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Lodging REITs

Hotel P&L Analyzer: August margins -4,530 bps y/y on -78.6% Total RevPAR

July/August margins: vastly improved vs. June (albeit still negative)

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

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

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

Based on "big data" observations from higher-rated U.S. hotels (data source: HotStats): August: -4,530 bps of y/y GOP margin growth on -78.6% Total RevPAR (Rooms RevPAR + outside-of-the-room spend). By comparison, July margins were -4,620 bps y/y on -82.4% Total RevPAR. Profit margins are "less bad" than 2Q (~ -13,290 bps on Total RevPAR of ~ -91%).

Until there is a material corporate demand recovery, profit margins will likely stay negative for many higher-rated hotels. We anticipate some bullish sell-side projections for upcoming quarters to be lowered both before and post-3Q earnings.

Following review of HotStats' high-quality data set, we have a few high-level takeaways:

Without a major near-term improvement to corporate demand, we do not expect EBITDA margins to turn positive for many Upper Upscale/Luxury hotels (resorts better positioned; unionized big box urban hotels far less so). As evidenced in last week's U.S. STR note (linked here), most higher-rated hotels cannot sustainably replace a traditional corporate orientation (often 60-80% of room nights) with leisure demand.

For most of our REIT coverage (and for Upper Upscale/Luxury C-corp managed non-resort hotels), we anticipate analyst projections for upcoming quarters are more likely to come down than hold or go up, ex-a faster than expected and well-distributed vaccine or medical solution. Without higher-rated corporate demand and the ability for hotels to frequently sell-out in part from citywide conventions, margins will likely remain challenged for the foreseeable future. Resort properties, smaller hotels with more flexible operating standards, and top markets with a bigger leisure component remain somewhat positive exceptions.

1. **Select-service hotels can and in some cases are running positive EBITDA margins.** The only REIT in our coverage with material select-service exposure is RLJ Lodging Trust (RLJ, Miller, Hold) although there are dedicated select-service REITS that started to make the turn to positive Hotel EBITDA in late 2Q.

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For example, we held investor meetings with Chatham (CLDT, Not Covered) yesterday and the company was able to speak to Hotel EBITDA breaking even by June.

2. **Our inclination is that many non-institutionally managed or owned hotels are faring worse than the HotStats set. While the above point has more subtle implications and is less discussed by investors, we view liquidity challenges by private owners as an eventual benefit to the public C-corps/ REITS.** Hotel owners of weaker brands, some individually-managed hotels, and some independent hotels often lack the sophisticated advantages that larger public owners/managers can apply in a demand shock. Some of these small and private owners are also experiencing major cash flow and liquidity concerns with lenders that may be less accommodating in today's environment. We discussed a local application to this trend (West L.A.) in yesterday's Pebblebrook (PEB, Hold, Miller) 3Q update note. Additionally, hotels that open late cycle/early cycle with more aggressive financing may have more issues due to riskier underwriting fundamentals especially for hotels with weaker brands and locations.
    a. For hotels likely underperforming HotStats results, we note the potential impact to the stocks:
        - **Eventual tailwinds:** as has been the case in past lodging cycle downturns, we would anticipate conversion opportunities for C-corps, accretive acquisition opportunities by the REITS, and hotel closures/conversions especially in markets that were challenged pre-pandemic (NYC, Chicago, and Houston are examples).
        - **Current headwinds:** we would be remiss to note that markets with many hotels recently opened/hotels scheduled to open in 2020/2021 are more likely to open with discounted rates to draw demand. Some existing hotels with liquidity issues may also have to lower rates in order to stay competitive. While rate discounting has yet to be borne out given there is such low demand for many Upper Upscale/Luxury hotels, we caution investors that a demand shock is often followed by material intentional rate discounting. If we see material intentional rate discounting, perhaps compounded by furloughs and layoffs of revenue managers, there may be a negative impact to margins.

<u>July and August HotStats results:</u>

- **<u>July results color:</u> Rooms RevPAR of -82.3% and Total RevPAR of -82.4% compare with GOP margins of -4,620 bps y/y.**
- **August** results were better than July for RevPAR but only slightly improved for margins. Our best interpretation is some hotels are ramping in demand and some hotels benefitted from pent-up leisure. We do not put too much focus on the limited margin improvement from July to August. **August Rooms RevPAR of -78.0% and Total RevPAR of -78.6% compare with GOP margins of -4,530 bps y/y.**
- On an absolute basis, GOP as a percentage of total revenue was -12.8% in July and -13.5% in August.

<u>The Silver Lining</u>

While higher-rated hotels are by and large still running negative EBITDA, the silver lining when analyzing July/August HotStats data is that QTD results are much improved vs. 2Q. The 'less bad" results speak to leisure strength and reopening hotels but also (and not insignificantly) owners and operators having time to adjust operating models to today's lodging environment.

- Much but not all the adjustments are labor related. Nevertheless, having to furlough (and in many cases eventually lay off) property staff is difficult both from a financial lens but also operationally. Hotels can breed strong cultures with employees having decades-long tenures. Remaining employees who lose longstanding coworkers may have to work extra hours and deal with depressed morale (which can impact service standards). Additionally, we are aware of furloughs/layoffs at the "above property" level, including revenue and asset managers and sales/marketing personnel. Said impact may lower some costs in the short-term but also can lead to static room rate pricing, imperfections in the oversight of hotel performance, and delayed owner/operator reactions to lodging fundamentals. There are few if any easy solutions for hoteliers of higher-rated hotels in today's environment.
- **To the credit of the Lodging C-corps/brands, owners, and third-party managers, we continue to be impressed with how quickly hoteliers have acted.** While some private owners complain that the brands could do more to support franchisees, owners are aware that their operators and the brands have their

own challenges in a low revenue environment. Owners have told us that accommodations on reducing non-critical costs are appreciated and that there is far less owner-operator/brand friction than during the Great Recession.

3Q20 Margin Forecasts

While we normally would have made a September or 3Q EBITDA estimate by this point in the quarter, we are not making profit estimates at this time due to the many hotels that are still closed/in the process of reopening combined with the noisy y/y High Holidays calendar shift comp.

PEB: Valuation and Risks

Valuation: Our price target of $9 for PEB is derived by applying a 13.0x target EV/EBITDA to our estimate for 2022 EBITDA. We believe PEB's historically sector-leading EBITDA/Key, 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-19 demand shock impact), we anticipate PEB's initial portfolio enhancements may take 3+ years to be fully materialized, beyond our projection period.

Upside Risks: Material near-term incremental EBITDA from repositioned Legacy LHO assets. RevPAR reaccelerates due to macroeconomic factors, leading to estimate revisions and multiple expansion. Private vs. public market valuation differentials contract. San Francisco labor and demand issues resolve faster than expected. Faster than expected medical solution to COVID-19 benefits: the stock price, trading multiples, lodging demand, and/or property sales comps.

Downside Risks: Planned 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. In the virus demand recovery, San Francisco (over 20% of EBITDA and PEB's largest market exposure) experiences a market-specific demand issue such as the continuation of the cleaning ordinance.

Our ratings and price targets generally represent our recommendations and forecasts based on a 12 to 18 month outlook. We acknowledge that near term uncertainty and volatility could affect financial inputs to our targets, and the likely multiples the market may pay for those metrics.

RLJ: Valuation and Risks

Our price target of $8 for RLJ is derived by applying a 11.5x target EV/EBITDA multiple (in line with portfolio quality; REIT peers are ~11.0x-12.5x) to our estimate for 2022 EBITDA.

Risks to our rating and price target:
Upside risks: RevPAR reaccelerates due to macroeconomic improvements, leading to estimate revisions and multiple expansion. Supply growth issues are less pronounced than expected, particularly competitive hotels that are under construction and never open. Asset management initiatives lead to material near-term EBITDA growth. Wyndham repositionings occur more quickly than expected (within 2022 timeframe) leading to faster than expected EBITDA growth. Airline passenger traffic rebounds quickly to pre-virus levels. Disposition of the Knickerbocker at attractive pricing.

Downside risks: Prolonged COVID-19 impact to the lodging space. RLJ's hotels are not relatively more desired by travelers during the recovery period and/or RLJ's hotels underperform competition. No announcement or vagueness on plans for Wyndham conversions through the valuation period negatively impact investor confidence.

Our ratings and price targets generally represent our recommendations and forecasts based on a 12 to 18 month outlook. We acknowledge that near term uncertainty and volatility could affect financial inputs to our targets, and the likely multiples the market may pay for those metrics.

Companies Mentioned in This Note

Pebblebrook Hotel Trust (PEB, $12.43, Hold, Gregory Miller)
RLJ Lodging Trust (RLJ, $8.64, Hold, Gregory Miller)
Chatham Lodging Trust (CLDT, Not Covered)

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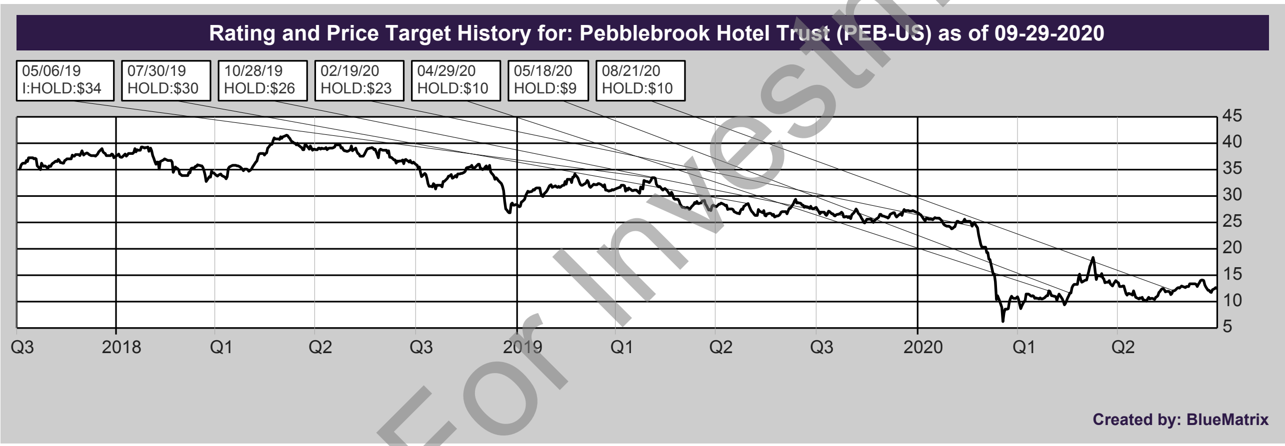

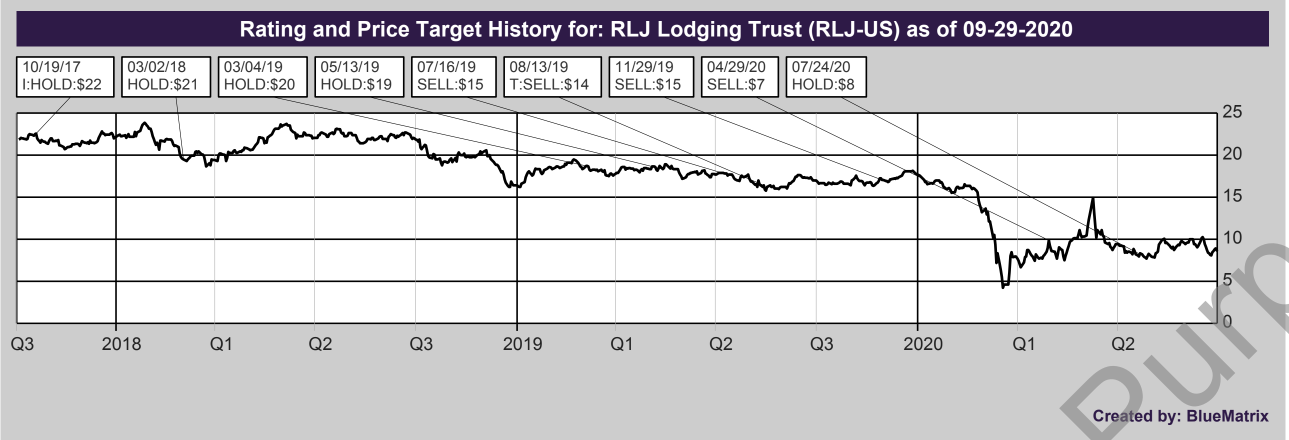

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