed is people are more comfortable with the operating environment we're in now. We haven't had points in cycles where we've been flatlining; it's always been up or down. What scared people early on was this single-digit growth range; people were saying it's got to fall off a cliff or reaccelerate, and it didn't. We had the election, we had tax reform, people got excited and they are now realizing not much is changing—we're still in this low-growth environment, but people feel more comfortable with it… On the margin, the underlying trends are pretty healthy. Our view is we're going to see more of the same barring some macro shock that we can't see." HB