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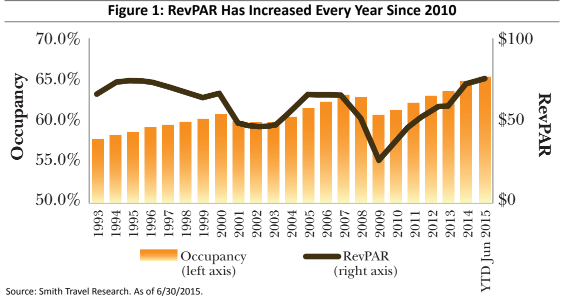
Airbnb: Expanding the Definition of Lodging | October 2015

Like any business, the financial well-being of hotels is heavily influenced by supply and demand dynamics. Hotels are in the sixth consecutive year of positive fundamentals in which demand has outpaced supply (**Figure 1**). REIT hotel demand is comprised of approximately 75% corporate and 25% consumer business. With corporate profits healthy (excluding energy) and consumer confidence above the long-term average, hotel demand is expected to continue to outpace supply in 2016 and 2017.

Figure 1: RevPAR Has Increased Every Year Since 2010



Source: Smith Travel Research. As of 6/30/2015.

Airbnb, an online short-term rental company, has emerged as a competitor for traditional hotels that could increase supply and thereby lower occupancy and rental rates at traditional hotels. Despite the strong fundamentals, hotel REITs (Bloomberg: BBREHOTL Index) have produced a total return of -22.2% year to date as of September 30, 2015, which compares to performance of -4.3% for the MSCI US REIT Index (Bloomberg: RMS). Though we have yet to see a measurable effect on hotel company income statements, we believe some of the recent decline in hotel REIT and C-Corp prices can be attributed to the thought of Airbnb as a rising threat.

Hotel Industry Disruption

Airbnb is not the first threat to revenue growth that hotels have experienced. Some hotels have had to face competition from condos/timeshares available for rent within their own properties. However, hotel owners adapted by offering to list the rooms on their reservation systems and providing cleaning services, for a fee of course. Over time, the “issue” became a source of revenue.

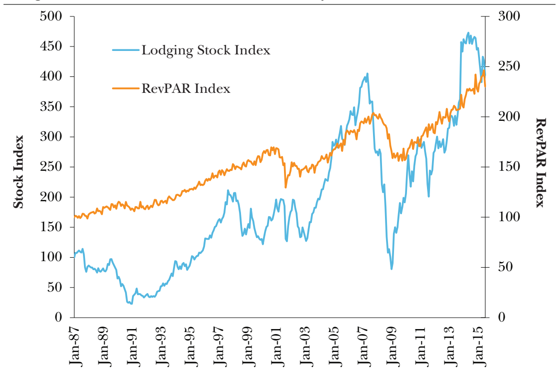
Online travel agents (OTAs) such as Expedia (NASDAQ: EXPE) and Priceline (NASDAQ: PCLN) have also attempted to disrupt the hotel industry. Though they helped to fill rooms that may have otherwise been vacant, the exorbitant fees that owners had to pay put pressure on margins. In order to maintain margins, hotels encouraged travelers to book directly through them by enticing guests with loyalty programs, digital check-ins, free wifi, food and beverage discounts, and other perks. OTAs remain popular in the industry today, but hotel owners have learned how to use them to their advantage instead of viewing them as competition.

Growing the Pie

Airbnb is a product of the sharing economy, connecting “hosts” with guests. Though about two thirds of the listings are for an entire home, guests have multiple options, ranging from living room couches to shared and private rooms to even castles, tree houses, and igloos! Airbnb makes money on both sides of the transaction. The host pays about 3% of the pre-transaction cost, while the guest pays anywhere from 6-12% of the cost (a higher subtotal leads to a lower percentage). Since Airbnb’s creation in 2008, it has hosted over 40 million guests across 34,000+ cities spanning over 190 countries. Currently there are over 1.5 million listings worldwide with about 25% of them in the U.S. In a recent $1.5 billion venture capital financing, the implied value of the company is over $20 billion.

Historically there has been over a 90% correlation between hotel RevPAR (Revenue per Available Room) and hotel REIT sector returns. **Figure 2** shows that the correlation has recently deviated from the historical trend, as hotel companies’ performance has not reflected the continued strength in fundamentals. Thus, we believe the recent performance can be attributed to headlines, one of which is the rising threat from Airbnb.

Figure 2: 92% Correlation Between Hotel Companies' Performance and RevPAR



Source: Smith Travel Research, FactSet, Canaccord Genuity estimates. Data through August 2015.

A 2013 study (revised in 2015) by Boston University titled "The Rise of the Sharing Economy: Estimating the Impact of Airbnb on the Hotel Industry" estimated that hotel revenue in Texas was negatively impacted by 8-10% cumulatively over a five year period due to the presence of Airbnb. However, hotels on the lower end of the price spectrum that focused on leisure travel bore the brunt of the impact from Airbnb despite accounting for a disproportionately small amount of total hotel revenues. **The study concluded that higher end chain scales, as well as hotels that cater to transient business travel, should be the most insulated from Airbnb.**

A more qualitative analysis also supports the conclusion drawn from the Boston University study. The existence of Airbnb supply does not dictate that it is directly competitive with hotel supply. Though Airbnb and hotel REITs compete for the same broad travel demand pool, it is more an instance of growing the "pie" rather than taking a bigger piece. Airbnb travelers tend to travel in groups, stay for longer, and be more price sensitive than the typical hotel guest, suggesting they are likely seeking a different experience than they would get during an urban, business-focused hotel stay. This is supported by 30-40% of Airbnb travelers reporting they would not have taken their trip if it were not for Airbnb. Additionally, in most cities, existing hotel supply does not overlap with the housing stock geographically, which has lead to 76% of Airbnb listings located outside of hotel districts. In contrast, most hotel REITs derive a majority of their business from corporate transient demand in urban business districts.

Depressing Compression Nights

Though some segments of the hotel industry may be impacted more than others, Airbnb's ability to increase supply at the click of a mouse has the potential to affect all hotel revenue by reducing the number of "compression nights". Compression nights are when high hotel occupancy (usually due to a special event) drives outsized pricing power. According to Wells Fargo research, compression nights tend to make up about 5-10% of nights, but account for 7-13% of annual room revenue. On Pebblebrook Hotel's (NYSE: PEB) 2Q 2015 earnings call, CEO Jon Bortz mentioned in reference to Comic-Con in San Diego, "You don't have the same marginal pricing capability today because of how much of the demand is getting filled by Airbnb hosts versus it having compressed and even pushed out into the suburban markets."

However, the complete erosion of compression nights is not a near-term threat. Using nights when market occupancy exceeds 95% as a proxy, total compression nights have continued to grow in the top 25 U.S. hotel markets despite the growth in alternative supply. By the end of 2014, there were almost 95% more compression nights than during the prior cycle peak in 2007. Even in a worst case scenario when all compression nights are reduced to "normal nights" due to Airbnb competition, the damage would be limited to only 2-3% of revenue.

Airbnb Enhancements

Currently only 10% of its business, Airbnb is beginning to focus more on corporate travel. In July 2015, Airbnb enhanced its "Airbnb for Business" product by launching a new global travel management platform that allows business travelers to book travel through Airbnb and automatically expense the cost back to their employer. As of August, over 1,000 companies from over 35 countries were signed-up for the program.

Though this initiative may increase Airbnb's business travel market share, most hotel REIT properties target a different kind of business traveler **(Figure 3)**. Airbnb is targeting longer-term business travel more consistent with corporate temporary housing, "team offsites", and convention travel, while the hotels are targeting corporate transient consumers with location preferences central to businesses. The average business stay for Airbnb is 6.8 days, which compares to just over 3 days for hotels.

In an effort to increase revenues (for both hosts and themselves), Airbnb introduced "Price Tips" in June 2015. Price Tips functions similarly to a revenue management system that a hotel, self-storage facility, or apartment owner would use to price space on a day-to-day basis. The system uses inputs such as listing type, location, price, and availability to determine an optimal price to maximize revenue. Hotel owners should be encouraged by Airbnb's addition of this new tool. A revenue management system could reduce Airbnb's price competitiveness and bring pricing more inline with hotels. In a similar fashion, the self-storage REITs were relieved when "mom and pop" owners began using revenue management systems because it raised the floor for rental rates and made it easier for the REITs to increase revenues.

Figure 3: Estimated Exposure by Demand Segment

	Group	Corporate Transient	Leisure Transient
INN	5%	75%	20%
HT	10%	70%	20%
HPT	10%	70%	20%
RLJ	15%	60%	25%
AHT	25%	50%	25%
AHP	30%	45%	25%
LHO	35%	45%	20%
DRH	35%	45%	20%
HOT	40%	40%	20%
HST	40%	40%	20%
SHO	40%	40%	20%
MAR	40%	35%	25%
BEE	45%	35%	20%

Source: Company reports, Canaccord Genuity estimates.

New Game, New Rules

Since 2008, Airbnb has been essentially unregulated, but cities are beginning to pay more attention. In some cities, Airbnb is already not allowed due to lease restrictions against subleasing an apartment, homeowners association or co-op board rules, or lack of proper zoning and permitting for what is essentially an "illegal hotel" (a residential property with three or more units that are leased for a period less than 30 days). Though the legal and political approaches for Airbnb vary by city, the conversation is getting louder. Some of the topics that cities have discussed include licensing, taxes, the total number of nights allowed, whether the host has to be present during the rental, and how the city will monitor the business. Cities' positions on these issues have had a significant effect on the magnitude of Airbnb's presence.

In 2011, Chicago adopted a highly regulated process for short term rentals and, as a result, has seen very low registered Airbnb participation relative to other cities of its size. Chicago's regulations apply to all properties that will not be occupied by the tenant or owner during the time of rental (offering a room while owner/tenant is present is allowed). Chicago offers a two-year renewable license for $500 that requires liability insurance, a maximum number of guests allowed, a guest registry, and that the host provides guests with hotel-like features such as soap, clean towels and linens, and room cleaning. However, before the host can obtain the license, they must pass a Department of Buildings inspection, a Department of Zoning board review, and file an application with the Department of Business Affairs. Chicago also requires that guests pay the 4.5% "Hotel Accommodations Tax".

Austin took a more welcoming approach to Airbnb regulations in their 2012 ordinance on short-term rentals. The city requires an annual license and that hosts pay a hotel tax. However, though the city limits the percent of housing that can receive the license within certain locations, it does not require the strict operating requirements or burdensome pre-licensing process that Chicago mandates.

San Francisco is an example of a major city currently working through regulations. The city has a proposal on the November ballot to limit hosts to 75 rental days a year and require Airbnb to monitor hosts. San Francisco's current policy is self-regulation and a 90 day rental limit only for hosts that are not present, but the city cannot even enforce the current policies. According to Inside Airbnb, more than one third of listings posted in San Francisco are leased for more than the legal 90 days a year. The new proposal will allow neighbors to take action against rental platforms through the court system if they find any violations.

Airbnb seems to be coming under the most pressure in cities like San Francisco with a housing supply shortage. Short-term rentals that are permanently offered to tourists remove already scarce housing supply from the market, driving up rents and thereby further displacing local residents. Opponents argue Airbnb also increases rental rates and home values because hosts can afford to pay more since payments are being subsidized by Airbnb revenue.

Though any addition of regulations on short term rentals will be beneficial to hotel REITs in the long-term by curtailing Airbnb supply, cities that have passed regulations are still figuring out the best way to implement them. Many cities will have to add (and fund) additional positions to the city bankroll to help enforce compliance and as a result it may take some time before the market starts to see a pullback in Airbnb supply.

Airbnb in N-Y-C

New York City is the second largest U.S. hotel market (behind Orlando) with over 115,000

Figure 4: US Exposure by Chain Scale

	MAR	HOT	HST	LHO	DRH	SHO	BEE	HT	HPT	AHT	AHP	RLJ	INN
Luxury	5%	10%	9%	1%	10%	8%	61%	13%	0%	2%	9%	0%	0%
Upper-Upscale	34%	76%	89%	99%	82%	88%	36%	39%	5%	48%	61%	20%	1%
Upscale	45%	14%	3%	0%	8%	4%	0%	33%	61%	42%	26%	65%	65%
Upper-Midscale	17%	0%	0%	0%	0%	0%	0%	5%	12%	6%	0%	14%	30%
Midscale	0%	0%	0%	0%	0%	0%	0%	9%	22%	0%	0%	1%	4%
Economy	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Independents	0%	0%	0%	0%	0%	0%	4%	0%	0%	2%	3%	1%	0%

Source: Smith Travel Research, Company Filings, Canaccord Genuity estimates; numbers may not add up to 100% due to rounding.

rooms and one of the most important markets based on hotel REIT exposure. Currently, there are more than 27,000 Airbnb units available to rent in New York City, with approximately 55% for an entire residence. When accounting for availability and listings that are not active, total available competitive Airbnb supply equates to 4.6% of total hotel supply. This pales in comparison to the 11% (or 13,000 room) expansion in supply that hotel developers have justified through underwriting future demand growth.

One of the hotel REITs that should fare the best against New York Airbnb supply is Hersha Hospitality Trust (NYSE: HT). Hersha's portfolio focuses on upscale and upper upscale chains **(Figure 4)** which do not compete with the typical Airbnb price point. 80% of NYC Airbnb listings are below $300 per night suggesting they are more competitive with lower chain scales that are not often in REIT portfolios. Additionally, a majority of HT's NYC properties are located in Midtown or the Financial District, which mostly attracts corporate transient demand. With only 3.7% of NYC Airbnb supply in Midtown and the Financial District, HT's properties should be resistant to any threat that Airbnb may pose.

Great Real Estate Wins Again

Many have tried to cite the adoption of Airbnb and other short term rentals as the cause for this year's poor performance. In reality, the recent performance probably has more to do with difficult year over year revenue comparisons and speculation that a tough macroeconomic environment will result in a deceleration of RevPAR growth. While it is true that Airbnb has gained more attention as an acceptable alternative to some hotels, it has yet to become the perfect substitute for all hotels. In particular, it does not compete with public REIT properties, which focus on different price points, locations, and customers.

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RMS: 1637 (9.30.2015) vs. 1710 (12.31.2014) vs. 346 (3.6.2009) and 1330 (2.7.2007)

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