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: Dec. GOP margins -3,080 bps y/y on -76.3% Total RevPAR. 4Q: -3,500 to -4,000 bps

Prelim 4Q REIT filings + HotStats data = 1H21 cons REIT EBITDA ests too high

What's Incremental To Our View

Based on "big data" observations from higher-rated U.S. hotels (data source: HotStats): December: -3,080 bps of y/y GOP margin "growth" on -76.3% Total RevPAR (Rooms RevPAR + outside-of-the-room spend). Combined w/prelim 4Q REIT results, we continue to assume disparate hotel-level results with sun/ski resorts far outperforming most urban full-service. We still view consensus Lodging REIT EBITDA estimates as too high, especially 2Q21, given prelim 4Q20 releases/HotStats data. Lower 1H21 almost certainly means lower 2021, with the possible lowering of consensus EBITDA ests. for subsequent years.

4Q: we forecast <u>property-level</u> GOP margins for full-service hotels of -3,500 to -4,000 bps y/y vs. our prior estimate of -3,500 bps to -4,500 bps.

In this month's P&L Analyzer, we discuss:

1. December HotStats hotel profit results and our revised estimates for 4Q20
2. What the preliminary 4Q20 Lodging REIT results may indicate for sector earnings results this month
3. Updated thoughts on 1H21 EBITDA based on above

<u>**December HotStats results and our updated 4Q profit forecast:**</u>

- **December: Rooms RevPAR of -75.8% and Total RevPAR of -76.3% compare with GOP margins of -3,080 bps y/y.**
- December results are seemingly "less bad" than October and November presented below. We remind investors that sequential changes have to be taken into broader context today. For December 2020, on a low season comp and despite easier holiday timing for Christmas and New Years in 2020 (Fridays in 2020 vs. Wednesdays in 2019), December y/y changes were not dissimilar to November. Based on conversations with private hotel owners and intraquarter updates from a few REITS, we maintain confidence that the

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primary December outperformers were "ski and sun" resorts (ex-Hawaii, with STR results that looked soft to us despite the reopening to tourism).

- **October: Rooms RevPAR of -77.9% and Total RevPAR of -79.3% compare with GOP margins of -3,190 bps y/y.**
- **November: Rooms RevPAR of -78.4% and Total RevPAR of -79.2% compare with GOP margins of -4,030 bps y/y.**

Based on the above results, we estimate 4Q property-level GOP margins of ~ -3,500 bps to -4,000 bps for full-service hotels. Our prior estimate was -3,500 to -4,500 bps. For full-service hotels in the U.S., we view reclosures of unprofitable hotels, increasing permanent hotel closures in Top 25 markets, tight asset management by hotel owners and tight operating standards by operators, and the ramp-up of full-service hotels staying open helped 4Q margins *to a modest extent*.

- On an absolute basis, GOP as a percentage of total revenue was -12.8% in July, -13.5% in August, -16.6% in September, **+8.9%** in October, -5.7% in November, and **+1.5% in December**. As a reminder, negative GOP margins effectively eliminate incentive management fees (IMFs) for most U.S. hotels, with possible exceptions to high occupancy resorts and the select hotels that lack a profit hurdle. A material return of IMFs to Lodging C-corps from U.S. hotels (and most markets ex-China) is unlikely for several quarters.
  - Occupancy for the HotStats sample was 21.5% in December vs. 28.1% in October, 24.2% in November, and 29.6% for FY 2020.
  - We estimate 4Q Rooms RevPAR for the HotStats set of -77.5% and Total RevPAR of -78.4%.
  - Departmental profit (reflective of the hotel operating departments) remains decently profitable with profit as a percentage of total revenue of 44.5% in October, 45.3% in November, and 47.4% in December. These results compare to FY 2020 of 49.1%. We continue to view many hourly roles being filled by property management in low occupancy hotels. **We add that despite reopening hotels and property managers in hourly-like roles, departmental profit has remained fairly even over the past few months -- not exactly a great tailwind into 1H21 assuming similar demand characteristics.**

Our 4Q GOP estimate range above compares with our forecasted Adjusted EBITDA margin for our covered REITS of -7,041 bps inclusive of Ryman (RHP, Sell) and -6,630 bps ex-RHP. (We weight-average by market cap; we model RHP's Hospitality EBITDA to materially underperform all other covered REITS given RHP's large group exposure and the temporary closure at Gaylord National). As evidenced by the difference between our GOP and Adjusted EBITDA estimates, individual REIT Adjusted EBITDA will likely underperform the full-service hotels in the HotStats sample given all our covered REITS are at least partly concentrated in 1) Top 25 gateway markets partly reliant on fly-in higher-rated corporate demand and/or 2) impacted by the lack of large group/convention exposure directly through owned hotels and/or the lack of convention citywide demand (effectively a zero today).

4Q20 for the full-service REITS: following recent intraquarter updates we suggest foci on the leisure/resort mixes as the primary (only) sources of positive EBITDA contribution.

- So far a few REITS have reported preliminary 4Q stats. While we cannot comment with great depth on names outside our coverage, we maintain confidence given updates from companies both within and outside our coverage that REITS with a more material resort/leisure mix, hotels with soft/no brand affiliations, and hotels with arguably more flexible third-party/affiliated operations can highlight those relative strengths to the bottom line even if top-line fundamentals remain very weak. Eventually hard-branded urban hotels will once again have their day in the sun -- when the readership of this note is attending NAREIT in person again, the branded underperformers should be back.
- Among the REITS that have reported some intraquarter results, within our coverage Pebblebrook (PEB, Hold, Miller) and Ryman (RHP, Sell) have provided recent updates. Our brief takeaways from both disclosures:
  - **PEB:** While some of PEB's resorts may have been negatively impacted in late 4Q from a rise in COVID cases/government restrictions in California and possibly the red tide issues around Vanderbilt Beach and surrounding Naples/Fort Myers for LaPlaya (red tide can cause respiratory issues on/near the beach), we view the macro for PEB's California and Florida "sun" resorts as helpful even though forecasted portfolio monthly Hotel EBITDA fell from

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($3.1M) in October to ~ ($8M-$9M) each for November and December (NBC 2 Ft. Myers). We add that Hotel EBITDA and Hotel NOI were approximately $1M worse in 4Q vs. 3Q, suggesting to us tight operating controls on PEB hotels that stayed open.

- **RHP:** The company pointed to holiday programs driving transient demand (read: leisure). While we did not receive much disclosure on 4Q group demand, we assume like for other major group-focused hotels and convention centers, there was limited group demand given 4Q occupancy ex-the closed National (near Washington, D.C.) of just 24.5%.

- While we do not cover dedicated select-service REITS, we also expect select-service hotels ex-Top 25 Markets to have somewhat better results on average than major market urban select-service hotels.

Within our coverage, we note our only Hold-rated Lodging REITS (the rest are Sells) are PEB and RLJ (RLJ, Miller). While there are a variety of dynamics contributing to our 7 REIT ratings including various ROI CapEx projects in progress that impact our 2023 valuation year EBITDA, we note a few key dynamics separate PEB and RLJ:

- **PEB:** 40% historical transient leisure mix -- highest among our covered REITS -- and relatively greater operational flexibility especially from PEB's soft- and un-branded hotels.
- **RLJ:** ~ 1/3 suburban exposure, ~ 60% select-service.

Segmentation By Company

	Transient Corporate*	Transient Leisure	Group
DRH	45%	25%	30%
HST	40%	25%	35%
PEB	35%	40%	25%
PK	35%	35%	30%
RHP	5%	25%	70%
RLJ	55%	25%	20%
SHO	45%	20%	35%

C-corps	Transient Corporate*	Transient Leisure	Group
CHH	45%	45%	10%
H	40%	20%	40%
HLT	50%	20%	30%
MAR	50%	30%	20%
WH	30%	70%	less than 1%

*For simplicity, transient corporate includes contract/crew (generally 5% or less of total demand for most companies). Contract/crew is generally very low-rated business.

Source: Truist Securities Research, company filings

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4Q20 read-through to 1H21: We still view consensus EBITDA estimates too high, especially for 2Q21, for the Lodging REITS given preliminary 4Q20 releases and 4Q HotStats data. Lower 1H21 almost certainly means lower 2021, with the possible lowering of consensus EBITDA estimates for subsequent years. We view December HotStats results as a strong read-through to January and February 2021, similarly low season months. There is increasing support from our private owner contacts, in concert with what some public and private ownership and management teams have noted, that 1Q21 EBITDA may be as similarly depressed as 4Q20 given low season in January/February. **Some of our private owner contacts have suggested that 2Q21 EBITDA may not be greatly improved vs. 1Q21.** Versus mid-2020, many of the REITS have reopened most of their hotels even if fly-to corporate demand has remained sluggish at best. As a result, we have less confidence that 2Q21 will be a great improvement over 1Q21, ex-leisure markets and resorts.

For now, consensus estimates for our covered REITS indicate positive Corporate Adjusted EBITDA for 2Q21. We are not convinced this positive EBITDA assumption will hold without a material improvement in corporate travel / rapidly improving virus situation. We admit consensus quarterly EBITDA is impacted by the number of estimates and the recency of updates, which for some names is just a few analysts. Nevertheless, all our covered names have positive consensus Corporate Adjusted EBITDA as of 2Q21 per FactSet. **Conversely, we model negative Adjusted EBITDA for 2Q21 for all our covered REITS.**

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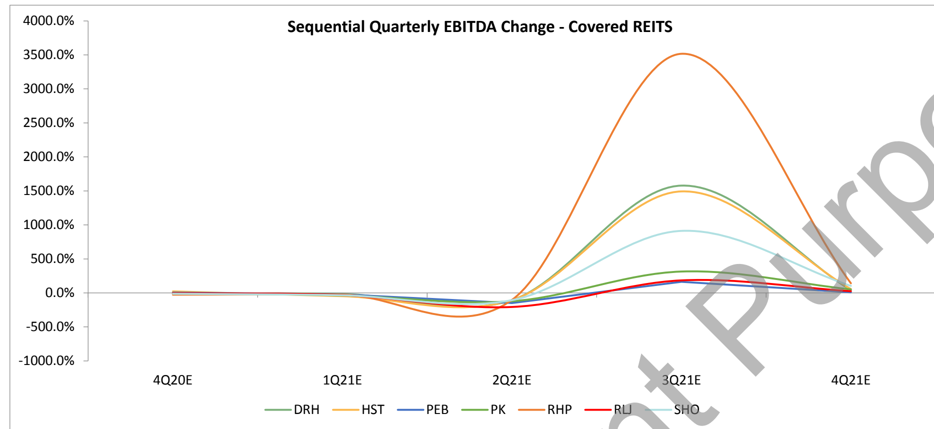
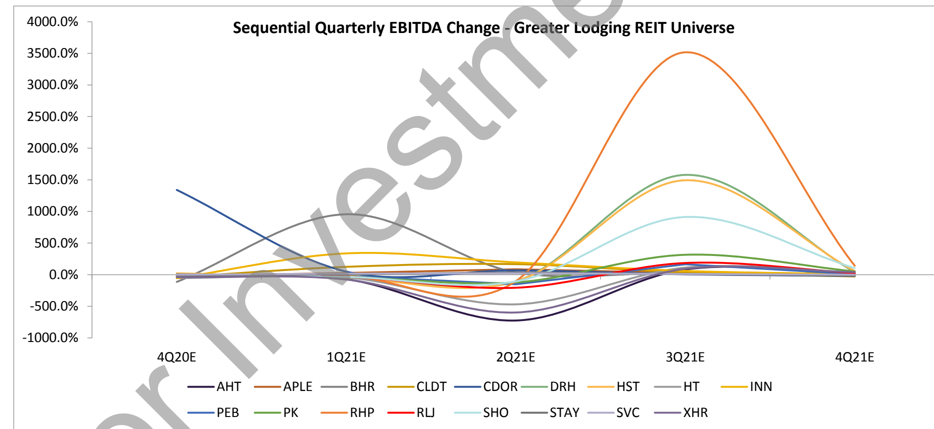
Consensus EBITDA By Quarter



Source: FactSet, Truist Securities Research. We note that some REITS have few quarterly estimates which can exaggerate sequential changes.



Source: FactSet, Truist Securities Research. We note that some REITS have few quarterly estimates which can exaggerate sequential changes.

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(Please send an email to either of us for the chart detail.)

We continue to view room rate integrity issues as a rising and pressing concern that could lead to our estimates falling not to mention those with more optimistic views on the Street. So far, ADR declines for full-service hotels have been largely driven by a shift of the mix of business (lower-rated leisure demand > higher-rated corporate demand). There is limited incentive for hoteliers to intentionally lower rates when demand remains so light. If/when room rates fall given weakened liquidity by private owners, and we believe it is just a matter of time for "when" to transpire, we expect a downside revision to estimates. As much as hoteliers are aware that intentional rate cuts have sharp and protracted impacts on profitability, as horribly evident from the last two lodging demand shocks (9/11 and GFC), we are unconvinced that we can get through this even worse lodging downturn without significant rate discounting.

- **While we commend hoteliers' efforts to maintain lean operating models, we view a ~ 100-300 bps of consensus permanent improvement to EBITDA margins, if/when that transpires, far less significant than a potential rate integrity issue. However, we do not expect many public executives will discuss room rate integrity challenges until they are transpiring so as to not spook the Street. With the possible exception of a select number of CEOs/CFOs, we expect room rate integrity concerns will remain outside of prepared earnings remarks and analyst earnings questions.** Rate integrity is arguably an "inside baseball" topic that generalists are less familiar with and/or may not care about the nuance. We posit that Lodging REIT investors should remain highly attuned to this issue, especially as private hotel owners struggle to maintain control of their hotels.

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PEB: Valuation and Risks

Valuation: Our price target of $18 for PEB is derived by applying a 14.5x 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 (~ 250-300 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.

RHP: Valuation and Risks

Our price target of $47 for RHP is derived by applying a 13.0x target EV/EBITDA multiple to our estimate for 2022 lodging EBITDA (in line with HST and PK) and a 12.0x multiple to our Opry/attractions estimate.

Risks to our rating and price target include:

Upside risks: Quicker than expected rebound of all of RHP's lodging and entertainment assets (especially group/convention demand).

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RLJ: Valuation and Risks

Our price target of $13 for RLJ is derived by applying a 12.5x 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.

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Companies Mentioned in This Note

DiamondRock Hospitality Company (DRH, $8.28, Sell, C. Patrick Scholes)
Host Hotels & Resorts, Inc. (HST, $13.64, Sell, C. Patrick Scholes)
Pebblebrook Hotel Trust (PEB, $18.30, Hold, Gregory Miller)
Park Hotels & Resorts Inc. (PK, $16.55, Sell, C. Patrick Scholes)
Ryman Hospitality Properties, Inc. (RHP, $66.99, Sell, C. Patrick Scholes)
RLJ Lodging Trust (RLJ, $13.22, Hold, Gregory Miller)
Sunstone Hotel Investors, Inc. (SHO, $10.52, Sell, C. Patrick Scholes)
Ashford Hospitality Trust (AHT, Not Covered)
Apple Hospitality REIT (APLE, Not Covered)
Braemar Hotels & Resorts (BHR, Not Covered)
Chatham Lodging Trust (CLDT, Not Covered)
Condor Hospitality Trust (CDOR, Not Covered)
Extended Stay America (STAY, Not Covered)
Hersha Hospitality Trust (HT, Not Covered)
Service Properties Trust (SVC, Not Covered)
Summit Hotel Properties (INN, Not Covered)
Xenia Hotels & Resorts (XHR, Not Covered)

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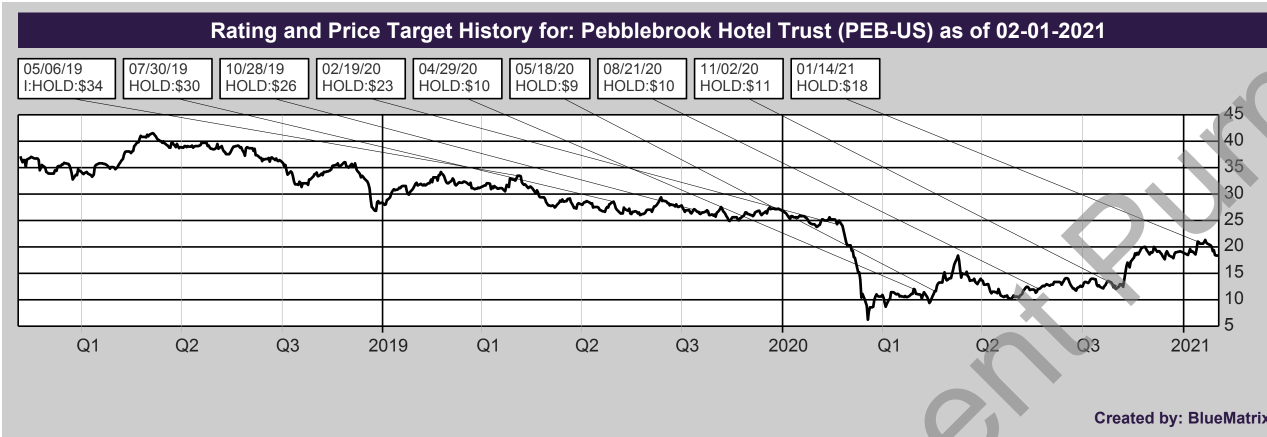

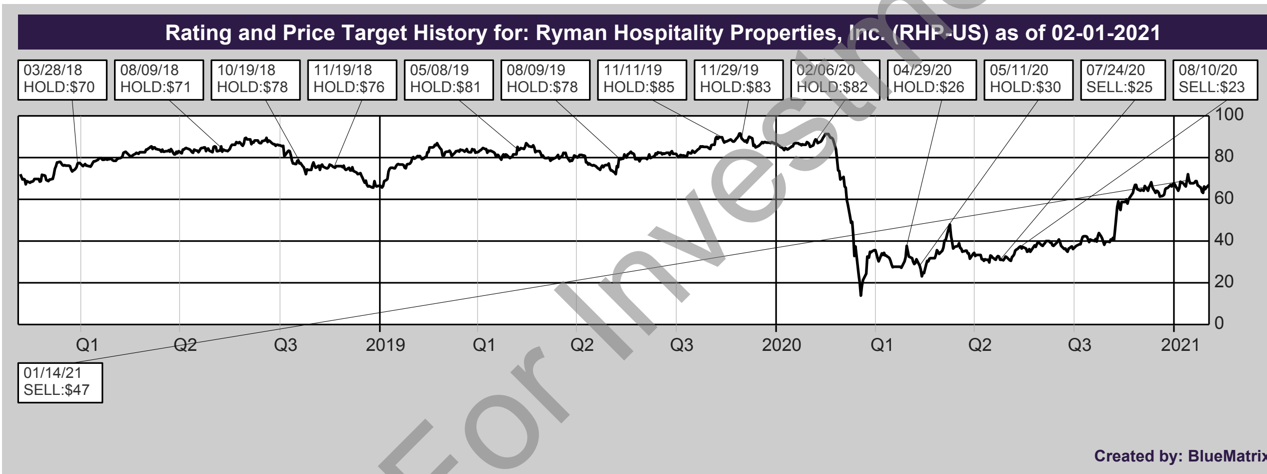

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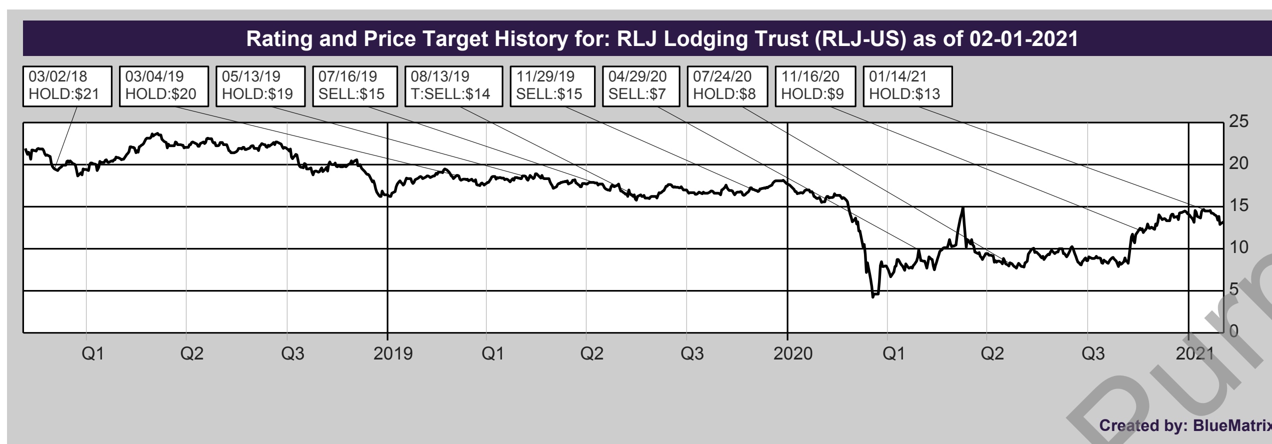

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