Equity Research Report

July 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.

July Hotel P&L Analyzer: 2Q owned margins -310 bps y/y as plateauing demand + rising costs = declining margins

In our analysis of over 1,000 U.S. full-service hotels (data source HotStats), 2Q23 hotel profit margins were 38.8%, down 310 bps y/y and down 60 bps vs. 2Q19. These figures are worse than 1Q23 (+150 bps y/y given an easy Omicron comp and flat vs. 1Q19). We view plateauing demand/insufficient midweek sellout days and continued cost pressures/service inefficiency as headwinds to profit margin growth for 2Q23 and probably 3Q23.

Our "Bottom Line": For the average full-service REIT-owned hotel, we expect margin pressures will continue to challenge the EBITDA recovery trajectory.

Companies most impacted in this note: HLT, H, MAR, and Lodging REITS.

(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:

Full-Service Lodging REITS: We see several indicators of plateauing demand well below 2019 levels/slowing room rate growth, at least for the time being, combined with labor and other cost pressures (i.e. insurance) as headwinds to EBITDA margins. This setup of RevPAR growth moderation and EBITDA margins with a slight decline is somewhat like the 2018-2019 period. Unlike in 2018-2019, there is still a post-pandemic lagging demand recovery story, especially in Fall 2023 and into 2024, driven by the continued recovery of convention demand and international inbound. **What is additive for margin growth and missing today are more days of midweek hotel sellouts (effectively demand compression) in the major U.S. urban hotel markets through a combination of robust convention activity and high-paying individual corporate travel where both pieces of demand would be paying more for their stays due to high occupancy.** Also unlike 2018-2019, the REITS have in many cases increased their non-Top 25 market resort and leisure exposure where we see tougher y/y near-term revenue and profit comps continuing for the foreseeable future.

- **Investor expectations** are low, in our view, and any beats/positive indicators may lead to short-term stock jumps; Pebblebrook (PEB, Hold) was an example last Friday.

Global C-corps: We expect same-store U.S. base and incentive management fees (IMFs) sequentially higher in 2Q23 due to normal seasonality. Our analysis suggests **U.S. full-service hotels contributed positive MSD base fee growth y/y but IMFs down single digits.** As a result, we expect **increasing reliance on the strength of international performance to drive earnings beats**, helped by rooms growth in Asia-Pacific where unlike the U.S. there are fewer managed hotels with profit hurdle thresholds. We assume **conservative forecasting/guidance for international markets will lead to strong base and IMF contribution and tailwinds for possible EBITDA beats.**

- **Investor expectations** assume stronger IMF results -- we do not expect as many investors to be positively surprised as they were in 1Q23. That said, forecasting global IMFs with granularity and accuracy remains next to impossible.

Profit forecasting beyond 2Q23:

- **Still tricky with limited visibility.** We view U.S. 3Q23 profits partly challenged by the tough summer leisure comp and the timing of the High Holidays (both in September this year whereas Yom Kippur was in October last year). Additional headwinds include insurance adjustments that have only been partly reflected in REIT guidance.

SEE PAGE 17 FOR REQUIRED DISCLOSURE INFORMATION

- **We are cautious on union activism**/negotiations that has occurred in Boston, suburban NYC, and now prominently in Los Angeles. We would not be surprised to see other union markets facing strikes and/or rising labor cost pressures.
- GOP margin seasonality has largely returned to pre-pandemic norms. **Full-service margins are flattish-to-down to 2019 whereas some institutional-quality select-service hotels' margins remain well below 2019 (our data set of hundreds of hotels shows margins roughly -10%). For now, we see no major deviations from the recent trends.**

Other takeaways:

- **Food and beverage (F&B) margins are starting to fall on a comparative 2019 basis**, and we see evidence of F&B cost growth in excess of revenues in some cases. Staffing is also more fully back than in 2022.
- **Service standards anecdotally remain challenged at some full-service hotels due to staffing shortages, particularly urban hotels.** We view a combination of a tight labor market, inefficiencies from below-normal occupancy, and room rates that challenge hiring as contributing factors.
- **Utility costs are plateauing/moderating due to lower gas prices.**

Stock calls:

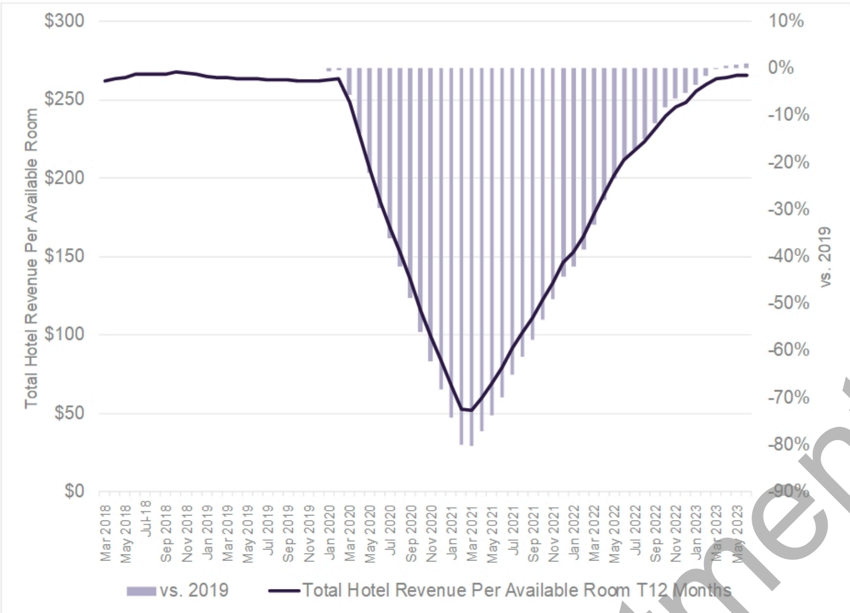
- **No changes to our ratings. We continue to view C-corps largely better positioned than REITS given the C-corps' international demand/pipeline growth relative to the choppier U.S. hotel profit margins and continued headwinds from labor and other cost growth.** We are more cautious on profit margins from luxury hard brands that have stringent labor and operating standards; several of our Hold-rated REITS (and non-covered REITS) have bought luxury resorts since 2021.

YTD results, forecasts, and readthrough to earnings:

For the C-corps, the good news is the recovery of group demand is of particular benefit to U.S. base management fees given outside-of-room spend such as food and beverage (F&B)/catering flowing to greater total revenues.

We can see the trend of the recovery of U.S. total hotel revenues and gross operating profits in the following exhibits. We assume inflationary cost pressures to push room rates and outside-the-room price increases on F&B, recreation, and meetings combined with strong group demand are drivers to Total RevPAR growth and therefore higher base management fees despite below normal occupancy. Even though total revenues have now slightly surpassed 2019 levels, the not-so-good news is total revenues remain well behind pre-pandemic levels when factoring in inflation.

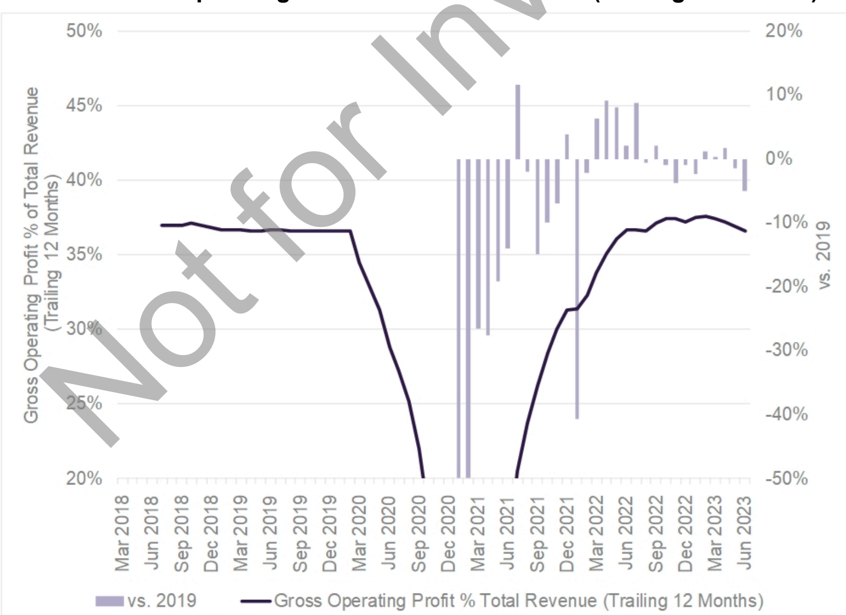
Exhibit 1: Total Hotel Revenue Per Available Room (Trailing 12 Months) and vs. 2019 Recovery



Source: Truist Securities Research, HotStats

The tougher news is headline margins on a trailing 12-month basis (to take out seasonality) has moderated this year. In an environment of slowing RevPAR growth and flattish-to-declining margins, we view today's environment somewhat similar to the 2018-2019 period where C-corps were more favored by investors than the REITS.

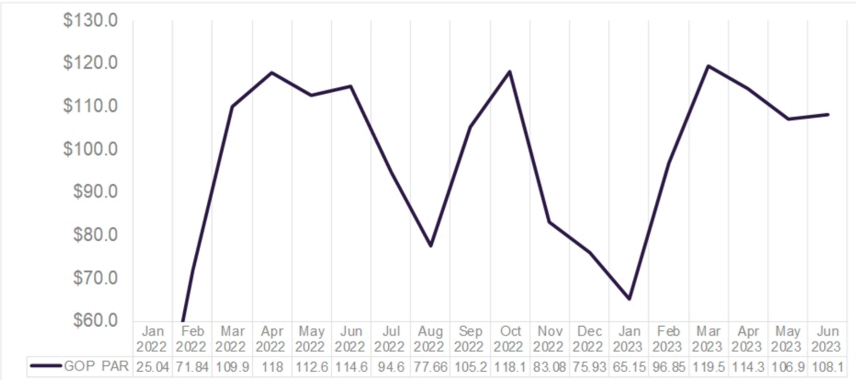
Exhibit 2: Gross Operating Profit % of Total Revenue (Trailing 12 Months) and vs. 2019 Recovery



Source: Truist Securities Research, HotStats

On incentive management fees (IMFs), we view the U.S. same store 2Q23 setup less favorably than 1Q23. We evaluated how hotel profits have trended for a possible read-through for U.S. C-corp IMFs (fees driven by the profitability of hotels that are managed by the C-corps). As we capture just U.S. hotels on a same-store basis, we are excluding new hotel openings/conversions both in the U.S. and globally. That said, in order for IMFs to continue to be a tailwind for EBITDA, we view new supply as the main driver today. GOP margins per available room relative to 2019 appear 200 bps worse in 2Q23 versus 1Q23.

Exhibit 3: Gross Operating Profit Per Available Room

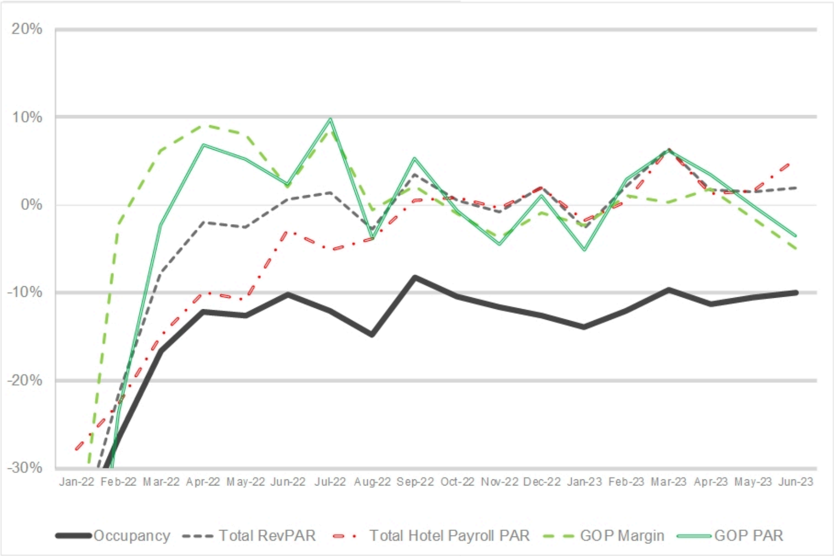


GOP PAR	2019	2022	2023	y/y	vs. 2019
January	68.69	25.04	65.15	160%	-5%
February	94.07	71.84	96.85	35%	3%
March	112.57	109.9	119.54	9%	6%
1Q	**91.72**	**68.82**	**93.75**	**36%**	**2%**
April	110.46	117.95	114.25	-3%	3%
May	107.04	112.56	106.94	-5%	0%
June	111.94	114.6	108.06	-6%	-3%
2Q	**109.78**	**115.01**	**109.72**	**-5%**	**0%**
2Q vs. 1Q	**19.7%**	**67.1%**	**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. That said, margin trends were worse in 2Q23 versus 1Q23 in part due to leisure travelers shifting internationally, slowing RevPAR and Total RevPAR growth (both rooms and outside-the-room spend), and operating cost growth headwinds.

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 the Europe, the Middle East, and East Asia (China, Japan, SE Asia) with the greatest fee tailwinds for 2Q23, positive in particular to **Hyatt** (H, Buy) and **Marriott** (MAR, Hold). Given international demand uncertainty built into 2Q guidance, we assume the recovery would benefit MAR, H, and **Hilton** (HLT, Hold) in that order. The Caribbean continues to be the strongest market relative to 2019 levels in the world driven in part by continued ADR growth which we think should flow nicely to profits. These results should benefit all-inclusives including H and **Playa** (PLYA, Buy) although not much of a surprise to investors, in our view.

Forecasting IMFs are incredibly challenging. What we continue to advise investors is to focus on regional performance and rooms growth in Asia-Pacific given these management contracts are not as subject to operating profit thresholds before a C-corp receives IMFs. Conversely, in the U.S., many hotel contracts use GOP or NOI hurdles before the C-corp receives an IMF.

MAR receives considerable IMF generation due to many higher-rated managed hotels across the world. 2Q23 IMF consensus of $185M is 37% above 2Q22 whereas 1Q23 IMFs finished 97% higher y/y (helped by an easy Omicron comp). **We do not have as much conviction on a material beat in 2Q as we did in 1Q, but we view 2Q23 IMF consensus of $185M possibly quite light to 1Q23 actuals of $201M given normal seasonality from 1Q to 2Q and the recovery of international demand.**

Shifting to the full-service Lodging REITS: We see a tougher overall setup relative to 1Q23. As our HotStats' data set is skewed somewhat more to institutional-quality higher-priced urban and resort hotels than the Luxury/Upper Upscale hotels from STR, we can be somewhat more narrow in analyzing trends that may be more germane to the REITS. Results in 2Q23 suggest the impact of leisure travel shifting overseas and the hiring of F&B/catering staff more fully baked into results. As evident below, 2Q23 total RevPAR (including outside the room spend) was up about 2% versus 2019, similar to 1Q23, but GOP on a percentage basis was down sequentially.

Exhibit 5: 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 6: 1Q23 Versus Prior Years Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 1Q23 vs. Prior Years

	1Q23	1Q22	*y/y % change*	1Q19	*4-yr % change*
Occupancy	64.9%	54.2%	*19.7%*	73.5%	*-11.7%*
ADR	$255	$240	*5.9%*	$221	*15.2%*
RevPAR	**$165**	**$130**	***26.8%***	**$162**	***1.7%***
Total RevPAR	**$262**	**$201**	***30.7%***	**$257**	***2.3%***
Room Margin	72.7%	72.9%	*-0.3%*	72.7%	*0.0%*
F&B Margin	30.7%	25.3%	*21.3%*	30.6%	*0.3%*
Operating Department Margin	60.5%	61.1%	*-1.0%*	59.8%	*1.2%*
GOP Margin	**35.8%**	**34.3%**	***4.4%***	**35.8%**	***0.0%***
GOP Per Available Room	**$94**	**$69**	***36.2%***	**$92**	***2.2%***
Total Hotel Payroll (% of Total Revenue)	35.8%	35.9%	*-0.3%*	35.9%	*-0.3%*
Total Hotel Payroll (Per Available Room)	$94	$72	*30.2%*	$92	*1.8%*
Total Hotel Payroll (Per Occupied Room)	$144	$133	*8.7%*	$125	*15.3%*

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: 2Q23 Versus 1Q23 Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance:
2Q23 vs. 1Q23

	2Q23	1Q23	*% change*	*Abs, variance*	
Occupancy	72.0%	64.9%	*10.9%*	710	*bps*
ADR	$256	$255	*0.6%*	$1.42	
RevPAR	**$184**	**$165**	***11.6%***	**$19.15**	
Total RevPAR	**$283**	**$262**	***8.0%***	**$20.95**	
Room Margin	74.0%	72.7%	*1.8%*	130	*bps*
F&B Margin	31.0%	30.7%	*1.0%*	30	*bps*
Operating Department Margin	62.3%	60.5%	*3.0%*	180	*bps*
GOP Margin	**38.8%**	**35.8%**	***8.4%***	**300**	*bps*
GOP Per Available Room	**$110**	**$94**	***17.0%***	**$15.97**	
Total Hotel Payroll (% of Total Revenue)	33.6%	35.8%	*-6.1%*	-220	*bps*
Total Hotel Payroll (Per Available Room)	$95	$94	*1.5%*	$1.36	
Total Hotel Payroll (Per Occupied Room)	$132	$144	*-8.8%*	-$12.66	

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.

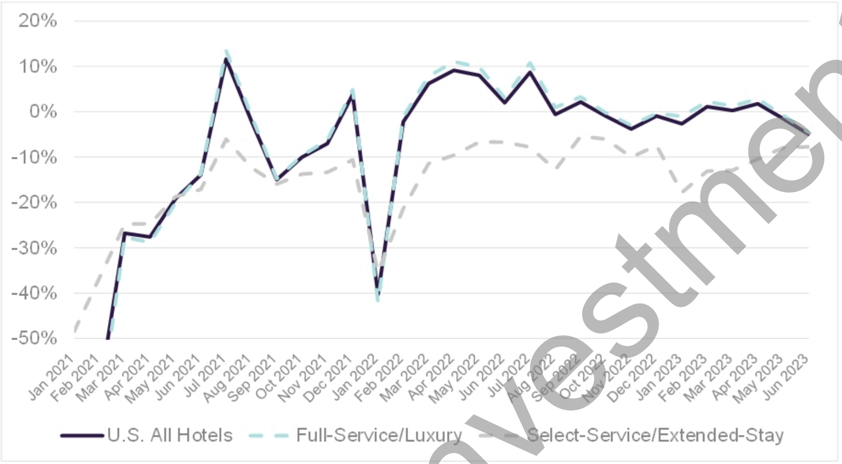
Source: Truist Securities Research; HotStats

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.

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

Full-service margins flattish-to-down vs 2019 whereas select-service remains well below 2019



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

Profit forecasting beyond 2Q23

We still view profit forecasting as quite challenging due to relatively limited demand visibility. For U.S. hotel profits, we view 3Q23 partly challenged by the tough summer leisure comp and the timing of the High Holidays being in September this year, therefore likely leading to corporate groups/conventions being pushed into early-mid September and early-mid October. **We also view annual insurance growth which could be on average in the +40-60% range (but likely more variable by company) as a headwind that may not be fully accounted for in sell-side modeling.**

It is harder for us to gauge the severity of hotel union activism and impact to margins, but we are cautious on what is occurring in Los Angeles and other union markets that have not had material contract negotiations in recent years. As hotel unions have been active in other markets this year, we do not view Los Angeles as isolated.

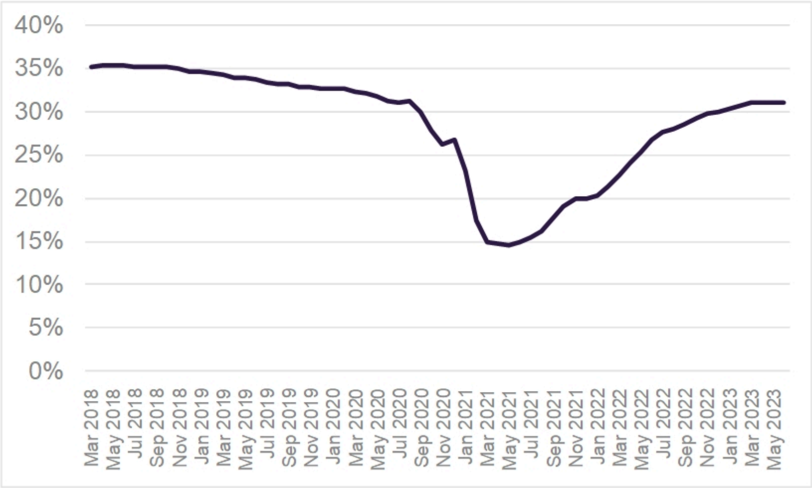
Our 2023 full-service GOP margin assumptions for now:

- **Base case:** Some softening on the macro, but hoteliers can adapt through reductions in variable costs (staffing). Strength in group demand very meaningful. **We view the trends in Exhibit 9 as holding where full-service margins remain flattish-to-down versus 2019 and select-service remaining below 2019.**
- **Bull case:** If the macro holds, driven in part by strong group occupancy/ADR and recovering transient corporate, rising costs are kept somewhat in check. Hotel IMF contributions are more robust. REIT EBITDA guidances could rise intraquarter and through 4Q. **We could assume flattish to positive y/y margin growth in this scenario.**
- **Bear case:** The biggest hit to many hotels' margins would be soft in-house group and leisure demand followed by declining ADR, leading to underutilization of rehired F&B staff.

Other takeaways:

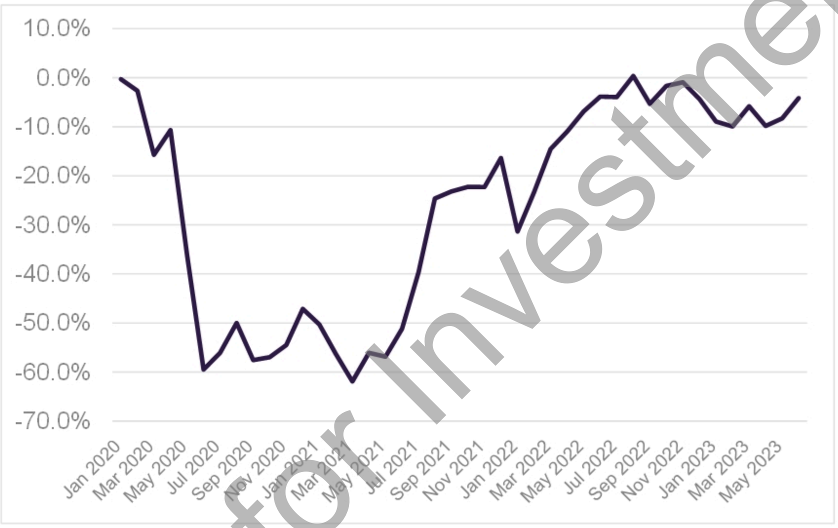
Group: We see clear evidence of the recovery of Group revenues in recent quarters although the group revenue mix is still ~3-5 points below 2018-2019 levels. We have seen a plateauing of group mix that may be partly driven by convention demand not fully returning, weaker international inbound, some leisure group that was pent-up in 2022 (i.e. weddings), and some corporate groups shifting to virtual.

Exhibit 10: Group Rooms Revenue Mix - Trailing 12 Months (Group % of Rooms Revenue)



Source: Truist Securities Research, HotStats

Exhibit 11: Group Rooms Revenue Mix (Group % of Rooms Revenue) vs. 2019

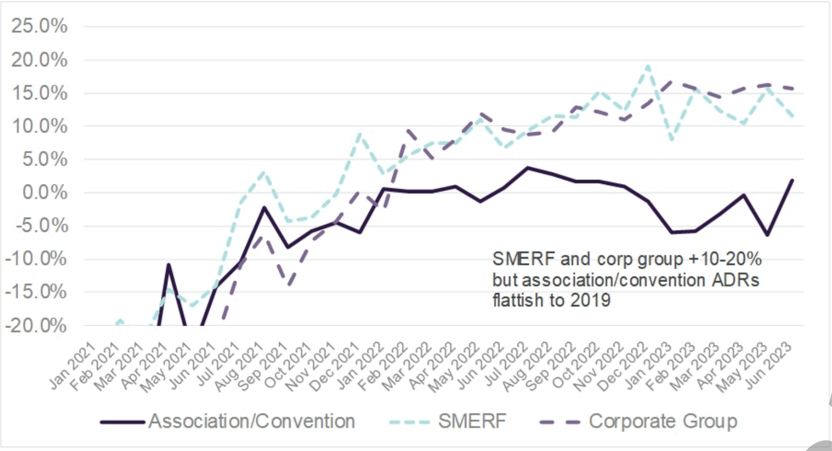


Source: Truist Securities Research, HotStats

Subsegment trends show corporate and SMERF group ADRs remaining +10-20% over 2019 levels but apparently plateauing for now. These subsegments remain well ahead of association/convention (flattish to 2019). We can interpret from ADR trends of the continued challenges in some large associations/conventions due to hybrid and virtual meetings as well as lower attendance both from domestic and international travel. As a consequence, big cities have less opportunity for citywide hotel sellouts and pushing higher room rates. The pricing trends of corporate groups and SMERF or SMERFE (social/military/educational/religious/fraternal/ethnic group which is often lower-rated and weekend-led) remain strong by comparison.

The benefiting hotels cater to in-house groups. We view **Ryman (RHP, Buy) as best positioned** within the REITS for large in-house corporate group.

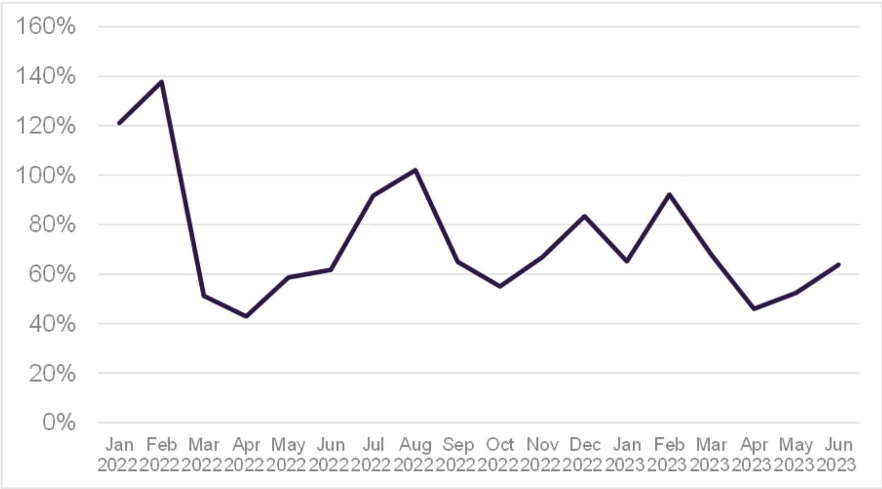
Exhibit 12: Subsegment Group ADR: % Recovery vs. 2019 Levels



Source: Truist Securities Research, HotStats

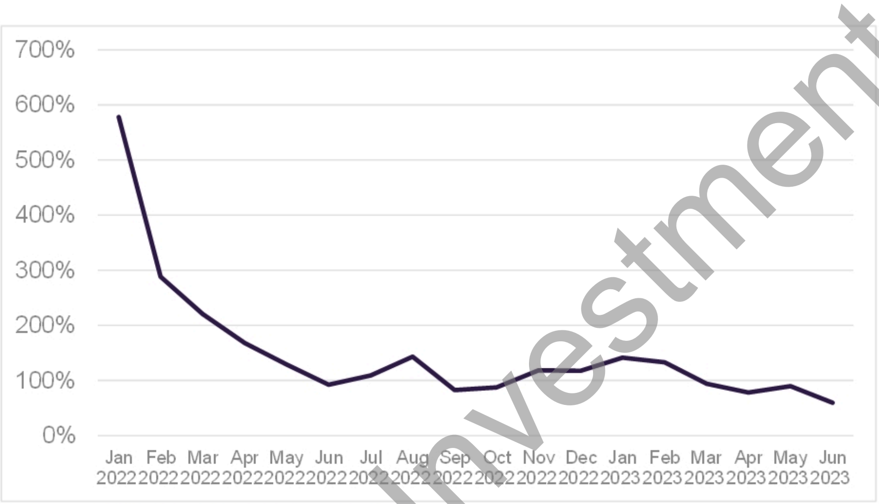
Further diving into the detail, we see that cancellation and attrition fees are still well above 2019 levels. Compared to April, we see cancellation fees now coming down again as opposed to being relatively stable at +100% earlier this year.

Exhibit 13: Attrition Fees Per Occupied Room (vs. 2019): Remaining Elevated



Source: Truist Securities Research, HotStats

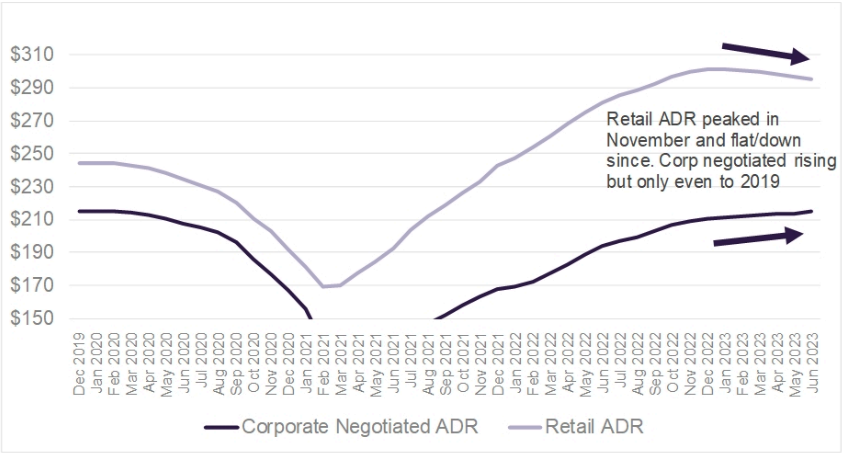
Exhibit 14: Cancellation Fees Per Occupied Room (vs. 2019): Elevated but Moderating



Source: Truist Securities Research, HotStats

Transient leisure (high-end) and corporate negotiated (individual business travel): Retail ADR (proxy for high-rated leisure travel) and corporate negotiated ADR (individual business travel) continue to move in opposite directions. We see continued evidence in the last few months of Retail ADR declining on a trailing 12-month basis starting in November 2022. That said, we note that retail hotel ADR is still 15-20% above 2019 levels. Conversely, corporate negotiated ADR is trending more positively but barely even to 2019 levels. With higher-rated business travel remaining well below 2019 levels on demand combined with ADR running flattish to 2019, the net impact is lower ability for hoteliers to push room rates in the midweek due to less demand compression. **We think the consequence is a negative impact for hotel profits, possible ceilings on hiring decisions (less staff due to lower occupancy and ADR growth below cost inflation), and consequently some reduced service standards given fewer high-paying travelers.**

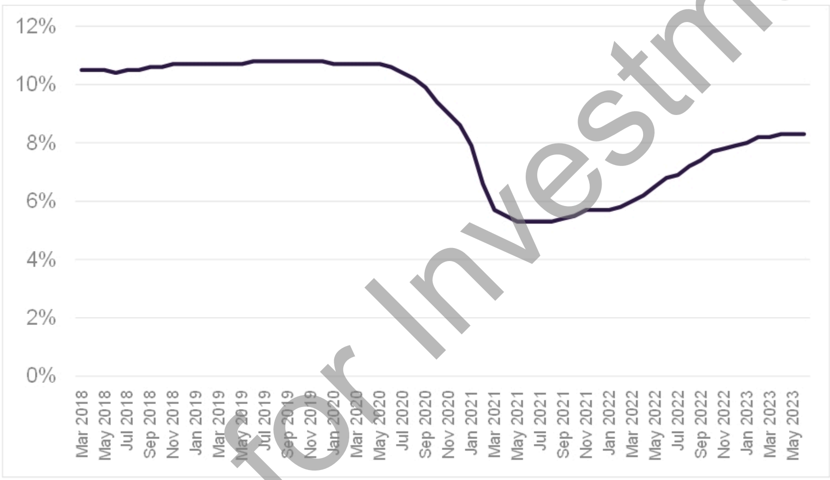
Exhibit 15: Retail and Corporate Negotiated ADR: Trailing 12 Months



Source: Truist Securities Research, HotStats

Below we can see that corporate negotiated revenue mix has effectively plateaued on a Trailing 12-month basis.

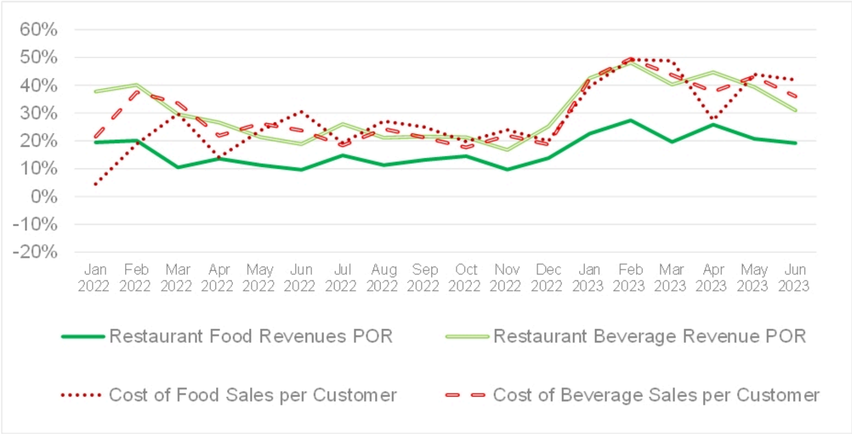
Exhibit 16: Corporate Negotiated Revenue Mix -- Trailing 12 Months (% of Rooms Revenue)



Source: Truist Securities Research, HotStats

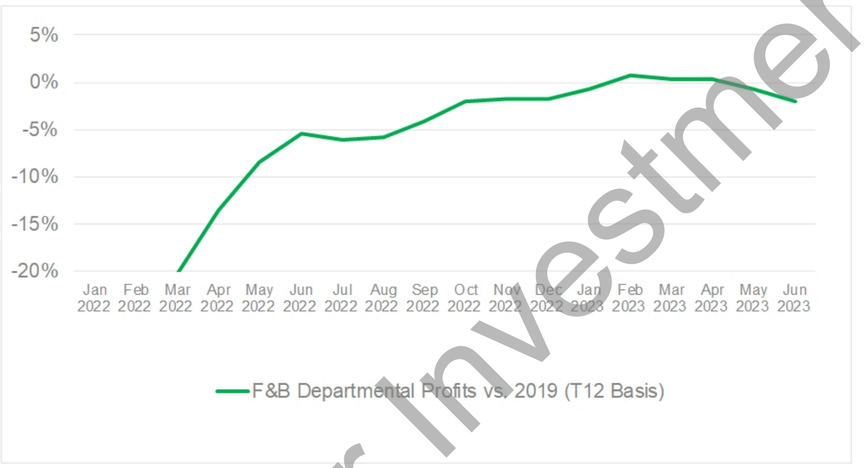
Operations challenges and why we see issues in margins and service standards: While we see challenged margins in several departments due to labor/operating costs that appear at times well above revenue growth, we highlight the food and beverage (F&B) department as one example. While we view restaurant and bar tickets have risen significantly since the pandemic, the cost structures may be rising even faster. While we saw this spread earlier this year, we view the issue as possibly more pronounced further into 2023 (outside of summer months) now that we have shifted to more of a corporate traveler base from 1Q's greater leisure mix. We also assume staffing is more fully back than in 2022.

Exhibit 17: Restaurant Revenue and Expense Trends vs. 2019 Levels: Prices Up and So Are The Expenses (Not Customer Gauging)



Source: Truist Securities Research, HotStats

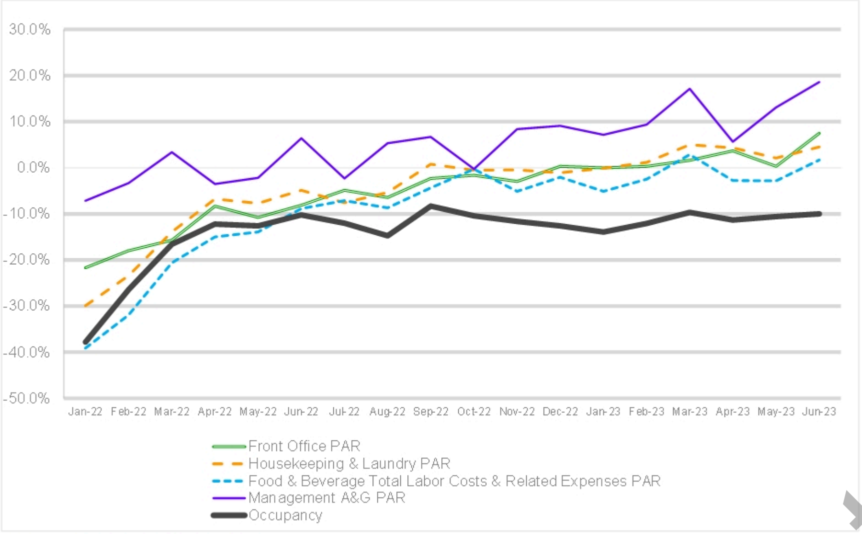
Exhibit 18: F&B Profits Hovering Around/Slightly Below 2019 Levels



Source: Truist Securities Research, HotStats

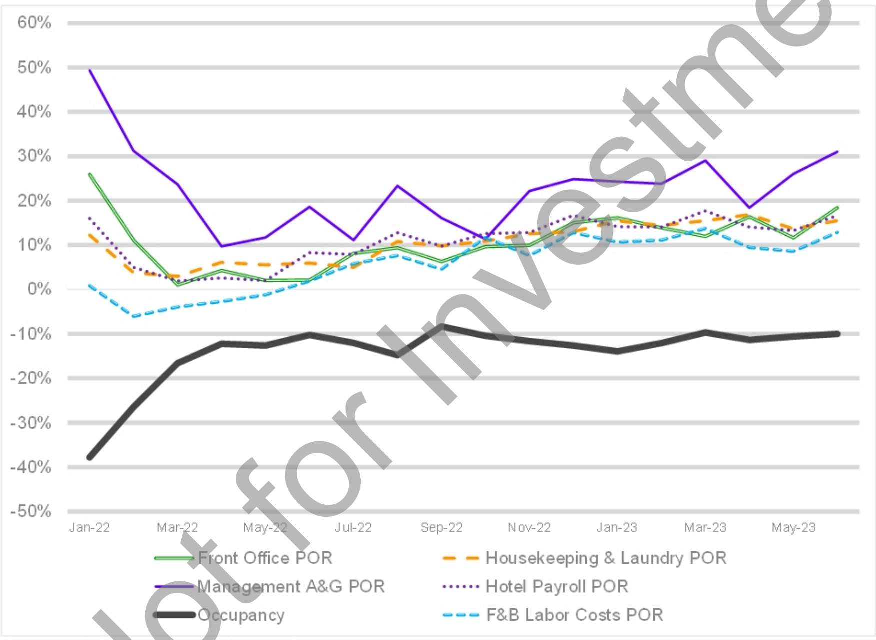
Labor cost analysis suggests the property management costs are rising faster than some hourly departments. That said, the relatively good news is we are not seeing tremendous spikes in hourly labor costs even in a moderating revenue growth environment. We encourage a focus on per occupied room (POR) 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 encourage greater attention to PAR data.

Exhibit 19: Occupancy Compared to Labor Costs by Hotel Department Per Available Room (PAR) vs. Same Month 2019



Source: Truist Securities Research, HotStats

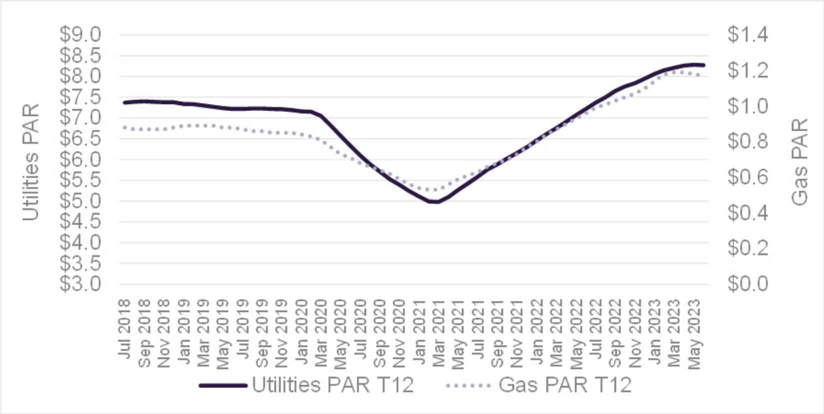
Exhibit 20: Occupancy Compared to Labor Costs by Hotel Department Per Available Room (POR) vs. Same Month 2019



Source: Truist Securities Research, HotStats

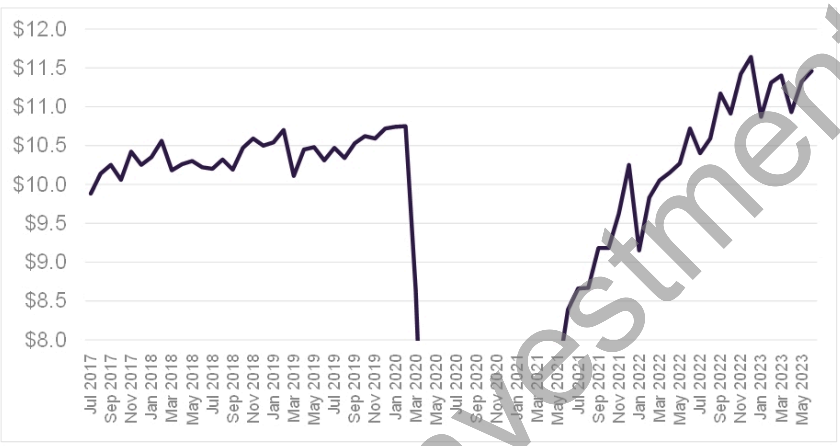
Undistributed expenses: We have seen some recovery/stabilization of utility costs as gas prices have moderated. Conversely, we are seeing further increases in the repairs and maintenance department which we view as a partial consequence of the need for staffing to handle deferred CapEx that has remained since the pandemic.

Exhibit 21: Utilities Costs Per Available Room – Spiking Costs Since Early 2022 But Gas Starting To Decline



Source: Truist Securities Research, HotStats

Exhibit 22: Repairs and Maintenance – Labor and Other Expenses Per Available Room - Starting To See More Cost Growth



Source: Truist Securities Research, HotStats

Companies Mentioned in This Note

Hyatt Hotels Corporation (H, $125.18, Buy, C. Patrick Scholes)
Hilton Worldwide Holdings Inc. (HLT, $154.17, Hold, C. Patrick Scholes)
Marriott International, Inc. (MAR, $199.61, Hold, C. Patrick Scholes)
Pebblebrook Hotel Trust (PEB, $15.19, Hold, Gregory Miller)
Playa Hotels & Resorts N.V. (PLYA, $8.23, Buy, C. Patrick Scholes)
Ryman Hospitality Properties, Inc. (RHP, $94.92, Buy, C. Patrick Scholes)

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