Lodging REITs

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What's Inside

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

Hotel P&L Analyzer: Sept. GOP margins -5,300 bps y/y on -79.0% Total RevPAR

3Q GOP margins: -4,840 bps y/y on -80% Total RevPAR. 4Q likely not much better.

What's Incremental To Our View

Based on "big data" observations from higher-rated U.S. hotels (data source: HotStats): September: -5,300 bps of y/y GOP margin growth on -79.0% Total RevPAR (Rooms RevPAR + outside-of-the-room spend). By comparison, August margins were -4,530 bps y/y on -78.6% Total RevPAR. September results were a step in the wrong direction for many urban hotels that focus on corporate demand. Ex-resorts, full-service hotels should see material cost headwinds in 4Q20 (and into 1H21+) given limited corporate/group travel. As demand slowly rebuilds, "permanent" labor cuts are helping the bottom line.

We view hotel profit data from HotStats as a leading indicator for our REIT-covered earnings over the next two weeks. This data would in normal times also provide some insight into incentive management fee (IMF) contribution to C-corps although IMFs from U.S. hotels will be extremely limited given few higher-rated C-corp managed hotels are currently profitable.

For 3Q profitability among full-service hotels, we view the quarter largely falling within four storylines:

1. **Resorts materially outperformed urban properties from the top-line to the bottom-line** and we expect some REITS will point to examples of leisure strength post-Labor Day. **Large groups, corporate travel remain very limited** -- a major headwind to profits for urban hotels, especially hotels with significant meeting space. The bigger the facility, the bigger the potential cash burn.
2. **Hotels reopening over the quarter with Spartan staffing, including in urban markets** (furloughs and layoffs adding noise to 2H20 results).
3. **Cleaning costs are generally cost-neutral to P&Ls:** greater overall cleaning time but less frequent room cleaning. Additionally, as we discussed in our earnings preview, industry data has shown that areas like housekeeping have shown significant productivity improvements. However, cleaning cost ordinances (alongside union efforts to bring back as many members as possible) are headwinds in select markets.
4. **REITS generally better positioned than many private owners, in no small part due to portfolio quality and proactive corporate-level asset management. Having experienced corporate executive management that worked through multiple lodging cycles cannot be more important today** --

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and all our REIT covered executive teams (as well as pretty much the vast majority of our lodging coverage) worked in the lodging industry during the Great Recession and in the 2001-2003 period. This statement cannot be said for many private owners -- where inexperience, risky portfolios/underwriting, higher leverage, and weaker lending relationships exist. While we read of a number of hotels closing permanently in 3Q, especially in NYC, there were more headline news stories on one-off properties than a groundswell of defaulted hotels, especially for investors less focused on the lodging industry outside of the public names. We view the next several months as increasingly challenged for full-service hotel owners, especially as forbearance ends and for private owners with less than a year of liquidity. And while institutional investors can be more focused on the highest-quality hotels that are institutionally owned and/or branded by the public C-corps, there are many hotels in the U.S. that do not fit either category. While 3Q was not a good quarter for the REITS, many private owners were in a far far more impaired position. We expect some REIT teams may note this differentiation on their earnings calls.

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September and 3Q HotStats results:

- **September: Rooms RevPAR of -77.5% and Total RevPAR of -79.0% compare with GOP margins of -5,300 bps y/y.**
  - On an absolute basis, GOP as a percentage of total revenue was -12.8% in July, -13.5% in August, and -16.6% in September. Note that we view the reopening of many hotels in urban markets as a mixed blessing -- higher cash flows for owners but also more competition in many respects.
  - The relative good news is that departmental profit (operating departments) remains quite profitable; in September departmental profit as a percentage of total revenue was 42.9% (vs. 59.9% y/y). We view deep labor cuts at the hourly level and property management running some hourly positions as contributing to the positive figures.
- **3Q: Using a weighted average of each month by occupancy, we estimate Rooms RevPAR of -79.1%, Total RevPAR of -79.8% and GOP margins of -4,840 bps y/y.** These stats compare with our estimated 2Q results of -90.8% Total RevPAR growth on GOP margins of -13,290 bps.
- September and 3Q results came in around the middle of our internal expectations (occupancy was slightly stronger and GOP margins slightly weaker).

3Q for the REITS: Better than 2Q (obviously) but corporate-level EBITDA remains sharply negative and we are not seeing a material month-month improvement in margins. Also, expect noise in financial adjustments and reconciliations for furloughs/layoffs which may be inconsistently applied across the sector.

- While 3Q20 was a vastly better quarter on the bottom line for the REITS vs. 2Q20, driven by hotel reopenings and pent-up leisure demand, we do not see a fast recovery to positive corporate-level EBITDA for our REIT coverage. Importantly, the HotStats data that we analyze does not factor in corporate costs. While we view REIT discussions on positive hotel/property-level EBITDA as encouraging (we see this storyline largely for select-service hotels especially hotels outside of top 25 markets), the reality is corporate costs are not falling materially across the sector - especially as some firms take on expensive debt and without notable staff reductions or salary cuts for some owners.
- Noisy comparisons across the sector - at a high-level, the more layoffs/furloughs for a portfolio, the more one-time adjustments will likely be applied. While companies such as HST provided an intraquarter update to help guide Street expectations, some companies have not provided an update. We expect one-time adjustments will continue in 4Q. There may be varied approaches by ticker for labor costs that may/may not be add-backs to Adjusted EBITDA/FFO.
- Given HotStats' September results, we still view the *relatively* best positioned REIT in our coverage as RLJ, driven by its select-service hotels (especially its extended-stay hotels), suburban assets (~ 1/3 of the portfolio), and smaller labor models at many hotels. Yet for RLJ's full-service corporate-oriented hotels, we see similar headwinds as is the case for the dedicated full-service REITS.

4Q: Like over the summer, we see the better positioned hotels as those with primarily transient leisure exposure to warm weather and drive-to markets. Clearly we have seen no material recovery to corporate demand post-Labor Day. We are approaching about the last 4-6 weeks of traditionally strong corporate

demand pre-December holidays. Given rising virus cases nationwide combined with continued resistance to mask wearing and social distancing in parts of the U.S., the potential emergence of new shutdown policies, and many travelers unwilling/unable to travel for work or leisure this fall, we do not see 4Q margins materially improving for urban, corporate-focused hotels or group hotels that target corporate customers. And while hotels have largely cut labor costs significantly, we could see more Spartan approaches to hotel operating expenses if demand falls back closer to April/May levels. European performance is not encouraging -- the lax approaches to the virus in recent months by some citizens have led to virus cases spiking and new shutdown policies (leading to lower RevPAR). We could easily see a similar storyline in the U.S.

- **We are cautiously optimistic on Hawaii but rising virus cases in the mainland may dent a winter recovery.** We are not public health experts but we view places like Hawaii as potentially very challenged if virus cases spike. It is unreasonable to expect thousands of sick Hawaiians to be transported to hospitals along the West Coast or Guam. Smaller Hawaiian islands may lack sufficient hospital beds for virus cases. The reopening of hotels is critical for the State's economy but a public health crisis could be even more damaging for the long-term.

Other big profit topics pre-earnings:

- **Demand visibility improving? Forget it.** (HotelNewsNow). Note that leisure bookings (the majority of today's bookings) are not just last-minute, often less than a week before the day of arrival, but cancellation policies are more generous to travelers. As a consequence, we find revenue management strategies more challenged. Not helping -- the layoffs of many revenue and asset managers (then again, without the complexity of corporate and group bookings well into future months, a more static approach to rate positioning is also arguably more tolerable in today's environment).
- **NYC is not just challenged from demand and supply concerns** -- additionally a new law requires hotel buyers to keep existing staff for at least 90 days (HotelNewsNow).
- **Will industry lobbying efforts for financial relief from the government eventually support hotel owners? To be determined. However, finally we are starting to publicly see a more coordinated front from the greater travel industry.** We noted back in early July the need for a "multi-industry publicized effort by impacted industries (not just from the hotel lobbies but also meetings/conventions, restaurants, airlines, etc.) on the long-term economic impact to cities and the U.S. economy if virus cases do not come down materially". As the months wore on, we heard from some of our private hotel industry contacts (owners, asset managers, etc.) on the increasingly dire state of U.S. lodging. On September 30th, a wide gamut of travel related entities signed a letter to Congressional leadership on emergency relief (AHLA). We are unsure if/when Washington will act and it is impossible from our seat to speculate. However, we stand by our original view that the potential closure of many hotels, restaurants, attractions, and bankruptcy of associations that run conventions and trade shows could lead to a far slower recovery for the lodging space and the greater travel industry if not permanent dislocation. We add that we view a dislocated travel industry having a negative bullwhip impact to industries and local economies in all 50 states. In theory, such a wide impact should lead to bipartisan relief efforts and improved coordination between the White House, the Senate, and the House.

A word on the permanency of property-level staffing cuts, a topic that we also expect will be given attention by some C-corps and REITS at earnings: We have heard some companies point to hotel labor changes as permanent and material. While we could see digital check-in, the outsourcing of concierge, and reduced F&B leading to some permanent staffing cuts, we find that the topic of permanent labor cuts is appealing messaging to hotel owners and investors in troubled times with low occupancy. However, if and hopefully when hotels return to normalized occupancy levels, we expect staffing to largely return to pre-COVID levels.

- We view hotel labor somewhat like an accordion. As a lodging cycle gets longer, the accordion grows wide and hotels add staff (technically we also see this at the corporate level). After a demand shock and an end to a lodging cycle, the accordion contracts and labor is reduced. We have seen this labor movement transpire in past cycles through our years working both at hotels and in corporate C-corp positions. While we view COVID as a far more severe impact to hotel labor than any recent downturn, we also are hard-pressed to see higher-rated hotels function on Spartan staffing. For one, there is a service element that supports a multi-hundred dollar/night stay. But more simply, many hotel functions simply require staff -- from setting up a meeting room for a function to the maintenance of the physical plant.
- In 3-5 years, we do not expect we will hear much messaging on the benefits from permanent staff cuts (assuming occupancy recovers in full). More likely we will be hearing about rising labor costs. Further, especially given that we continue to have limited immigration of low-skilled workers into the U.S., **we and some**

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of our private hotel owner contacts remain unconvinced that hotel margins will become sustainably superior to pre-COVID levels. As such, we do not support REIT modeling that assumes recovery margins above 2016-2018 levels.

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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

Host Hotels & Resorts, Inc. (HST, $10.45, Sell, C. Patrick Scholes)
RLJ Lodging Trust (RLJ, $7.93, Hold, Gregory Miller)

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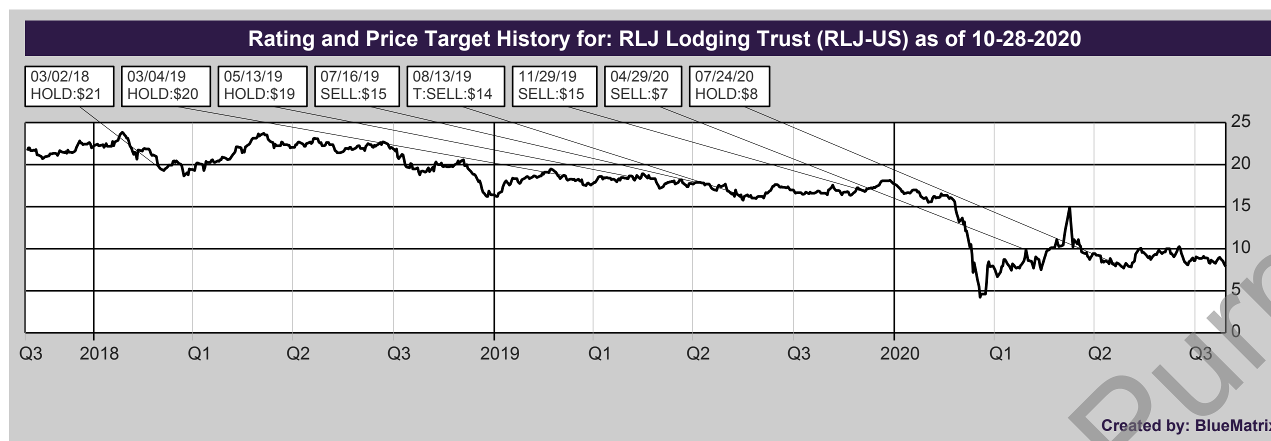

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