SunTrust Robinson Humphrey

Key points from CBRE conf. call on asset values, labor costs, and 2018 RevPAR

CBRE: Fundamentals remain attractive for most markets; profit growth still slow

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What's Inside

A recap of yesterday's conference call with CBRE Hotels' Americas Research

What's Incremental To Our View

Yesterday we held a conference call with CBRE Hotels' Americas Research, a leading hotel consultancy. CBRE provided their 2018 RevPAR forecasts (and thoughts past 2018), transaction and labor costs trends, and a detailed analysis of hurricane-related impact. *Bottom line for us: CBRE believes high occupancy today provides leverage for ADR increases in the next 2-3 years. Near-term RevPAR growth continues to gradually erode. Headwinds include supply growth (expected to peak in next 1-2 years) and labor cost increases pressuring profit growth. Hurricane impact may be a positive for 4+ months.*

On the whole, CBRE remains positive about hotel fundamentals for most markets. Their positivity is being driven by a number of fundamentals:

- **High occupancy levels provide leverage to achieving ADR growth (for the next 2-3 years).** Note that ADR growth generally flows more to the bottom line than occupancy growth (a view shared by CBRE and STRH.)
    - **Despite the generally attractive fundamentals, CBRE views ADR growth as currently lackluster.** This is partly driven by shorter booking lead times, the growth of the sharing economy, revenue management focus on occupancy, and intermediaries receiving a greater portion of rate increases. CBRE notes that the "cost of acquisition" is increasingly a greater area of industry focus.
- **Hotel construction is expected to level off in the next year or two** (many factors contributing to this, see below for detail).
- **Profit growth will remain slow**, with headwinds including supply growth and increasing labor costs. **CBRE is forecasting NOI growth of 1.8% in 2017 and to decrease by 20 bps annually through 2019.**
- **CBRE is forecasting U.S. RevPAR growth to be 2.8% in 2017 and 2.4% in 2018.** Further, CBRE forecasts occupancy to achieve another record performance in 2017 (65.6%) and again in 2018 (65.7%). This is expected to occur concurrently with further erosion in ADR growth.
    - CBRE received a number of questions on the composition of their demand model. Their model assumes no change in tax policies or immigration policies, includes higher employment assumptions, and incorporates market specific dynamics.

- **CBRE is forecasting RevPAR growth in the Top 25 markets to increase in 2018 to +1.7% (vs. +0.7% in 2017).** Top RevPAR growth markets in 2018 are forecasted to be San Antonio, Dayton, and Orlando (other top markets with REIT exposures include LA, Oahu, and Boston). Lagging RevPAR growth markets include Seattle, SF, Charlotte, Pittsburgh, and Houston (this includes hurricane impact, which will benefit 2H17 but will be a tough comp in 2H18.)
- **However, the strongest RevPAR growth in 2018 is expected to be outside the top 25 markets. The Economy chain scale is forecasted to be the strongest RevPAR gainer at +4.5%.** Independents remain strong but CBRE noted that part of this is due to these hotels playing catch up as a significant segment of total supply is already running full, leading to price increases at branded hotels.)
- Note to observant readers of our monthly Lodging RevPAR Monitor: our RevPAR forecasts are for branded US full-service domestic hotels which incorporates somewhat different dynamics than the forecasts noted above.

A deeper dive into the current and near-term environment:

- **Of the top 60 markets that CBRE analyzes in depth, 44 markets will have supply increases >2% over the next four quarters.** The markets seeing the largest supply increases are: NYC, Charlotte, Dallas, Austin, and Charleston. The markets seeing the smallest supply increases are Orlando, Tucson, and Albuquerque (the latter's supply growth is slightly negative).
- CBRE views that hotel supply is close to peaking (next 1-2 years). **Interesting to us at STRH, CBRE discussed a few rationales why supply growth is not expected to grow past 2019:**
    - Some schools of thought suggest flat macroeconomic growth in 2019 and 2020 (suggesting that hotel developers are cognizant of not wanting to open a hotel into an economic downturn).
    - Scarcity of high quality brands available for development. What is happening is the most desired brands (also ones that receive the most development support from capital markets) are less available in some geographic areas (we consider this largely a consequence of territorial restrictions for same-brand development). CBRE alluded that some newer brands may become favored flags for developers but that this may take time. We agree with this sentiment and suggest that some of the newer brands being launched by the big C-corps are trying to accommodate this issue. However, it may take a few years before lenders become more comfortable with the new brands.

The changing traveler -- more leisure-focused and more senior-focused. CBRE provided an interesting analysis highlighting that absolute ADR over the weekend now exceeds weekday ADR and demand growth supports this. CBRE views the overall demand momentum as "very very positive" long-term for the industry. **Also interesting to us -- seniors (55+) have become the largest share of lodging demand by share of households and spend.** Despite the rising population of millennials as working adults, the share of lodging spending appears to be falling.

Labor costs -- a rising issue. Labor costs are the largest expenses for hotels (~ 43% of expenses). In the currently tight job market, CBRE notes that labor costs are likely to rise more measurably. The hotel industry has made efforts to reduce the impact from labor cost growth through F&B initiatives (a move to "grab and go" meals) and time and motion studies to increase productivity. We note that a number of our REITS have discussed these efforts in recent quarterly earnings calls.

Cap rates are forecasted to increase modestly. From the cycle low of 8.15% in 2013/2014, US cap rates are forecasted to increase to 8.89% in 2017 (up 37 bps from 2016). Cap rates are forecasted to rise to 8.91% in 2019 but will remain below the long-run average of 9.39%. **CBRE forecasts that national hotel values are forecasted to be steady to slightly declining through 2019.**

Historical evidence suggests that hurricane demand impact can be positive for many months post storm. CBRE analyzed four major hurricanes and highlighted the peak demand impact is in month one but there can be relatively strong demand increases four to seven months later. Impact can be significantly positive for nearby metros due to group displacement.

- CBRE's revised Houston RevPAR forecast suggests a 4-6 month positive RevPAR impact in 2H17 followed by hard comps in 2H18 and a recovery of oil prices and demand normalization in 2019 (low-to-mid single-digit RevPAR increases.)

CBRE believes brands still matter. CBRE views brands as providing a 100-150 bps premium on ADR which has multiple positive implications, including profits and hotel valuation.

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