April Hotel P&L Analyzer: Not a great start to 2Q margins; May will be critical

April GOP margins down (as expected): -110 bps on a tough Easter comp

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What's Inside

An analysis of recent hotel labor cost trends, one of the critical components impacting hotel EBITDA margins

What's Incremental To Our View

April: 110 bps of GOP margin loss on approximately -0.4% Total RevPAR partly due to the tough Easter comp (Total RevPAR includes Rooms RevPAR plus outside-of-the-room spend). For 2Q, we believe May results will be critical for companies to hit EBITDA guidance -- led by corporate travel catch-up following the extended Spring Break. **We forecast 2Q EBITDA margin loss of flat to -75 bps for US full-service hotels.**

We observe most hotel REITs doing a commendable job of controlling costs (aka "self-help") in a very low RevPAR growth environment. HST's +50bps. of margin improvement on -1% RevPAR growth in 1Q is a good example of this. With continued growth in F&B and ancillary revenue spend and owners' success at cost containment, **we are raising our 2019 EBITDA margin forecast to flat to -50 bps from our prior estimate of flat to -75 bps.** *If it were not for the proactiveness of management teams, margins could be far worse in this RevPAR environment.*

Hoteliers continue to find ways to continue to squeeze incremental profits anywhere they can given limited RevPAR growth. The continued success (or the lack thereof) of these efforts will be critical not just for 2Q earnings but as the year rolls along. As our Rooms RevPAR projection for the remainder of the year is just +0-1%, hoteliers will continue to have to push non-rooms spend (F&B, ancillary fees, etc.) and further cost containment in order to drive margin growth. Positively, even in an environment of negative RevPAR growth in April, GOP margins were modestly down (see more detail in the following section of this note).

Despite the above commentary, we do not suggest that hotels today are not highly profitable. In fact, stronger cash flows from high absolute RevPAR combined with more conservative balance sheets and lower interest rates on debt among the REITS have helped support the dividend payout ratios being somewhat more sustainable in the event of a moderate EBITDA decline (given today's strong occupancy, a scenario of modest EBITDA declines would come off of a high EBITDA baseline). Among our data set of nearly a thousand high-rated U.S. upper priced hotels (data source in this note: HotStats), trailing twelve month GOP margins are a highly respectable 37.5%.

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We see no relenting to labor cost growth. Labor costs per available room rose 340 bps over the last twelve months, rising materially faster than most hotel Rooms RevPARs, and the math to us to determine margin growth suggests:

- **Add:** +1-2% Rooms RevPAR (largely room rate driven, so highly profitable)
- **Subtract:** 3-4% increases in labor costs (labor is 30-50+% of total expenses)
- **The increasingly important variables:** Whatever out-of-rooms revenue spend and expense savings that the hotel owner and operator can muster (we provide some recent trends below). Talented owners and operators can prove their worth in these scenarios (and we expect the role of the asset manager to become increasingly more valuable to the REITS). **So far, hoteliers have been able to counter much of the labor cost growth through these variables. We still believe that Rooms RevPAR needs to grow 2.5-3.5% to keep EBITDA margins flat and when RevPAR growth falls short of that range, the "variables" become all the more critical towards EBITDA margin preservation/expansion.**

The net-net of the above math has landed to margin growth of ~ +10 bps over the last twelve months. Despite strong efforts by hotel operators and owners, it is not surprising to us that Lodging REIT investor sentiment remains neutral-at-best on even the most compelling names in the sector.

As we look towards the remainder of the year: given RevPAR growth that is nearly flattish, we believe that the focus for hotel owners will increasingly be concentrated on margin preservation. Doing the math: if we assume that Rooms RevPAR grows 1% on average for the remainder of the year, we believe at best hoteliers should be able to achieve flattish margins (given various operating revenue and expense asset management efforts, we see a 100 bps spread between Rooms RevPAR and GOP margin growth as a "best case" scenario). However, continued increases in labor costs (which we expect will continue to rise moderately in 2019 but with no plateau in the near term) will make margin growth in 2019 all the more difficult to achieve.

What margin savings' efforts are on the near-term horizon?

- **Revenues:** We believe there could be more aggressive foci on fees (beyond cancellation fees and daily ancillary fees (a.k.a. destination fees/amenity fees). Unlike for U.S. airlines who arguably have an oligopoly and can add fees with more success, we assume a "prisonners' dilemma" of sorts for hotels given more customer choices in a market (St. Louis Fed). Some hoteliers balk at some tack-on fees, not dissimilar to hotels that rate cut its competitors, and we believe fee balking will be done largely to take customer market share.
- **Expenses:** As of late, some of the REITS have noted environmental/green efforts as driving expense savings. While we believe it is still premature to suggest that the majority of transient travelers will pay more for a hotel with environmentally progressive strategies, anecdotally we have increasingly heard from various public and private hotel owners that group customers are increasingly asking hoteliers about their environmental approaches. What we believe is mostly driving the environmental efforts by hoteliers is simply ROI -- lower utility costs in particular where investments have a 2-4 year return.
    - **What we have heard less about are technological efforts that may reduce operating expenses -- especially on the labor front.** While we may see an increase in the usage of robots for basic services, labor cuts from automation do not come up in our discussions with hotel owners (more focus is on shared staffing roles and more traditional labor efficiencies) (San Francisco Magazine). So far, ambitious hoteliers that have attempted to have a heavily robot-led operation have failed (a hotel near Nagasaki, Japan "laid off" over half of its 243 robots for creating incremental work for the human staff) (Wall Street Journal). That being said, in conversations between hotel owners and institutional investors, we hear more questions about ESG policies than disruptive technologies that could alter the hotel labor force.
- **Do-it-yourself-ism or a la carte pay-per-service:** While we believe many travelers enjoy the comfort of not having to clean their hotel rooms (assuming they have the time to do so), there has been somewhat increased focus from some investors on recommending hotel guests rewards points for eliminating housekeeping service if not encouraging charges for guests that want housekeeping. If implemented, we see more of this focus at lower-rated limited-service hotels than higher-rated full-service hotels. (We also note that operational and life-safety issues can arise for hotels when rooms are left untended or unmonitored by hotel staff for extended periods.) Still, in an era of "charge where you can," we would not be surprised to see some modest implementations of service charges that are labor-related.

One important aside to the above discussion -- hoteliers are going to be more focused on investments that have a multi-year ROI such as environmental efforts so long as hotels are less likely to be sold. We see the extended hold periods for owners as somewhat related to the strong debt markets, the ability for owners to refinance, and the relatively less active transactions environment.

April results:

April margins were challenged from the Easter/Passover/Good Friday calendar shift and lower corporate demand due to the holiday and extended Spring Break calendar. Margins were -110 bps given Rooms RevPAR of -1.7% and ADR growth of -0.8%. Given the continued strong trend of faster growth in out-of-room spend (food and beverage, ancillary fees, etc.), Total RevPAR growth was -0.4% (130 bps better than Rooms RevPAR).

2Q19 and 2019 forecasts:

2Q19: Given the challenged April results (although anticipated given the holidays) and our projection of flattish Rooms RevPAR in June, we see the best opportunity for margin gains to come in May. Even though we currently forecast Rooms RevPAR in May to be +1.5-2.5%, we believe the demand will be somewhat more skewed to higher-rated corporate travel (both transient and group) and that should lend favorably to EBITDA margin growth. **Net-net we forecast EBITDA margins to be flat to -75 bps for 2Q.** May will be an easier comp (Total RevPAR of +1.4% in May 2018); June will be a much tougher comp (Total RevPAR of +4.7% in June 2018) due to the timing of July 4th.

- Among our REIT coverage, our aggregated Adjusted EBITDA Margin estimate (weighted average by market cap.) remains -50 to -100 bps y/y.
    - Please note that there are anomalies for specific REITS due to portfolio changes and property renovations, hurricane impact, etc. thus we focus on the aggregate numbers. **Hotels owned by the REITS orient more heavily to Upper Upscale versus Luxury, thus our expectations for margin growth for REITS reflects that differential. We expect REITS with a greater proportion of Luxury hotels (ex-idiosyncratic factors as aforementioned) to have a greater opportunity for slight margin expansion (or lower margin declines) in 2Q19 given the positive leisure influence of the April holidays.**

Our 2019 margin forecast up at the low end to generally flat to -50 bps (our prior estimate was generally flat to -75 bps). We are adjusting our forecasts modestly due to 1Q margin performance and FY 2019 guidance adjustments by the REITS (our forecasted weighted average Adjusted EBITDA margin y/y change in 2019 for the Lodging REITS in our coverage has been raised to +8 bps from -19 bps (+27 bps). We expected REITS to raise their EBITDA guidance margins (as we noted last month) and we continue to believe margin guidance remains largely conservative.

- Consistent with our prior note, we still maintain a somewhat more positive bias on this data set for 2019 than our macro RevPAR projections in our RevPAR Monitor given that our margin analysis data set has a somewhat larger luxury exposure, where there is relatively limited new rooms growth (and limited impact from the growth of Upscale urban hotels, which we deem to "ankle-bite" the Upper Upscale hotels for price-sensitive demand). The lower supply growth and relatively stronger leisure demand should help on rate growth for 2019 which flows more positively to both Rooms and Total RevPAR growth and margin growth.

Monthly Profitability Metrics

April profitability: Flattish RevPAR and moderately negative margins.

Industry Metric	Apr 2019 y/y	YTD		Apr 2019	YTD	FY2018	2018 y/y	FY2017
Occupancy	*-70*	*-100*	*bps*	81.6%	76.7%	77.7%	*30 bps*	77.4%
ADR	-0.8%	1.7%	*%*	$238	$236	$225	2.5%	$220
RevPAR	-1.7%	0.4%	*%*	$194	$181	$175	2.8%	$170
Total Revenue PAR	-0.4%	2.0%	*%*	$324	$309	$289	3.3%	$280
Total Dept. Profit % Total Rev.	*-40*	*20*	*bps*	62.3%	60.8%	60.0%	*10 bps*	59.9%
Total Hotel Labor Costs % Total Rev.	*100*	*20*	*bps*	33.2%	35.0%	35.5%	*20 bps*	35.3%
Total GOP PAR	*-3.0%*	*2.2%*	*%*	$132	$120	$108	*4.1%*	$104
Total GOP % of Total Rev.	*-110*	*0*	*bps*	*40.9%*	*38.8%*	*37.4%*	*20 bps*	*37.2%*

Source: STRH Research, HotStats

All dollar figures are in USD. 2017 figures have been revised as of December 2018 to account for the updated sample set.

March profitability: Slightly negative RevPAR growth although y/y margins were modestly positive.

- **1Q:** Operating Department margins were ~ + 40 bps and GOP margins were ~ +50 bps.

Industry Metric	Mar 2019 y/y	YTD		Mar 2019	YTD	FY2018	2018 y/y	FY2017
Occupancy	*-160*	*-110*	*bps*	81.1%	75.1%	77.7%	*30 bps*	77.4%
ADR	1.3%	2.7%	*%*	$245	$236	$225	2.5%	$220
RevPAR	-0.8%	1.2%	*%*	$198	$177	$175	2.8%	$170
Total Revenue PAR	2.3%	2.9%	*%*	$333	$304	$289	3.3%	$280
Total Dept. Profit % Total Rev.	*20*	*40*	*bps*	63.0%	60.2%	60.0%	*10 bps*	59.9%
Total Hotel Labor Costs % Total Rev.	*-30*	*-20*	*bps*	32.5%	35.6%	35.5%	*20 bps*	35.3%
Total GOP PAR	*3.2%*	4.3%	*%*	$142	$116	$108	*4.1%*	$104
Total GOP % of Total Rev.	*40*	*50*	*bps*	*42.7%*	*38.1%*	*37.4%*	*20 bps*	*37.2%*

Source: STRH Research, HotStats

All dollar figures are in USD. 2017 figures have been revised as of December 2018 to account for the updated sample set.

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February profitability: Decent RevPAR growth resulted in modest y/y margins.

Industry Metric	Feb 2019 y/y	YTD		Feb 2019	YTD	FY2018	2018 y/y	FY2017
Occupancy	-40	-70	bps	76.0%	72.0%	77.7%	30 bps	77.4%
ADR	4.4%	3.6%	%	$235	$231	$225	2.5%	$220
RevPAR	3.9%	2.5%	%	$179	$166	$175	2.8%	$170
Total Revenue PAR	3.6%	3.2%	%	$308	$288	$289	3.3%	$280
Total Dept. Profit % Total Rev.	100	60	bps	60.6%	58.5%	60.0%	10 bps	59.9%
Total Hotel Labor Costs % Total Rev.	-40	-10	bps	35.3%	37.5%	35.5%	20 bps	35.3%
Total GOP PAR	7.1%	5.0%	%	$118	$102	$108	4.1%	$104
Total GOP % of Total Rev.	120	60	bps	38.4%	35.2%	37.4%	20 bps	37.2%

Source: STRH Research, HotStats

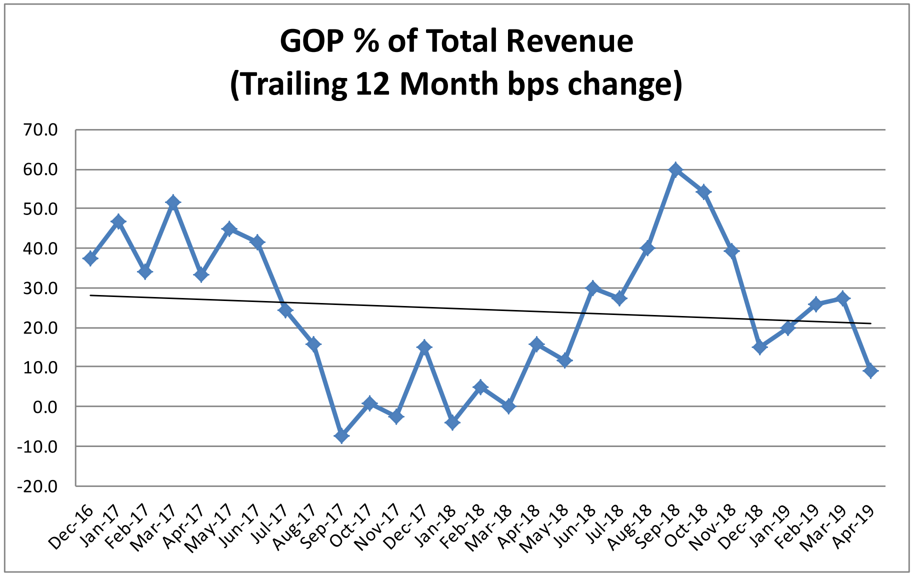
All dollar figures are in USD. 2017 figures have been revised as of December 2018 to account for the updated sample set.

January profitability: Limited RevPAR growth resulted in flat y/y margins.

Industry Metric	Jan 2019 y/y		Jan 2019	FY2018	2018 y/y	FY2017
Occupancy	-110	bps	68.3%	77.7%	30 bps	77.4%
ADR	2.6%	%	$226	$225	2.5%	$220
RevPAR	1.0%	%	$154	$175	2.8%	$170
Total Revenue PAR	2.8%	%	$271	$289	3.3%	$280
Total Dept. Profit % Total Rev.	20	bps	56.4%	60.0%	10 bps	59.9%
Total Hotel Labor Costs % Total Rev.	20	bps	39.7%	35.5%	20 bps	35.3%
Total GOP PAR	2.7%	%	$87	$108	4.1%	$104
Total GOP % of Total Rev.	0	bps	32.0%	37.4%	20 bps	37.2%

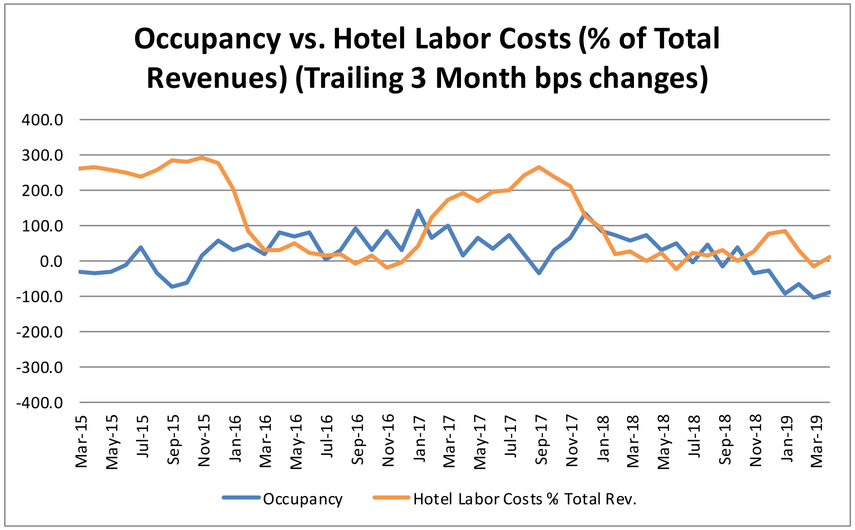
Source: STRH Research, HotStats

All dollar figures are in USD. 2017 figures have been revised as of December 2018 to account for the updated sample set.

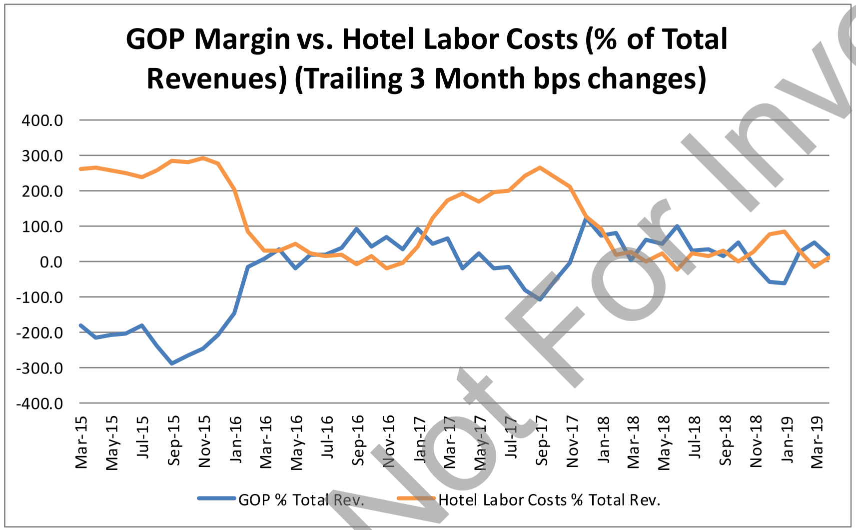


Source: STRH Research, HotStats

- The following charts highlight trends in labor costs vs. occupancy and GOP margins.



Source: STRH Research, HotStats



Source: STRH Research, HotStats

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