Equity Research Report

October 31, 2023

CONSUMER: Lodging

Gregory J. Miller
212-303-4198
Gregory.J.Miller@truist.com

C. Patrick Scholes
212-319-3915
Patrick.Scholes@truist.com

Vishaal Shekara
212-319-5834
Vishaal.Shekara@truist.com

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Reasons for this report

✓ Deep dive analysis of recent U.S. hotel revenues and profits, a proxy for the Lodging REIT portfolios and within Lodging C-corps an excellent overview of franchisee health/fee generation of institutional hotel owners.

✓ The analysis is also a read-through on C-corp base and incentive management fees (IMFs) and owned/leased margins.

October Hotel P&L Analyzer: 3Q owned GOP margins -130 bps y/y. Labor costs still rising faster than room rates

In our analysis of over 1,000 U.S. full-service hotels (data source HotStats), 3Q23 hotel Gross Operating Profit (GOP) margins were 35.2%, -130 bps y/y and flat vs. 3Q19. These figures are relatively better than 2Q23 (-310 bps y/y and -60 bps vs. 2Q19). 3Q headline stats reflect insufficient ADR growth to match labor/other cost growth. While 4Q23 should be a better quarter on revenue growth due to strong groups, concerns for 2024 U.S. property-level margins are growing.

Our "Bottom Line": We are incrementally cautious for Lodging REIT profit margins and to a lesser degree U.S. C-corps because of their exposures to incentive management fees.

(Please note our data set continues to skew slightly above the average Upper Upscale hotel and to institutionally-owned urban and resort hotels which may add some variance to STR data and individual public company results. ***Please view the PDF version of this note for superior quality of exhibits.***

Major takeaways:

- **3Q23: Better property margin results sequentially than 2Q23 but property-level costs still rising faster than revenues.** Given ADR growth flows much better to hotel profits than occupancy growth, we view choppy room rates relative to labor cost growth as one of the particular drivers to 3Q being another quarter of profit margin deceleration.
- **Lodging REITS: Incrementally cautious with downside risks greater than upside risks. Potential for downward revisions on 2024 estimates, though it is difficult to make a strong case that valuation multiples will take a material hit from their already depressed levels.** While we expect 4Q23 to be a decent revenue quarter given strong group trends, cost headwinds may exceed revenue growth once again for many higher-rated hotels. As for 2024: budget season is currently underway and we view forward demand visibility still more challenging than pre-2020. We expect we will have somewhat better clarity on 2024 starting around the time of our December conference in Boston. Our current expectations for 4Q23 and 2024 are presented below.
  - 4Q23 revenue growth > 3Q23 revenue growth given strong group and business travel and favorable holiday calendar shift.
  - 4Q23 property margins with continued operating cost headwinds (especially labor) and fixed cost growth (e.g. taxes, insurance).
  - Maui fires and 2023 tropical storms add downside risks on property insurance for 2024.
  - **Excluding uncertainty on the macroeconomy and the wars in Europe and the Middle East, 2024 downside risks for U.S. hotel margins are growing given organized labor activity and federal government action** on overtime pay and joint employer rules.
- **Lodging C-corps:** While we remain far more favorable on hotel C-corps than hotel REITs, C-corps are not immune to the above noted pressures, especially with their incentive management fees (IMFs). That said, IMFs are a far less important component of C-Corp revenues than in the past as growth for these companies has primarily been via franchising and not from managing hotels; IMFs are approximately 15% of Marriott's (MAR, Hold, Scholes) fee revenues today vs. 25% fifteen years ago.
  - Assume pressure on what is already fairly lethargic new-build construction activity for U.S. full-service hotels.

SEE PAGE 11 FOR REQUIRED DISCLOSURE INFORMATION

Our stock recommendations: While we are not adjusting estimates for today's note, we view a greater potential for downward estimate revisions for U.S. hotels, especially the REITS. Even in what could be a decent group/convention year in 2024 with group RevPAR +MSD combined with negotiated corporate rates seeing another year of +MSD/HSD increases, cost pressures from organized labor to federal government rules to taxes and insurance are incremental 2024 headwinds to hotel profits and operating efficiencies. In short, we view downside risks for U.S. property-level margins far greater than upside risks.

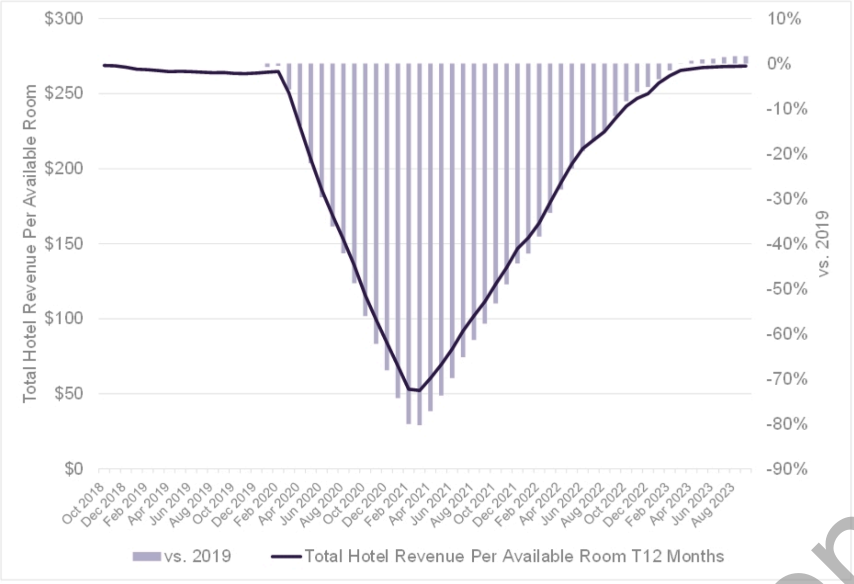
- Our favorite Lodging C-corp continues to be **Hyatt** (H, Buy, Scholes) given its several avenues of longer-term growth (e.g. high-fee generating rooms growth, recovery in China, ALG expansion, group recovery, etc.),
- Our favorite Lodging REIT continues to be **Ryman** (RHP, Buy, Scholes) given limited supply growth for large group hotels, strong group fundamentals, and excellent asset management initiatives/investment in its hospitality and entertainment divisions.
- **Investors were concerned with Pebblebrook's (PEB, Hold) remarks on Friday's earnings call** noting "we shouldn't be surprised if we see a slowdown or a recession sometime in the next 12 months". PEB's stock fell 10% on Friday and other Lodging REITS fell MSD (e.g. DRH, PK, RLJ). While we have yet to see clear evidence of a material weakening of lodging demand fundamentals, our commentary in this note focuses on non-revenue drivers that present a somewhat distinct headwind for U.S. hotel profitability.

Why do we not have any Sell ratings on Lodging REITS today? ***A moderate risk of another privatization (see Hersha (HT, Not Rated) for example).*** This is not to say we expect many go-privates anytime soon (of course, we could always be proven wrong; as we say, “never say never when it comes to such things”). High interest rates and not-particularly-trough level multiples (our Lodging REITS in aggregate: 10.3x 2024 EV/EBITDA as of Monday 10/30) may dissuade private equity and other potential acquirers for now. However, the spread between private and public market valuation remains considerable and the operating environment has in our view greater near-term downside risks than upside risks. We could see some management teams deciding it would be better to exit now than if fundamentals and multiples contract further in a softer environment in 2024/2025, if actualized. At the same time, we could be in a very low supply growth environment for years, eventually leading to improved real estate economics and where a PE buyer with a 5-7 year hold period could take advantage of short-term stock levels and then divest their acquisition after several years of low hotel rooms supply growth eventually create a more favorable RevPAR and profit environment for hotel owners. **In short, long-term demand-supply fundamentals may prove more attractive than the potential downside risks over next 12-18 months.**

YTD results, forecasts, and readthrough to earnings:

The good news is we are seeing clearer trends of hotel revenue growth now exceeding 2019 levels driven in part by outside-the-room spend (food and beverage, meetings, etc.) However, results are still well shy of inflationary cost growth. We view slowing room rate growth as a partial driver to why revenues remain well behind 2019 levels when factoring in inflation. Understandably, it is difficult to push room rates when occupancy for many higher-rated business hotels remains below pre-pandemic levels.

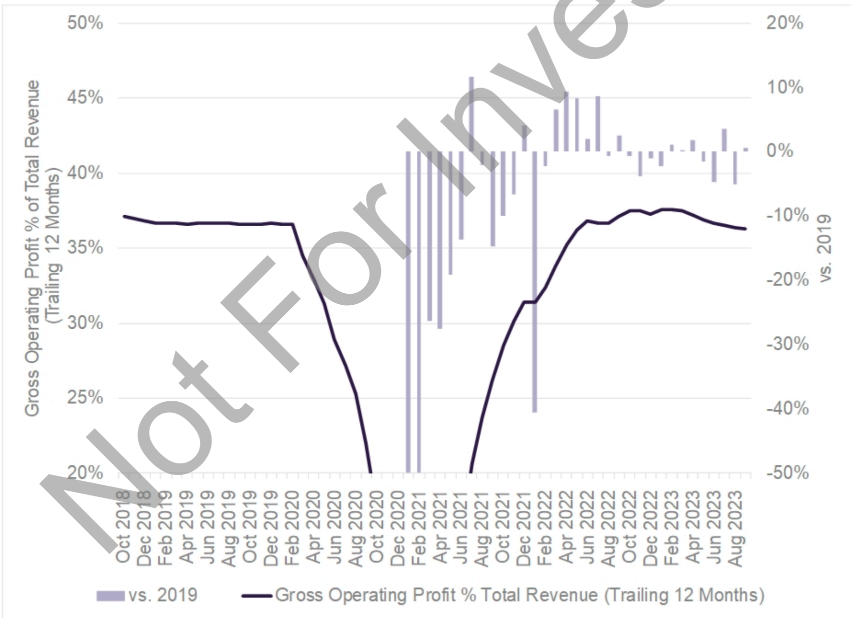
Exhibit 1: Total Hotel Revenue Per Available Room (Trailing 12 Months) and vs. 2019 Recovery



Source: Truist Securities Research, HotStats

GOP margins continue to show signs of margin deceleration. The relatively good news from our vantage point is 3Q was a better quarter than 2Q in terms of operating efficiencies. Despite 3Q23's lower ADR and a more leisure oriented customer mix, margins relative to 3Q19 were better than 2Q23 to prior years. We can point to the dark purple line showing some flattening of margin deceleration towards September 2023.

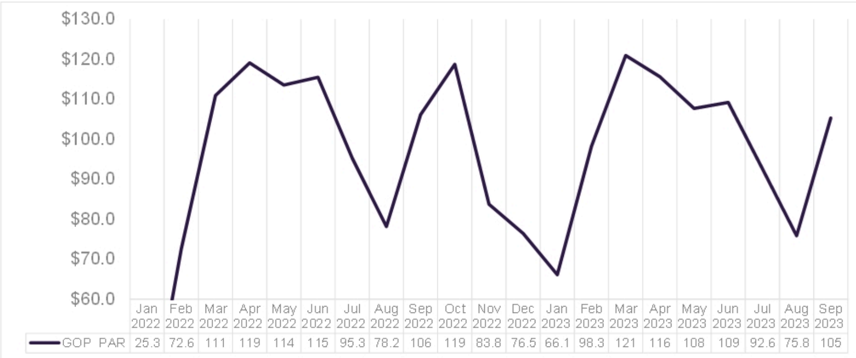
Exhibit 2: Gross Operating Profit % of Total Revenue (Trailing 12 Months) and vs. 2019 Recovery



Source: Truist Securities Research, HotStats

On incentive management fees (IMFs), we view the U.S. same store 3Q23 setup more favorably than 2Q23 in terms of y/y and versus 2019 change although given normal seasonal patterns we expect IMFs to be lower in absolute dollars in 3Q versus 2Q.

Exhibit 3: Gross Operating Profit Per Available Room

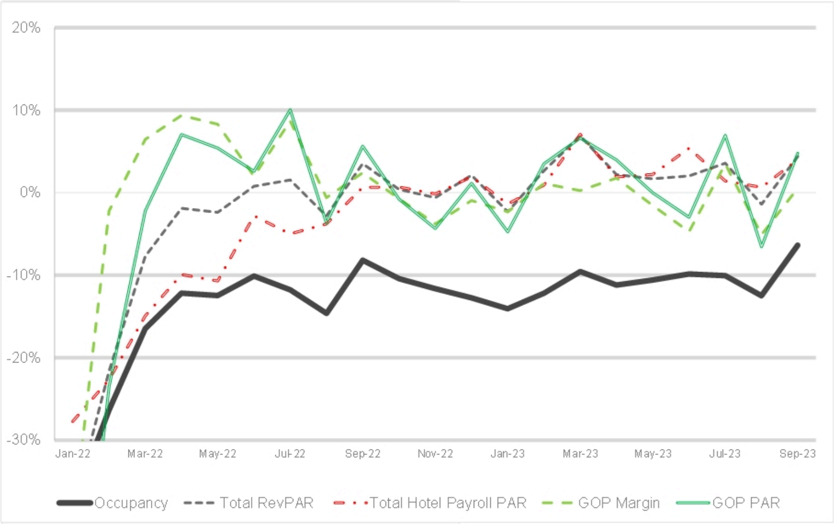


GOP PAR	2019	2022	2023	y/y	vs. 2019
January	69.38	25.34	66.09	161%	-5%
February	94.93	72.59	98.25	35%	3%
March	113.43	110.94	120.95	9%	7%
1Q	**91.72**	**68.82**	**93.75**	**36%**	**2%**
April	111.24	119.08	115.65	-3%	4%
May	107.72	113.54	107.72	-5%	0%
June	112.57	115.49	109.22	-5%	-3%
2Q	**109.78**	**115.01**	**109.72**	**-5%**	**0%**
July	86.58	95.29	92.6	-3%	7%
August	81.17	78.17	75.84	-3%	-7%
September	100.48	106.15	105.3	-1%	5%
3Q	**89.29**	**93.08**	**91.12**	**-2%**	**2%**
3Q vs. 2Q	**-18.7%**	**-19.1%**	**-17.0%**		

Source: Truist Securities Research, HotStats

In the below summary chart, we can see that even though occupancy remains depressed, total RevPAR and profits continue to hover in the -5% to +5% range versus 2019.

Exhibit 4: Occupancy, Total Revenue, Margins, and Labor Costs vs. Same Month 2019



Source: Truist Securities Research, HotStats

For international base management fees, we view Europe, the Middle East, and East Asia (China, Japan, SE Asia) with the greatest fee tailwinds for 3Q23, positive in particular to **Hyatt** and **Marriott**. In the Caribbean, while y/y comps are tougher, we view overall ADR growth since 2020 remaining a relative tailwind to absolute profits. However, the strength of the Mexican peso should continue to negatively impact hotel-level profits until hotels can reprice rooms and non-package revenue items to account for higher operating costs.

- We continue to view superior opportunities for IMF growth from regions of the world not subject to operating profit thresholds before a C-corp receives IMFs. As a result, Asia-Pacific (specifically Northeast and Southeast Asia) remains our favored region of IMF growth due to the lack of a profit hurdle, recovery of domestic and international travel, new rooms growth, and distance from conflicts in Eastern Europe and the Middle East. That said, these conflicts may also temper travel demand to Asia-Pacific and result in other cost pressures (i.e. utilities).

Shifting to the full-service Lodging REITS: 3Q23 presented another quarter of modest revenue growth amidst a higher cost growth environment. We note that 3Q is a bit of a variable quarter given July is skewed to leisure demand, August is a transition month, and September had holidays and holiday shifts. We add that 3Q was a tougher y/y comp due to pent-up international leisure travel and the decline of some champagne spenders. One positive as we compare 3Q23 sequentially to 2Q23: despite much lower ADR and F&B margins given the normal summer shift to a greater mix of leisure customers, GOP margins were stronger sequentially than in 2Q. We view increased normalization of hotel operations as a factor. While normalization does not equate to profit margin growth for now, at least we sense some improvement in hotel efficiencies as hotel staff have had more quarters to ramp up under more "normalized" (or "new norm") staffing levels.

Exhibit 5: 3Q23 Versus Prior Years Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 3Q23 vs. Prior Years

	3Q23	3Q22	*y/y % change*	3Q19	*4-yr % change*
Occupancy	71.3%	69.8%	*2.1%*	79.0%	*-9.7%*
ADR	$244	$245	*-0.3%*	$216	*13.2%*
RevPAR	**$174**	**$171**	***1.9%***	**$170**	***2.2%***
Total RevPAR	**$260**	**$256**	***1.4%***	**$254**	***2.3%***
Room Margin	72.8%	73.4%	*-0.8%*	72.9%	*-0.1%*
F&B Margin	23.3%	25.1%	*-7.2%*	23.2%	*0.4%*
Operating Department Margin	60.5%	61.3%	*-1.3%*	59.9%	*1.0%*
GOP Margin	**35.2%**	**36.5%**	***-3.6%***	**35.2%**	***0.0%***
GOP Per Available Room	**$91**	**$93**	***-2.1%***	**$89**	***2.0%***
Total Hotel Payroll (% of Total Revenue)	35.7%	34.6%	*3.2%*	35.7%	*0.0%*
Total Hotel Payroll (Per Available Room)	$93	$88	*4.9%*	$91	*2.0%*
Total Hotel Payroll (Per Occupied Room)	$130	$126	*2.7%*	$115	*13.1%*

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

Source: Truist Securities Research; HotStats

Exhibit 6: 2Q23 Versus Prior Years Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 2Q23 vs. Prior Years

	2Q23	2Q22	*y/y % change*	2Q19	*4-yr % change*
Occupancy	72.0%	71.2%	*1.1%*	80.6%	*-10.7%*
ADR	$256	$252	*1.6%*	$224	*14.3%*
RevPAR	**$184**	**$179**	***2.9%***	**$180**	***2.2%***
Total RevPAR	**$283**	**$275**	***3.1%***	**$279**	***1.7%***
Room Margin	74.0%	75.6%	*-2.1%*	74.4%	*-0.5%*
F&B Margin	31.0%	34.6%	*-10.4%*	32.3%	*-4.0%*
Operating Department Margin	62.3%	64.3%	*-3.1%*	62.1%	*0.3%*
GOP Margin	**38.8%**	**41.9%**	***-7.4%***	**39.4%**	***-1.5%***
GOP Per Available Room	**$110**	**$115**	***-4.6%***	**$110**	***-0.1%***
Total Hotel Payroll (% of Total Revenue)	33.6%	31.1%	*8.0%*	33.2%	*1.2%*
Total Hotel Payroll (Per Available Room)	$95	$85	*11.5%*	$93	*2.6%*
Total Hotel Payroll (Per Occupied Room)	$132	$120	*10.0%*	$115	*14.6%*

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

Source: Truist Securities Research; HotStats

Exhibit 7: 3Q23 Versus 2Q23 Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 3Q23 vs. 2Q23

	3Q23	2Q23	% change	Abs, variance	
Occupancy	71.3%	72.0%	*-1.0%*	-70	*bps*
ADR	$244	$256	*-4.6%*	-$11.73	
RevPAR	**$174**	**$184**	***-5.6%***	**-$10.24**	
Total RevPAR	**$260**	**$283**	***-8.4%***	**-$23.76**	
Room Margin	72.8%	74.0%	*-1.6%*	-120	*bps*
F&B Margin	23.3%	31.0%	*-24.8%*	-770	*bps*
Operating Department Margin	60.5%	62.3%	*-2.9%*	-180	*bps*
GOP Margin	**35.2%**	**38.8%**	***-9.3%***	**-360**	*bps*
GOP Per Available Room	**$91**	**$110**	***-17.0%***	**-$18.60**	
Total Hotel Payroll (% of Total Revenue)	35.7%	33.6%	*6.2%*	210	*bps*
Total Hotel Payroll (Per Available Room)	$93	$95	*-2.7%*	-$2.57	
Total Hotel Payroll (Per Occupied Room)	$130	$132	*-1.5%*	-$1.97	

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

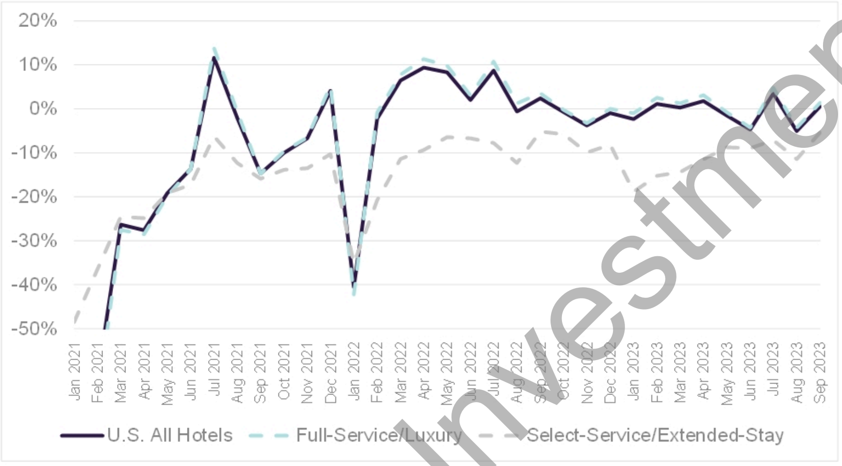
Source: Truist Securities Research; HotStats

Exhibit 8-9: Gross Operating Profit Margins as a Percentage of Revenues (top exhibit) and vs. 2019 (bottom exhibit)

Please note that while we receive an aggregation of hundreds of U.S. select-service hotels, it is possible that our data is not a clear representation of the performance of the higher-rated select-service and extended-stay hotels in the U.S. However, logically, we expect select-service margins to improve relative to full-service margins as individual business travel continues to recover.

GOP margin seasonality (% of revenue) has largely returned to pre-pandemic norms…

Full-service margins still flattish vs 2019. Select-service remains well below 2019 but improving



Note: We have intentionally not presented the deeply negative margins in 2020 for easier visuals.
Source: Truist Securities Research, HotStats

Profit forecasting beyond 3Q23

Lodging REITS: Incrementally cautious with downside risks greater than upside risks. Potential for downward revisions on 2024 estimates.

- **4Q23:**
  - **Revenues better than 3Q:** For the core fall business travel period, we expect 4Q23 revenue growth to exceed 3Q23 revenue growth given strong group and business travel and a High Holidays calendar shift. Christmas/New Years will impact leisure hotels and markets differently than business-oriented hotels, including challenging headlines from Maui following the fires that could lead to a shift of some holiday demand to other Hawaiian islands and other destinations entirely. We add that the Middle East conflict could also result in some Americans choosing to vacation closer to home.
  - **Margins may have some sequential improvement (ex-Maui) but we view a tough profit environment unless hotel revenues can exceed mid-single digit growth:** We anticipate continued operating cost headwinds (especially labor) and fixed cost growth (e.g. taxes, insurance) weighing on profitability. Insurance and other fixed costs are not reflected in our HotStats data and we assume a net headwind given property and casualty insurance cost growth of 40-60% y/y on average. For a hotel where insurance is 1% percent of hotel revenues (a good starting place assumption), a 50% increase to costs is a 50 bps hit to margins.
- **2024:** As hotels are going through budget season, we do not have great visibility from private or public hotel industry contacts on 2024 expectations. We anticipate earlier signs of clarity starting in December. Overall we view a continued theme of expense growth exceeding revenue growth being a likely dynamic, leading to margin pressures.

Lodging C-corps: We are also somewhat incrementally cautious as headwinds to U.S. property-level profit performance is a negative to franchisee health, though as noted previously, hotel management by C-corps continues be a less and less important part of their business models.

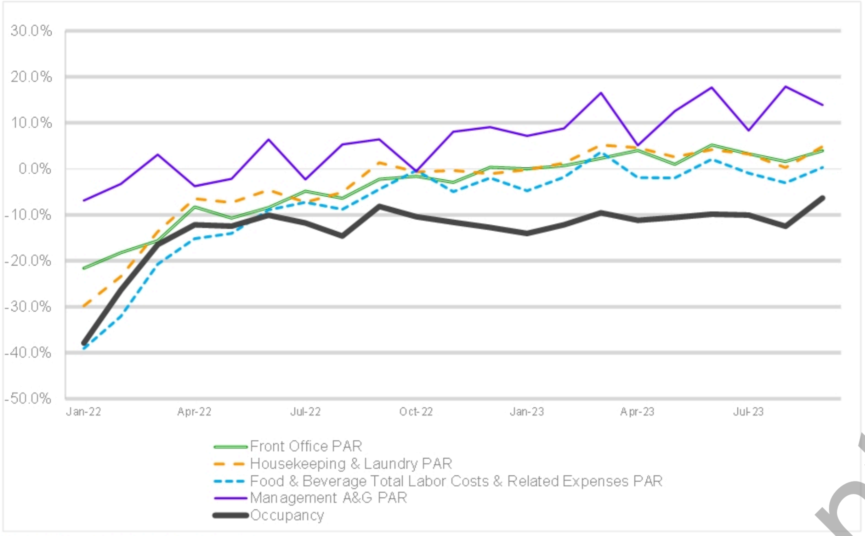
Beyond the above: We recommend investor attention to several labor related downside risks that are not drawing many investor questions for now. Due to operating leverage and geographic concentration, we view Lodging REITS more impacted than Lodging C-corps. However, the C-corps would also be directly impacted by the following in terms of financial impact, reputation, and the franchise model.

1. **Organized labor activity.** With strikes in Southern California that have not fully resolved and several major hotel markets with contract expirations in 2024, we view both the potential for operating inefficiencies from strikes/picket lines and lost demand as transient and group travelers avoid hotels on strike. We await how the Southern California hoteliers conclude their union contract negotiations as a read-through to other union markets.
2. **Overtime rule.** According to the American Hotel & Lodging Association (AHLA), the Department of Labor is proposing to increase the minimum salary threshold from ~$36K to $60K, a nearly 70% increase. Industry experts including lawyers on an AHLA webinar suggest the impact would likely be to entry/mid-level property managers (e.g. Housekeeping Manager). The potential impact could include higher labor costs, a reduction of staffing or adjustment of role responsibilities, and non-labor costs. If implemented, the overtime rule would commence in mid-2024 (a few U.S. states excluded).
3. **Joint-employer rule (potentially quite negative to C-corps over time if implemented).** Also according to AHLA, last week the National Labor Relations Board (NLRB) issued its final rule that expands the joint-employer standard under the National Labor Relations Act (NLRA). The impact of the rule challenges the franchise model and the liabilities/responsibilities of parties not under the direct responsibility of employment, meaning the franchisors/brands could be party to any collective bargaining obligations and unfair labor practices. One additional possibility is the joint-employer rule could lead to greater unionization of hotel workers which we view as a net negative to hotel profits and operating efficiencies. If implemented, the policy change is effective as of December 26th, 2023.

Other takeaways

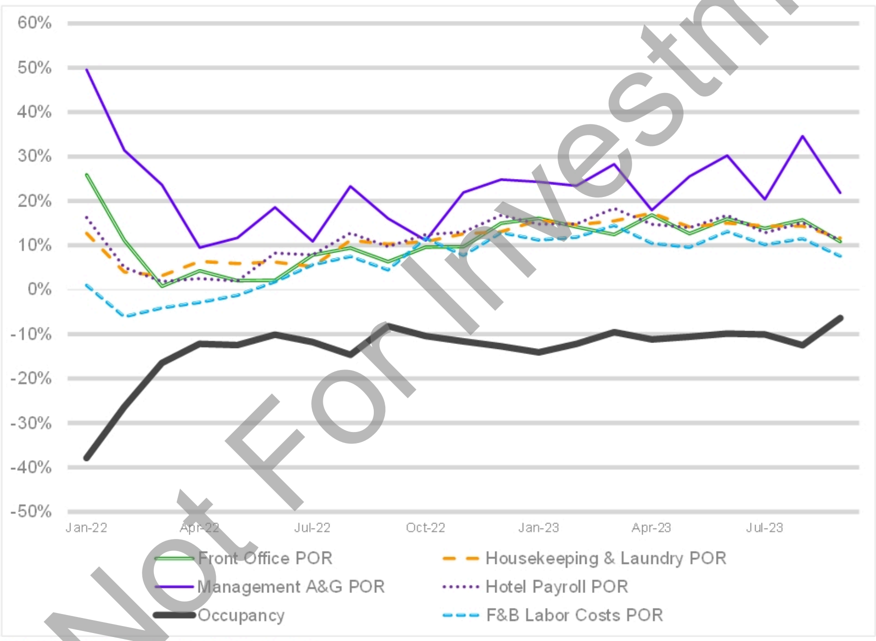
Labor cost analysis suggests some stabilizing of operating costs although property management costs remain quite elevated relative to hourly department roles. As we have discussed previously, we currently encourage a focus on per occupied room (POR) data today rather than per available room (PAR) now that occupancy levels are more plateaued for the time being. In the event there is a stronger recovery of business travel, international inbound, and convention demand later this year and into 2024 leading to increased hiring, we may once again encourage greater attention to PAR data.

Exhibit 10: Occupancy Compared to Labor Costs by Hotel Department Per Available Room (PAR) vs. Same Month 2019



Source: Truist Securities Research, HotStats

Exhibit 11: Occupancy Compared to Labor Costs by Hotel Department Per Available Room (POR) vs. Same Month 2019



Source: Truist Securities Research, HotStats

H: Valuation and Risks

Our price target of $146 is derived by applying a 14.1x target EV/EBITDA multiple (a blended average of the industry multiples for each business segment) to our estimate for 2024 EBITDA. Our sum-of-the-parts analysis on our 2024 segment multiple assumptions include (12.5x owned EBITDA u/c, 16x fees EBITDA u/c) and other segments/ALG (10-12x, u/c).

Risks to our rating and price target: Lodging recovery takes longer than expected. Planned dispositions take longer than expected. Material labor issues to owned hotels. Regional risks to the Caribbean including material new competitive supply growth. H pipeline growth slower than expected. Apple Leisure Group underperforms Hyatt's guidance.

MAR: Valuation and Risks

Our $221 price target is based on a 16.7x blended multiple on our 2024E EBITDA. In the parts, we assign a 13.0x multiple of EBITDA to the Owned segment and 17.0x fees EBITDA (the fees EBITDA also includes credit card branding fees, a 10x multiple business) to the managed/franchised business. The multiple is towards the higher end of the historical range of 9-18x.

Risks to our rating and price target:

Upside Risks: Significant U.S macroeconomic improvement results in large recovery in transient corporate and group/convention demand. Owned assets sell for premium prices relative to MAR expectations. Supply growth is stronger than expectations. Consolidation in the lodging industry benefits MAR.

Downside Risks: Deep macroeconomic recession. Geopolitical, inflation, and policy risks negatively impact lodging demand. Inability to grow pipeline in line with Street expectations.

RHP: Valuation and Risks

Our price target of $123 for RHP is derived by applying a 13.0x target EV/EBITDA multiple to our estimate for 2024 lodging EBITDA and a 16.0x multiple to our Opry/attractions estimate. We view the multiple assignments as appropriate for the quality and unique nature of the portfolios (slight premium to REIT peer average of ~12.0-12.5x on Hospitality).

Risks to our rating and price target include: Group demand returns slower than expected. Property-specific risks given a small portfolio.

PEB: Valuation and Risks

Valuation: Our price target of $15 for PEB is derived by applying a 13.5x target EV/EBITDA to our estimate for 2024 EBITDA. We believe PEB's relatively high aggregate RevPAR, strong portfolio quality, heavy mix of flexible management contracts (more so than most REITs), and precedence for high multiples on dispositions suggests a marked premium to our sector average (~ 100-150 bps premium). Due to the timing of repositioning efforts and the ramp-up to stabilization (ex-COVID demand shock impact), we anticipate PEB's initial portfolio enhancements may take 3+ years to be fully materialized, beyond our projection period.

Upside risks to our rating and price target: 2023/2024 are not significantly impacted by a macro downturn. PEB has quicker than expected Legacy LHO ROI CapEx EBITDA gains. RevPAR accelerates due to macroeconomic factors, leading to estimate revisions and multiple expansion. Private vs. public market valuation differentials contract and/or transaction pricing leads to upward property valuation revisions. San Francisco demand issues resolve faster than expected.

Downside risks to our rating and price target: Further asset sales do not materialize as expected and/or at lower-than-expected pricing. Incremental EBITDA growth following major CapEx investment takes longer than anticipated and/or does not materialize, resulting in multiple contraction. International inbound demand from Asia-Pacific remains depressed. Market concentration risk to Boston, Los Angeles, San Francisco, San Diego, and South Florida. Natural disasters are especially impactful to both hotel physical plants and demand (we focus especially on West Coast earthquakes/fires and hurricanes in South Florida that can impact several hotels -- Ian in 2022, Irma in 2017, and Andrew in 1992 are good examples). Labor and other hotel-level costs climb materially.

Companies Mentioned in This Note

DiamondRock Hospitality Company (DRH, $7.67, Hold, C. Patrick Scholes)
Hyatt Hotels Corporation (H, $101.47, Buy, C. Patrick Scholes)
Marriott International, Inc. (MAR, $188.09, Hold, C. Patrick Scholes)
Pebblebrook Hotel Trust (PEB, $11.81, Hold, Gregory Miller)
Park Hotels & Resorts Inc. (PK, $11.50, Buy, C. Patrick Scholes)
Ryman Hospitality Properties, Inc. (RHP, $84.59, Buy, C. Patrick Scholes)
RLJ Lodging Trust (RLJ, $9.33, Buy, Gregory Miller)
Hersha Hospitality Trust (HT, Not Rated)

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I, C. Patrick Scholes , hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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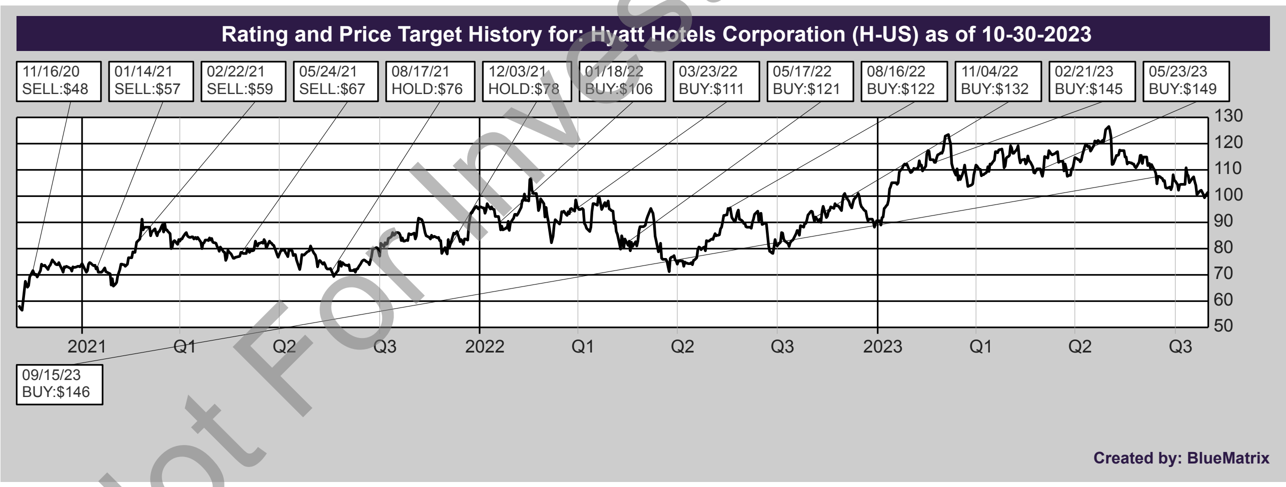

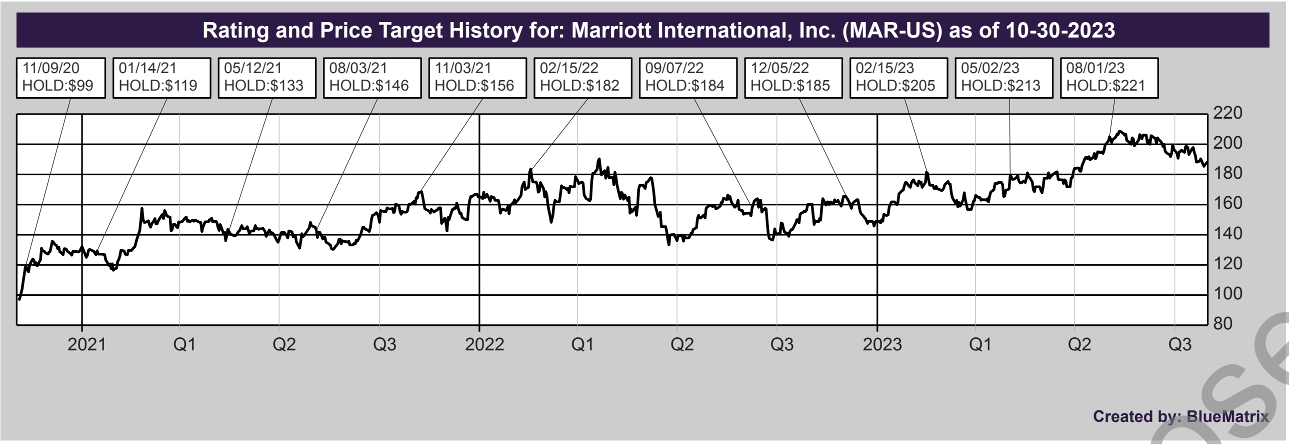

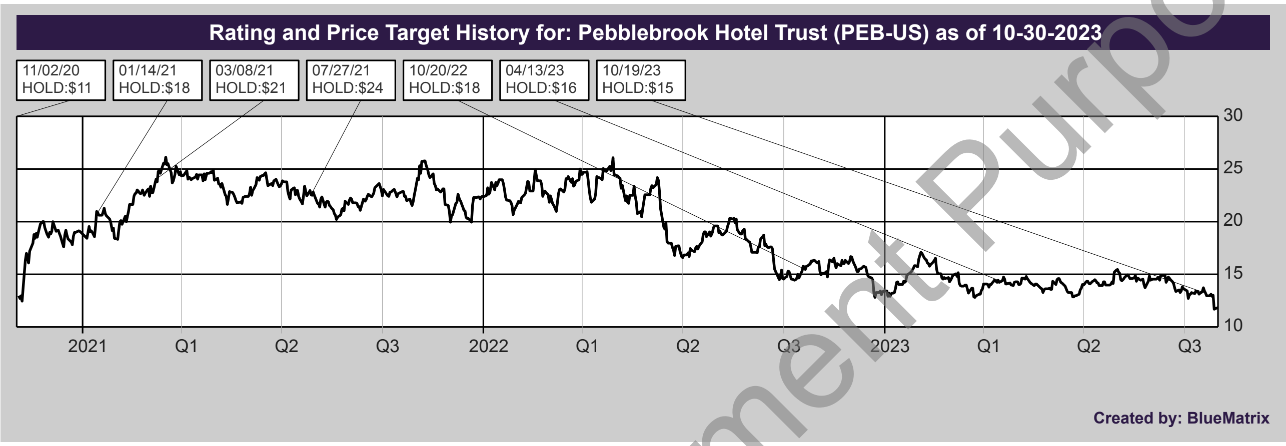

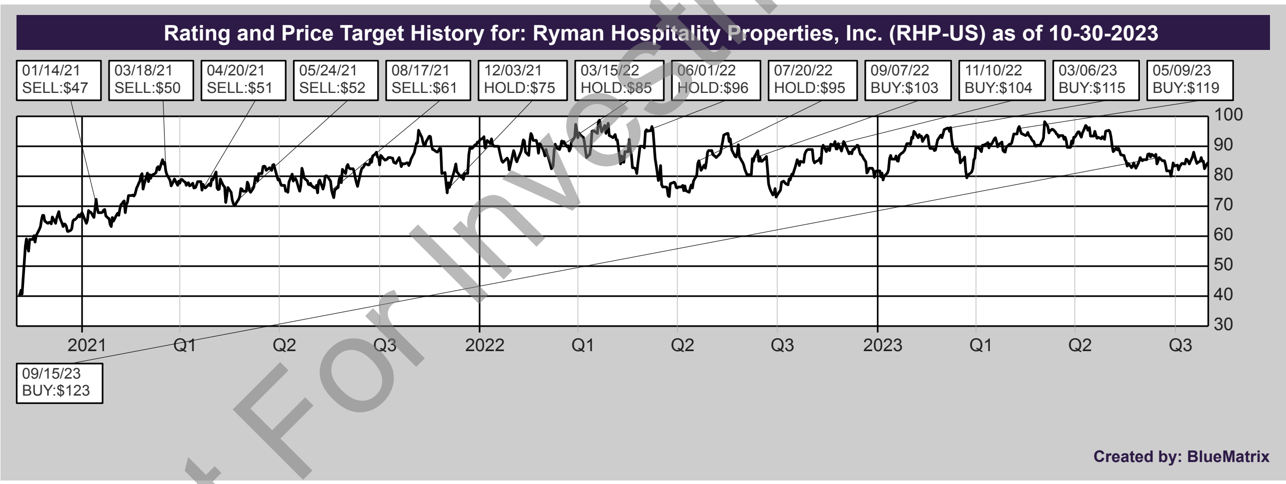

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Legend for Rating and Price Target History Charts:

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H = Hold

S = Sell

D = Drop Coverage

CS = Coverage Suspended

NR = Not Rated

I = Initiate Coverage

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Coverage Universe			Investment Banking Clients Past 12 Months		
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Sell	5	0.70%	Sell	1	20.00%

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