Chilton
Capital
Management

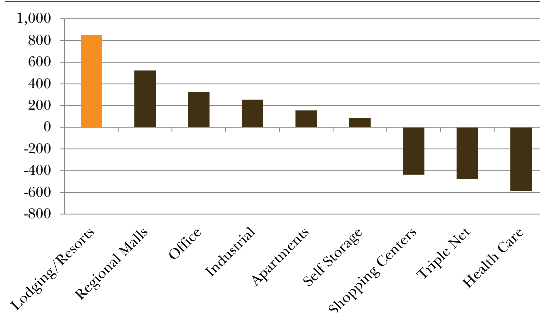
1177 West Loop South, Suite 1310
Houston, Texas 77027

TELEPHONE: 713 650 1995
FACSIMILE: 713 650 1739
TOLL FREE: 800 919 1995

# 5-Star Analysis is Key in the Lodging Sector | July 2015

Lodging REITs are the most volatile REIT property type due to the extremely short term nature of their leases: one day. When demand is strong, a one day lease is beneficial as lodging REITs can increase prices, and therefore revenues, at their properties immediately. As shown in Figure 1, the lodging REIT sector has historically been the best performer in times of rising interest rates due to their ability to raise Average Daily Rate (or ADR) so quickly. However, revenues of short term lease sectors are vulnerable when demand weakens. In such times, it's possible (though unlikely) for a hotel to experience a night without any guests. Therefore, the predictability of lodging REIT earnings is low relative to other REIT sectors, which creates volatility in stock prices. As active REIT managers, we view the volatility as an opportunity to produce alpha for our clients by finding outperformers and avoiding underperformers.

**Figure 1: REIT Subsector Relative Performance During Times of Rising Interest Rates**



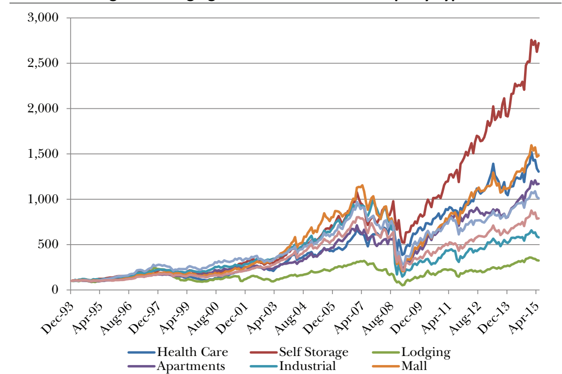

Source: Citi Research and Analysis. As of March 31, 2015. Returns relative to S&P 500.

## Historically High Risk, Low Reward

As measured by the FTSE NAREIT Equity Lodging/Resorts Total Return Index (Bloomberg: FNLODTR), the lodging REIT sector has been the worst performing property type from 1994 through May 31, 2015 – and it's not even close (see Figure 2). Using the price-only index (Bloomberg: FNLOD), lodging REITs are still 23% below their 2007 stock price highs as of May 31, 2015. To make matters worse, the lodging REIT index had the highest standard deviation in returns since 1994, meaning an investor took on the *most* risk, but received the *least* reward.

Because of their volatility, we place all lodging REITs in the "opportunistic" risk category, thus requiring the highest expected returns for inclusion in client portfolios. This portion of the process has historically limited our allocation to lodging REITs. However, there have been periods in which lodging REITs have outperformed over the short term. In 2013 and 2014, the lodging sector produced returns of +27% and +33%, respectively, comfortably above the benchmark. Before getting too excited about the prospects of lodging REITs, an investor needs to be aware of the idiosyncrasies of this unique sector.

**Figure 2: Lodging Returns versus Other Property Types**




Sector returns are represented by the total return of the FTSE NAREIT Equity REIT Index SubSector, with a starting value of 100 on December 31, 1993

## Necessary "Fee"-vil

Similar to other REIT property types, most of our readers have stayed in a REIT-owned hotel at least once in their lives. Unlike apartments or self storage however, it is unlikely that many guests know who the owner of a hotel is, even after staying there. The name on the hotel (for example, Westin or J.W. Marriott) is usually a brand, or "flag", owned by companies such as Starwood Hotels (NYSE: HOT), Marriott International (NYSE: MAR), Hilton Worldwide

(NYSE: HLT), and Hyatt Hotels (NYSE: H). If a hotel is not associated with one of the brands, it is likely an *independent* hotel, but still not carrying the name of the owner in most cases. Due to tax laws unique to REITs, there are actually *three* layers to the structure of a REIT-owned hotel: the owner (the REIT), the management company (ex. Kimpton, Interstate, White Lodging), and the brand (if there is one). Lodging REITs are entitled to all revenues after paying fees to the management company and the brand, which are based on a percentage of revenue to the hotel.

*"...the owners have had to bear the expense of installing wi-fi in their hotels, but the brands have been pushing them to give away wi-fi service for free."*

The major revenue benchmark used by hotels is RevPAR, or Revenue Per Available Room. RevPAR is the combination of average occupancy and ADR. Because the management company and brand are paid based on *revenue*, there are inherent conflicts of interest between them and the owners, who are also concerned with *expenses*, and thus net operating income. In particular, the costs to maintain and improve hotels are almost always the responsibility of the owner. Therefore, the owners of full-service hotels with upscale aspirations tend to have high capital expenditures to ensure their guest experiences meet expectations and they do not become obsolete by missing a trend. For example, the owners have had to bear the expense of installing wi-fi in their hotels, but the brands have been pushing them to give away wi-fi service for free.

Despite the conflicts of interest with the brands, there are many benefits from associating with one of them. As of 2014, approximately 70% of US hotels were affiliated with a brand. In particular, the loyalty programs drive guest traffic to the hotel via each company's booking site. If it can drive occupancy and room rate, the 4-5% "franchise fee" on each occupied room is well worth it.

In contrast, an independent hotel has to do its own marketing to find guests, often relying on OTAs, or Online Travel Agencies. Examples of OTAs include Orbitz (NYSE: OWW), Expedia (NASDAQ: EXPE), and Priceline (NASDAQ: PCLN). Instead of paying 4-5% of all room revenues for the year to a brand, an independent hotel has to pay 20-22% of revenue for each booking sourced by an OTA. Ideally, an independent owner can drive traffic to its own website without relying too heavily on OTAs, but it can prove difficult without a sophisticated marketing group or a widely renowned reputation. Owners with branded hotels are very careful on how many rooms (and at what price) they release to OTAs given that they have to pay the OTA fee *and* the franchise fee for that room.

To complicate things further, there are also "soft brands", which allow independent hotels to take advantage of the brand booking sites and reward systems while keeping some of their uniqueness. In exchange, the hotel must comply with a minimum quality standard and pay around 10% of revenue to the brand for each room booked from that source. Hilton does this through their Curio and Canopy brands, Starwood through Tribute and The Luxury Collection, and Marriott through their Autograph Collection. Some of the more recognizable "soft brand" hotels are the Atlantis in the Bahamas and the Cosmopolitan in Las Vegas (both Marriott Autograph).

Though they aren't REITs, the brand companies' fundamentals should track those of the hotel owners as they are dependent on hotel revenues to earn their fees. We refer to them as the lodging "C-Corps", reflecting their IRS classification. Apple (NASDAQ: AAPL) and Exxon (NYSE: XOM) are examples of other C-corps. As shown in Figure 3, the brand companies tend to create flags for each type of

**Figure 3: C-Corp "Flags"**

| Hilton | Starwood | Marriott | | Hyatt | |
|---|---|---|---|---|---|
| Waldorf Astoria | Le Meridien | Ritz Carlton | AC | Park Hyatt | Hyatt Ziva |
| Conrad | St. Regis | Bulgari | Courtyard | Grand Hyatt | Hyatt Zilara |
| Hilton | W | Edition | Residence Inn | Hyatt Regency | |
| DoubleTree | Westin | JW Marriott | Springhill Suites | Andaz | |
| Embassy Suites | Sheraton | Renaissance | Fairfield Inn & Suites | Hyatt | |
| Hilton Garden Inn | Aloft | Marriott | TownePlace Suites | Hyatt Place | |
| Homewood Suites | Element | Delta | Protea | Hyatt House | |
| Home2 | | Gaylord | | Hyatt Centric | |
| **Soft Brands** | | | | | |
| Canopy | Luxury Collection | Autograph Collection | | | |
| Curio | Tribute | | | | |

customer, from midscale all the way up to luxury, including both limited-service and full-service. In addition to experiencing revenue growth from higher rate and occupancy in their current portfolio, lodging C-Corps can also increase their revenues merely by signing new management or franchise agreements - thus, requiring no capital investment.

This strategy is known as "asset-light", and has been most embraced by Marriott, which has the highest percentage of revenues from fees at 75%. Starwood Hotels is currently in the middle stages of its plan to sell over $2.5 billion of hotels by the end of 2016. Most recently, Starwood sold the Phoenician Hotel and Spa in Scottsdale to Host Hotels (NYSE: HST) for $400 million, or $622,000 per room. The hotel sale garnering the most press this year has been Hilton's sale of the New York Waldorf Astoria to Anbang, a Chinese insurer, for $1.95 billion, or $1.3 million per room.

**Don't Knock the "Lock"**

Most business and leisure travelers book their room using the advertised rates on a hotel website, brand website, or OTA (or the old-fashioned method of calling). Such "transient" business comprises about 70% of annual room bookings. However, about 30% of rooms are booked using reference codes given for "group bookings". A group booking refers to a reservation of ten or more rooms at a rate that has been negotiated with the hotel for an event. Businesses and associations can block rooms up to seven years in advance, depending on the amount of rooms they need.

*"...in times when demand decreases, hotels with heavy group business may have less revenue downside than their peers due to cancellation fees."*

Though it requires an investment on the hotel's part to maintain large meeting rooms and a catering service, the ability to book a large portion of a hotel's rooms in advance at a fixed rate can dramatically lower the risk of future revenues. The hotel is taking a risk by "locking in" a rate that may be below where it would've priced if someone wanted the room tomorrow, but knowing that a large percentage of room nights are already booked allows the owner to push rates for the unsold rooms. Furthermore, the hotel receives deposits for the rooms, and includes hefty cancellation fees as the event gets closer. Therefore, in times when demand decreases, hotels with heavy group business may have less revenue downside than their peers due to cancellation fees.

Another benefit of group business is that it drives profitable food and beverage (or F&B) margins as large quantities of similar plates can be made efficiently, and alcohol sales from hotel bars spike during conferences. In contrast, a more transient-focused hotel would be happy to have F&B be a breakeven business. Similar to not being able to close an entire hotel, restaurants, room service, and bars have to maintain certain hours with or without customers.

**Limited-Service, Limited Expenses**

Group bookings and F&B service usually describe attributes of "full-service" hotels. For investors that are looking to avoid the complexity of large hotels with high-cost amenities for guests, there are some REITs that focus only on limited-service hotels. They usually have only a small lobby, possibly a small gym, and simple breakfast service, forgoing any restaurant, bar, or meeting room space. Thus, margins tend to be much higher at limited service hotels, as shown in Figure 4. Limited-service hotels also can benefit from group business indirectly, as an increased number of events drives occupancy around the submarket, which lifts prices for all hotels.

**Figure 4: Full-Service vs. Limited-Service**

| Service Level | Full-Service | Limited-Service |
|---|---|---|
| Revenue From Room | 60-70% | 80-90% |
| Non-Room Revenue* | 30-40% | 10-20% |
| EBITDA Margin | 20-30% | 30-40% |
| Rooms per Hotel | 200-2,000 | 100-300 |
| Sample Brands | Ritz-Carlton, Westin | Hampton Inn, Courtyard |

*includes parking, F&B, spa, etc.

**Time to Spin**

The final nuance to understanding lodging C-corps is the timeshare business. In 2011, Marriott spun-out its timeshare business into its own company, Marriott Vacations (NYSE: VAC). As of the end of 2011, VAC traded at just over $17 per share. As the business has begun to be better understood by investors, VAC's share price has increased dramatically to $88.34 as of June 19, 2015. Starwood and Wyndham Worldwide (NYSE: WYN) are the other two C-corps with large timeshare businesses. On February 10, 2015, Starwood announced that it would spin out its timeshare business by the end of the year. We have since learned that it will be called Vistana Signature Experiences, and will trade with the symbol 'VSE'.

The timeshare business is a little more complex than the typical lodging business, but it can be a significant driver of profit margins for the brand and management company. MAR receives $50 million per year in royalty payments from VAC, plus 2% of all revenues at branded properties. Similarly, VSE will pay Starwood $30 million per year, along with 2% of revenues at branded properties. WYN has not made any announcements for a timeshare spinoff.

**Danger = Opportunity**

Though lodging demand directionally follows GDP, the nature of being dependent upon travel, business, and conferences creates risks that are unlike other REIT property types. For example, the Ebola scare in 2014 caused a large selloff in lodging REITs and C-Corps as many travelers cancelled flights. Currently, REITs and lodging C-corps with exposure to a rising US Dollar are under pressure, as investors worry that a stronger dollar will restrict travel to the US. Additionally, all international revenues are worth less in USD in a rising dollar environment. So far, we have yet to see any diminution in demand from international traveler into the US. In fact, the Office of Travel and Tourism Industries *increased* its projection to 77.6 million US visitors from 76.6 million earlier this year, a 3.6% increase over 2014's record-breaking performance.

The other risk that is pressuring lodging REIT prices is an influx of new supply into the New York City market, one of the largest hotel markets in the US with 102,000 rooms (Las Vegas and Orlando are the only markets with more rooms). Projections call for new supply to increase by 4-5% for the next two years, which would be difficult for any city to absorb. However, NYC hotel occupancy was 84.8% in 2014, an all-time record, suggesting that visitors are staying elsewhere or moving their destination due to hotels being full. Additionally, many experts predict that 2015 will set all-time record for business travel, which should disproportionately benefit NYC. Therefore, we believe that the new supply fears will prove overblown.

Though it is one of the smaller property types at only 7.5% of the MSCI US REIT Index, we believe we can produce outsized returns through selective exposure to a few of the many investment options. In a high risk segment, our deep fundamental analysis and risk mitigation techniques should prove more important than ever going forward.


**Matthew R. Werner, CFA**
mwerner@chiltoncapital.com
(713) 243-3234

**Bruce G. Garrison, CFA**
bgarrison@chiltoncapital.com
(713) 243-3233

**Samuel E. Rines**
srines@chiltoncapital.com
(713) 243-3263

**Blane T. Cheatham**
bcheatham@chiltoncapital.com
(713) 243-3266


RMS: 1604 (6.30.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) 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 Capital REIT Outlook are available at www.chiltoncapital.com/reit-outlook.html.*


*Indexes are unmanaged and have no fees or expenses. An investment cannot be made directly in an index. The funds consist of securities which vary significantly from those in the benchmark indexes listed above and performance calculation methods may not be entirely comparable. Accordingly, comparing results shown to those of such indexes may be of limited use.*

*The information contained herein should be considered to be current only as of the date indicated, and we do not undertake any obligation to update the information contained herein in light of later circumstances or events. This publication may contain forward looking statements and projections that are based on the current beliefs and assumptions of Chilton Capital Management and on information currently available that we believe to be reasonable, however, such statements necessarily involve risks, uncertainties and assumptions, and prospective investors may not put undue reliance on any of these statements. This communication is provided for informational purposes only and does not constitute an offer or a solicitation to buy, hold, or sell an interest in any Chilton investment or any other security.*


C