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No Room at the Inn | April 2013

Despite the sequester, the electricity bill was still paid in March, allowing the markets to continue their climb. The MSCI US REIT Index (RMS) produced a total return of +2.9% for the month, bringing the year to date total to +8.1%. In comparison, the S&P 500 produced a total return of +3.8% in March, for a year to date total of +10.6%. The continued appreciation in the index seems to be affirming our positive long term view on REITs expressed in the previous REIT outlooks, overpowering short term fluctuations from headlines out of Europe and Washington DC. In light of the positive performance, this month we will refocus on our theme of "All Properties are Not Created Equal".

Social Responsibility of REITs
Before getting to the meat of the report, the question of whether REITs are a socially responsible investment comes up from time to time. Due to the nature of REITs serving as landlords, they pass all screens for socially responsible companies. Therefore, we feel confident that the Chilton REIT Strategy would pass even the most stringent socially responsible screens.

Furthermore, there is an emerging trend in commercial real estate to "go green". Some property types have begun to convert and build properties with varying degrees of LEED certification. LEED stands for Leadership in Energy and Environmental Design. The ratings range from LEED 'Certified' to LEED 'Platinum', graded on a point system with the following categories: Sustainable Sites, Water Efficiency, Energy and Atmosphere, Materials and Resources, Indoor Environmental Quality. In conjunction with the US Green Building Council (USGBC), NAREIT and FTSE have created the FTSE NAREIT USGBC U.S. Green Real Estate Index Series. The index contains 72 companies with a minimum percentage of their portfolio LEED certified. A REIT's weighting in the index is based on market capitalization and the portion of its portfolio that is LEED certified. Investors hope to benefit from long term cost savings and higher rents.

All Properties Are Not Created Equal: Lodging Focus
Lodging REITs represent one of the smallest sectors at a market capitalization of $30.9 billion versus a total for all publically traded equity REITs of $503.9 billion as of February 28, 2013. This 6.1% share is spread among 14 REITs, but Host Hotels and Resorts, Inc. (NYSE:HST) is the largest, accounting for $12.5 billion of the market capitalization. As a group, lodging REITs have produced a total return of 7.1% versus 5.1% for all Equity REITs in the first two months of 2013. Hotels are a unique property type due to many factors; namely, 1) the "daily" lease, 2) the extraordinary importance of operations including the branding or "Flag" used, 3) the seasonality of results, and 4) the high capital expenditures required to maintain a property.

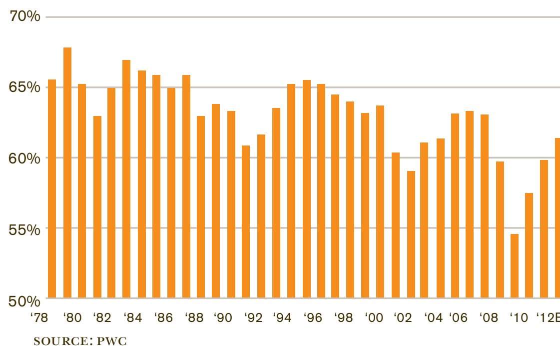
Lodging Basics
Due to tax laws, a REIT owning a hotel must employ a third party manager to run the day to day operations. The structure of a typical hotel usually consists of the following: the REIT owns the land and the building, employs a management company to operate the hotel, and then pays a franchisor to help bring in consumers through their platform and branding. Examples of flags include W, Westin, and Sheraton, which are owned by Starwood Hotels (NYSE: HOT), and Ritz-Carlton, JW Marriott, and Courtyard, which are owned by Marriott (NYSE: MAR). Other owners of flags are Hyatt (NYSE: H), Wyndham (NYSE: WYN), Orient-Express (NYSE: OEH), and Intercontinental (NYSE: IHG). Hilton is also a franchisor of its brand, but it was taken private by Blackstone in 2007 for $26 billion. The franchisor may also act as the management company, which is often the case with Marriott and Starwood. The franchisor of the brand usually receives 4-5% of revenues. The management company usually receives a base fee of 2-5% of revenue, varying

based on the incentive fee after achieving a predetermined preferred return hurdle. The REIT receives all revenues after paying the franchisor and the management company. Due to the disparate functions and fee streams, the asset allocation role that REITs provide is critical to maximize long term value for shareholders.

Investments can be further broken down by quality, service/amenities, and geographic locations. Hotels are typically segmented into six categories: Luxury, Upper Upscale, Upscale, Upper Midscale, Midscale, and Economy. REITs tend to own properties in the first three. The level of service and amenities differentiate between the classifications. Full service hotels may have a combination of restaurants, meeting rooms, and fitness centers, while limited service hotels provide little more than the room and a small lobby area. Lastly, lodging investors can choose which part of the world or country in which they would like exposure. Some lodging REITs focus on upper midscale, limited service hotels concentrated in one part of the country, while others may focus on luxury, full service hotels in vacation destinations around the world.

With regards to the franchisors, they have made it part of their strategy to cater to the full spectrum of consumers by maintaining a presence all over the world and having brands for economy or midscale through luxury. However, there are some nuances between portfolios with tilts to a certain geography or quality segment so that the stock may trade differently if, for example, China RevPAR growth outpaces expectations, or a recession causes businesses to book less resort conferences.

FIGURE 1: INDUSTRY OCCUPANCY

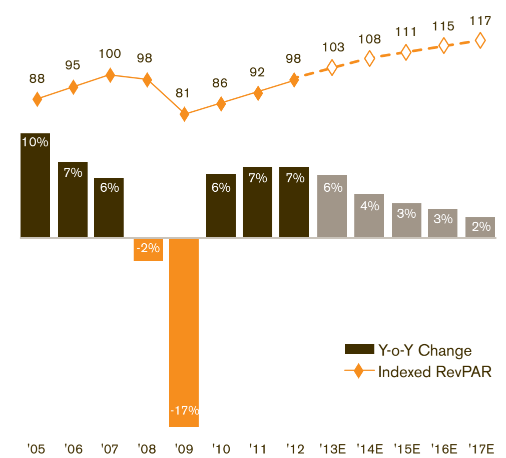


SOURCE: PWC

Lodging Fundamentals

Fundamentals have significantly rebounded from the lows seen in 2009, but we believe they remain attractive. Supply, particularly in the quality segments owned by REITs, remains low by historical standards and we envision that this will be the case for several years. At under 1% of stock, new supply is still less than estimated obsolescence. Lackluster economic growth rates in the US and difficulty in obtaining attractive construction financing are helping to keep developers on the sidelines. Except in rare circumstances, room rates have yet to recover from the 2007 peaks and investors are still able to purchase hotels at a discount to replacement cost. Demand for lodging has historically been highly correlated to GDP and job growth due to the influence of everything from business trips to the Super Bowl. However, strong corporate profits over the past few years have been the major tailwind for improving lodging fundamentals in this cycle.

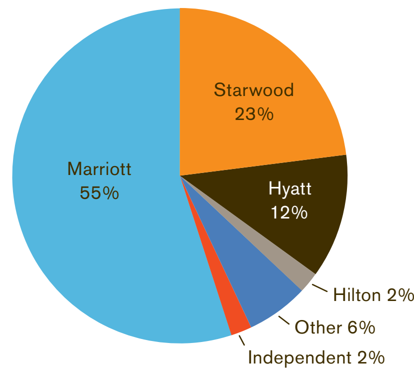
FIGURE 2: REVPAR GROWTH



SOURCE: GREEN STREET ADVISORS

RevPAR, or Revenue Per Available Room, is the industry benchmark closely followed by owners and investors alike to track and project hotel economics. It reflects the combination of the average daily room rate (ADR) and occupancy. According to industry sources, RevPAR across all hotels is expected to grow in the range of 4-5% for the next three years but we envision better results in the Upper-Upscale category that most REITs own. Portfolio upgrades to better markets should also help REIT portfolios to outperform industry wide RevPAR statistics. Since occupancy rates for REITs have recovered to more normal levels near 70%, most of the increase in RevPAR is expected to come from higher room rates. This plays well into higher profit margins for owners and, eventually, to a full recovery in values last seen in 2007. It is this combination of limited new supply and rising room rates that keeps us interested in the

FIGURE 3: HOST HOTELS PORTFOLIO



SOURCE: COMPANY REPORTS AS OF 12/31/2012

space, particularly for REITs that own properties in the major "gateway" cities in the United States such as New York City, San Francisco, Los Angeles, and Miami. Not surprisingly, lodging REITs appear fairly priced in the stock market with price to EBITDA (earnings before interest, taxes, depreciation, and amortization) multiples of 12.8x. Below, we feature two lodging REITs and a franchisor as examples of ways to gain exposure to lodging.

Host Hotels and Resorts
Host is the biggest lodging REIT and one of the largest owners of luxury and upper-upscale hotels with a portfolio valued at $17 billion. In the United States, the portfolio includes 103 properties and internationally Host owns 15 hotels. The room count stands at 62,500. Figure 3 shows the composition of their portfolio by operator. Premium brands include Ritz-Carlton, Westin, W, St.Regis, The Luxury Collection, Hyatt, and Four Seasons. RevPAR increased 6.4% in 2012 from $133.87 to $142.48 with occupancy growth of 2.0 percentage points to 74.5%. For 2013, the company anticipates an increase in RevPAR in the range of 5.0% to 7.0%. Smith Travel numbers year to date are tracking within this range nationwide. The largest markets for Host in descending order includes New York City, Washington D.C., Florida, San Diego and San Francisco, which account for over 50% of the portfolio value when added together.

Management is considered to be among the best in the REIT industry and it has a great track record to prove it. Its capital allocation has been superb and the company has been very astute to bring leverage down considerably since 2008. Today, it stands at 31% including preferred equity as debt. This REIT epitomizes one of the strengths of being a public company considering it has unmatched access to capital, both debt and equity, and both public and private. In March, it raised $400 million of 10 year unsecured debt at 3.75%. Consensus estimates for FFO are $1.25, $1.42 and $1.59 per share, respectively, for the next three years. The dividend, now at an annualized rate of $0.40 per share, reflects a payout ratio of only 32% on 2013 estimates, one of the lowest in the REIT industry.

Hersha Hospitality Trust (NYSE: HT)
Hersha owns interests in 64 hotels containing 9,221 rooms in major gateway cities in the United States. All but six hotels are wholly owned. New York City represents roughly 50% of the portfolio by EBITDA. HT focuses on upper-upscale and upscale, limited service hotels that cater to the transient traveler as opposed to group business. Occupancy rates have never fallen below 67% over the past six years and last year averaged 75.8%. RevPAR in 2012 increased 8% to a record of $123.22 and is now well above the previous peak reached in 2008 of $98.00. The average daily rate in 2012 was $162.65.

Since 2007, the portfolio has been transformed more than any other lodging REIT by disposing of hotels in slow growth suburban cities and purchasing properties in NYC and other higher growth markets including Boston, Miami, and Los Angeles. Most of the hotels operate under franchise licenses from leading companies, including Marriott, Hilton, and IHG. Popular flags in the portfolio encompass Courtyard by Marriott, Hilton Garden Inn, Hampton Inn, Hyatt House, and Holiday Inn Express.

We estimate that about 40% of EBITDA is from the newer hotels suggesting good internal growth that should augment the growth in RevPAR emanating from the rest of the portfolio. In addition, the company has three hotels in development (all in New York City), two of which should open this year and one in 2014. Management has been an astute capital allocator and HT boasts a solid balance sheet. A recent preferred equity offering was used to redeem a higher cost issue with $15 million of excess proceeds. No amounts are drawn on its $250 million credit line. The dividend of $0.24 per share suggests a yield of 4% on the common stock and a payout ratio on FFO (funds from operations) of approximately 55% using 2013 estimates of $0.44 per share. Management appears reluctant to increase the

dividend until the market more fully appreciates the growth catalysts inherent in the story, a strategy that we embrace.

Marriott

Marriott has some of the world's most popular hotel brands. After spinning out most of its real estate holdings into Hosts Hotels in 1993, Marriott has focused on growing earnings through brand recognition across the quality spectrum and new hotel openings without having to put up any capital. In 2011, Marriott spun out its vacation rental business to become a true pure play on branding and hotel management. Ritz-Carlton has become a standard for 5 star service around the world with 42 hotels out of a total of 80 located outside of the US. MAR has their signature brand name "Marriott" on 558 hotels worldwide. However, MAR also owns the brands Courtyard, Fairfield Inn & Suites, SpringHill Suites, Residence Inn, and TownePlace Suites, of which there are over 2,600 in the US alone. Impressively, MAR has adapted to grow the business to cater to every type of traveler, regardless of budget.

In 2012, MAR had RevPAR growth of 6.1% to $97.34, increasing occupancy by 150 basis points to 70.8%. As a result, MAR was able to grow Adjusted EBITDA by 16% to $1.15 billion for the year. In 2013, the company is guiding to $1.22 billion in Adjusted EBITDA at the midpoint, which would be a 6% increase over 2012. The guidance is based on RevPAR growth of +5.5%. MAR is trading at an Adjusted EBITDA multiple of 13.2x, which is close to the middle of their historical range. MAR has a dividend yield of 1.3%, but has historically been a frequent buyer of its own shares in an effort to return cash to shareholders.

The Pulse of the Economy

Due to the nature of the "one day lease", lodging tends to be a volatile sector for both REITs and C-Corps. Even hotel companies with the best balance sheets, quality management, and steady dividend streams can experience rapid contractions or expansions in multiples. Hotels can be one of the first sectors to feel the pain of a recession, but also be the first to experience a rebound in economic health. We believe hotels are in the middle of an extended travel cycle, where high occupancy will be able to drive rates in select markets. Furthermore, there is a growing segment of new travelers abroad that display brand loyalty when it comes to where they want to stay. Last, the rebound in the luxury consumer is in full effect in the lodging segment, where high end hotels have been able to grow RevPAR at a quicker rate than at the low end. Similar to other sectors, we believe low new supply will make this an extended cycle and we view a market weight allocation as a valuable addition to a real estate portfolio.

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RMS: 1383 (3.31.2013) vs. 1280(12.31.2012) vs. 1087 (12.31.2011) vs. 1000 (12.31.2010) vs. 792 (12.29.2009) vs. 933 (9.30.2008) and 1330 (2.7.2007)

Please feel free to forward this publication to interested parties and make introductions where appropriate.

Previous editions of the Chilton REIT Outlook are available at www.chiltoncapital.com/publications.html

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