Equity Research

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CONSUMER: Lodging

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Reasons for this report

Deep dive analysis of recent U.S. hotel 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 as well as a read-through on incentive management fees (IMFs).

Companies most impacted in this note include: HLT, H, MAR, the Lodging REITS, and secondarily PLYA as a leisure read-through.

April Hotel P&L Analyzer: GOP margin of 42.9% (+920 bps vs 4/19) great but labor cost creep apparent

We analyze revenue and expense "big data" on over 3,000 U.S. hotels (data source: HotStats) and hold discussions with private hotel owners. HotStats data is helpful for analyzing both Lodging C-corps and REITS.

Bottom line: GOP margin in April was up materially vs. April 2019, +920 bps on -15% Total RevPAR. Versus 1Q22, GOP margin was +870 bps, to 42.9% from 34.2%. Additionally, vs. March 2022, GOP margin grew 50 bps. Recent trends may foreshadow strong profits this summer but labor costs are catching up to travel demand. We suspect staffing up at higher wages may pressure margins lower after the summer.

From our analysis of the data, we come away relatively favorable on how profit trends have progressed in recent months and what may be a precursor to strong profits this summer during another peak leisure period where record room rates should flow-through at a high margin to EBITDA. Headline results in isolation for 1Q22 and April look very positive -- both in terms of the absolute margin recovery and versus 2019. **However, over the past few months, we see increasing evidence of rising labor cost growth nearly matching the recovery of hotel occupancy. We think it is reasonable to postulate that profit margins relative to 2019 may contract to an extent following the summer.** We are unsure if recent margin results present a positive "head fake" or may be generally sustainable. For now, we provide graphs, data, and interpretation of how we see the labor and cost environment today.

- **For additional insights including on Europe and Asia-Pacific, we are meeting with HotStats on Monday (6/6) at the NYU Hospitality Conference.** Investors, travel industry professionals, and media are welcome. Please contact us for details.

First the good/great news: Absolute profits (our proxy for EBITDA is Gross Operating Profit or GOP) has rebounded in recent months to be within 10 points of 2019 levels, despite a relatively lower recovery of occupancy and Total RevPAR (Rooms RevPAR + outside-of-the-room spend).

Aggregated U.S. Hotel Operating Performance: April 2022 vs. Prior Years

	Apr-22	Apr-21	*y/y % change*	Apr-19	*3-yr % change*
Occupancy	68.9%	45.7%	*50.8%*	79.6%	*-13.4%*
ADR	$225	$162	*38.9%*	$219	*2.6%*
RevPAR	**$155**	**$74**	***109.4%***	**$174**	***-11.2%***
Total RevPAR	**$227**	**$102**	***122.4%***	**$266**	***-14.8%***
Room Margin	76.3%	73.6%	*3.7%*	74.7%	*2.1%*
F&B Margin	34.5%	18.9%	*82.5%*	31.9%	*8.2%*
Operating Department Margin	65.9%	64.2%	*2.6%*	62.5%	*5.4%*
GOP Margin	**42.9%**	**30.4%**	***41.1%***	**39.3%**	***9.2%***
GOP Per Available Room	**$96**	**$31**	***215.3%***	**$105**	***-7.8%***
Total Hotel Payroll (% of Total Revenue)	29.6%	34.5%	*-14.2%*	32.8%	*-9.8%*
Total Hotel Payroll (Per Available Room)	$67	$35	*91.2%*	$87	*-23.6%*
Total Hotel Payroll (Per Occupied Room)	$96	$76	*26.7%*	$109	*-11.8%*

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

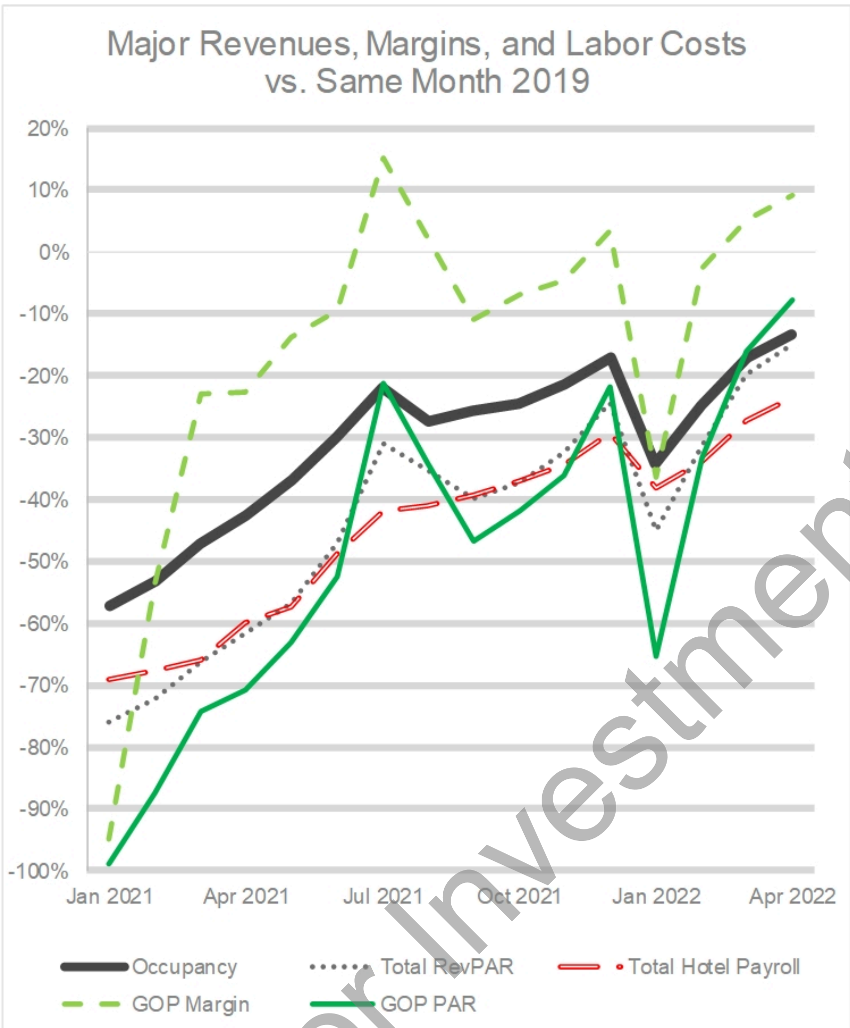
April results during a holiday month (Easter + Spring break) may be a prelude to similar trends over the summer where high room rates will likely flow materially to margins. However, we lack strong conviction for now. Two months of cleaner comps following the January/early February Omicron headwind are insufficient to call trends.

As we discussed in our last P&L Analyzer note, there are multiple implications when we see very strong GOP margins and improved absolute profits.

- **For the Lodging C-corps,** strong resort/leisure market profits driven in part by record room rates drive operational-driven incentive management fees. We saw these results in 1Q22 and expect both April and June to support 2Q22 EBITDA recovery versus 2019. We are particularly bullish on "ski and sun" destinations both in North America and the Caribbean/Mexican resort markets. Beneficiaries include Hyatt especially from its Apple Leisure Group exposure in the Americas (H, Buy, Scholes), Playa (PLYA, Buy, Scholes), and Marriott (MAR, Hold, Scholes).
- **For the Lodging REITS,** overall profit improvement in 2Q22 will in many cases be driven by the degree of improvement of business travel and supported by the continuation of record leisure room rates. As the winter is peak leisure season in South Florida and parts of Arizona, we expect less robust profits for some hotels in 2Q22 versus 1Q22.

We call out that recovery to 2019 offers a recent comparison but not necessarily the best year for analysis. A recovery to 2019 is arguably less impressive than a recovery to peak hotel-level EBITDA; for many institutional C-corp and REIT-owned hotels, peak profits were in the 2015-2018 period. By comparison, 2019 hotel profits faced several headwinds including rising labor costs and new supply growth (both hotels and alternative accommodations). San Francisco was one local positive exception in 2019 due to a record convention attendance year. As HotStats' data sample has grown considerably in recent months, for now we do not compare our P&L Analyzer notes pre-2020 to the data we have today.

Absolute profits (presented in the solid green line below) are still behind equivalent 2019 levels but improving fast (down 7.8% in April versus 16.1% in March). Unlike GOP margins (in green dashes), which is once again above 2019 levels, we view dollar profits far more important for Lodging C-corp franchisee health, REIT EBITDA, and returns to shareholders through dividends and buybacks. Total hotel payroll, presented in red dashes, remains far below the occupancy and Total RevPAR recovery; this is good although we note that many hotels are still running on lower-than-optimal staffing. **Rising labor costs and the restaffing of higher-end business and group hotels are not necessarily well represented in historical data and we provide more narrow analysis further in this note.**



Source: Truist Securities Research, HotStats

The somewhat less encouraging news is that the sequential GOP improvement from March to April may be somewhat misleading. Driving our views: occupancy improved 5% month-over-month and RevPAR was +6% but room and operating margins were slightly down. Granted, we do not assign too much focus on isolating two months of data, especially given April was a holiday month and March a seasonally slower month compounded by lower-than-normal corporate/group demand. Nevertheless, we view sequential changes month-to-month as helpful structurally in analyzing how both labor costs and profits may recover through 2H22. May and June data will be additive as May had a stronger business demand recovery and June is the start to what is very likely to be a very robust leisure summer and record room rates.

Aggregated U.S. Hotel Operating Performance: April 2022 vs. 1Q22

	Apr-22	1Q22	monnth % change	Abs. variance
Occupancy	68.9%	55.0%	25.3%	1,390 bps
ADR	$225	$209	7.3%	$15.28
RevPAR	**$155**	**$115**	**34.5%**	**$39.72**
Total RevPAR	**$227**	**$168**	**34.9%**	**$58.60**
Room Margin	76.3%	73.2%	4.2%	310 bps
F&B Margin	34.5%	24.2%	42.6%	1,030 bps
Operating Department Margin	65.9%	62.2%	5.9%	370 bps
GOP Margin	**42.9%**	**34.2%**	**25.4%**	**870** bps
GOP Per Available Room	**$96**	**$57**	**68.7%**	**$39.28**
Total Hotel Payroll (% of Total Revenue)	29.6%	34.8%	-14.9%	-520 bps
Total Hotel Payroll (Per Available Room)	$67	$58	14.2%	$8.28
Total Hotel Payroll (Per Occupied Room)	$96	$106	-8.9%	-$9.45

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

Aggregated U.S. Hotel Operating Performance: April 2022 vs. March 2022

	Apr-22	Mar-22	monnth % change	Abs. variance
Occupancy	68.9%	65.6%	5.0%	330 bps
ADR	$225	$222	1.0%	$2.33
RevPAR	**$155**	**$146**	**6.2%**	**$8.98**
Total RevPAR	**$227**	**$213**	**6.4%**	**$13.70**
Room Margin	76.3%	76.5%	-0.3%	-20 bps
F&B Margin	34.5%	33.5%	3.0%	100 bps
Operating Department Margin	65.9%	66.0%	-0.2%	-10 bps
GOP Margin	**42.9%**	**42.4%**	**1.2%**	**50** bps
GOP Per Available Room	**$96**	**$90**	**7.3%**	**$6.54**
Total Hotel Payroll (% of Total Revenue)	29.6%	29.5%	0.3%	10 bps
Total Hotel Payroll (Per Available Room)	$67	$63	6.1%	$3.85
Total Hotel Payroll (Per Occupied Room)	$96	$95	1.2%	$1.19

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

- GOP margins rose 50 bps whereas operating margins were down 10 bps. **We view reduced property management staffing as a contributing factor to this variance -- a topic frequently noted by both REITS and C-corps as a permanent labor reduction. However, with hourly department margins falling on higher occupancy (greater efficiency); the disconnect on margin performance month/month is somewhat concerning.**

By comparison, provided below are results for March (a less leisure driven month ex-resorts and seasonally-strong leisure markets such as South Florida and Arizona).

Aggregated U.S. Hotel Operating Performance:
March 2022 vs. Prior Years

	Mar-22	Mar-21	y/y % change	Mar-19	3-yr % change
Occupancy	65.6%	41.7%	*57.3%*	79.0%	*-17.0%*
ADR	$222	$156	*42.0%*	$220	*1.0%*
RevPAR	**$146**	**$65**	***123.3%***	**$174**	***-16.1%***
Total RevPAR	**$213**	**$90**	***136.4%***	**$266**	***-19.9%***
Room Margin	76.5%	75.2%	*1.7%*	74.9%	*2.1%*
F&B Margin	33.5%	17.4%	*92.5%*	32.5%	*3.1%*
Operating Department Margin	66.0%	65.9%	*0.2%*	62.8%	*5.1%*
GOP Margin	**42.4%**	**31.0%**	***36.8%***	**40.3%**	***5.2%***
GOP Per Available Room	**$90**	**$27**	***227.7%***	**$107**	***-16.1%***
Total Hotel Payroll (% of Total Revenue)	29.5%	33.3%	*-11.4%*	32.5%	*-9.2%*
Total Hotel Payroll (Per Available Room)	$63	$30	*112.4%*	$86	*-27.4%*
Total Hotel Payroll (Per Occupied Room)	$95	$71	*34.9%*	$109	*-12.7%*

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

<u>We wrap up this note by focusing on trends in the operating departments and where we see rising hourly labor and non-labor costs that are catching up to the rebound of demand.</u>

It is possible if not likely that margins may continue to remain above 2019 levels in general. Most REITS point to 100-350 bps of permanent margin expansion (or as we would state, reflecting the peak of the current lodging cycle and before the normal late-cycle cost creep picks up). It is also possible that hotels are simply not staffed enough to reflect normal operations; several public companies noted these considerations on the 1Q22 earnings calls.

There are strategic reasons why hotels are restaffing and adding costs ahead of the expectation of rising demand for corporate/ group travel and summer leisure. Especially today, high room rates are met with high guest expectations on service. We also think about the potential impact from: labor costs possibly slowing if unemployment rises in a softening macro, how will hoteliers adjust staffing if post-summer demand is weaker than expectations, and will supply chain issues/food costs/higher gas prices/inflation be sufficiently passed along to the consumer with higher room rates and food/beverage/catering pricing. It is also unclear to us the extent that property management cuts will be sustainable long-term.

For our analysis we focus on a few key labor departments that are both material costs to hotels and represent important but distinct areas of operations:

- **Front office salaries and wages** (non-managerial roles such as front desk): **1.2%** of total revenues in 2019
- **Housekeeping and laundry salaries and wages: 4.2%** of total revenues in 2019
- **Food and beverage labor costs and related expenses: 13.3%** of total revenues in 2019
- **Management A&G** (managerial roles such as the General Manager, Director of Finance, Controller, Director of Human Resources, etc.): **1.4%** of total revenues in 2019.
- **These four departments represent ~20% of total hotel revenues**, or approximately 58% of hotel payroll.

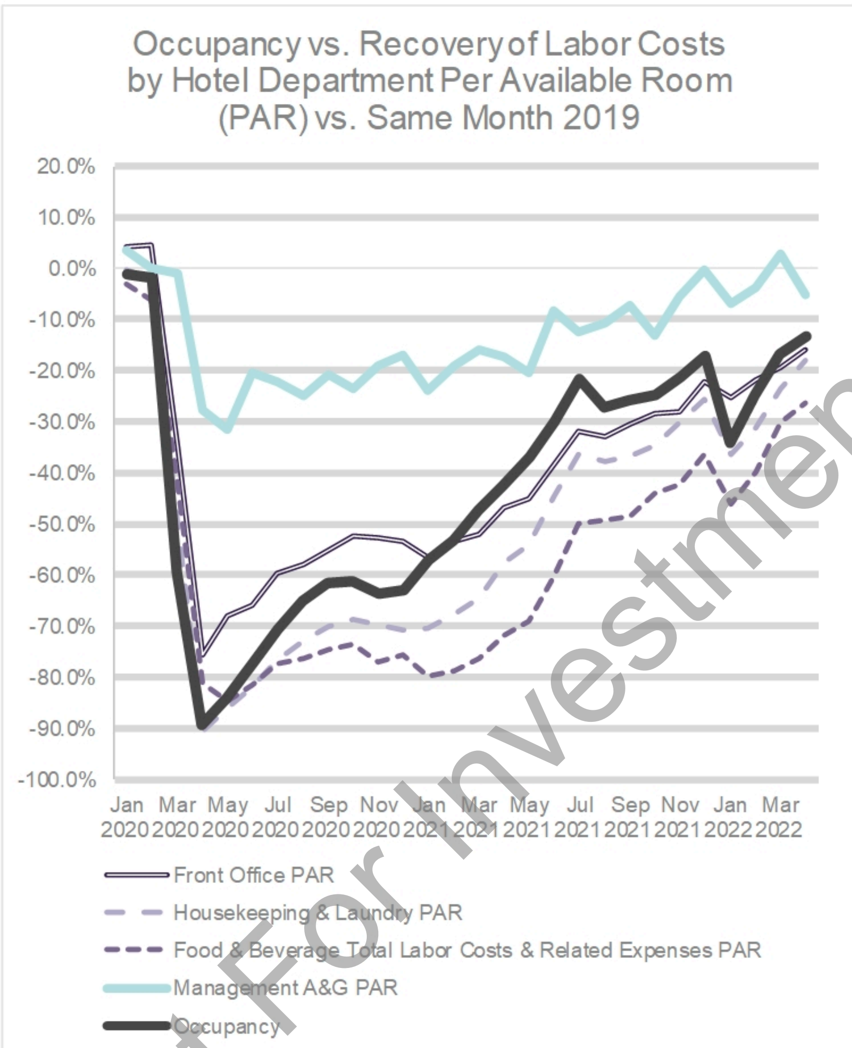
It is less clear to us how staffing counts may normalize for hourly roles. While not necessarily emphasized by some management teams, we anticipate permanent reductions in hourly roles such as housekeeping, front desk, and food and beverage. For several reasons, we do not expect public company messaging to focus on permanent hourly labor reductions:

- **Guests are paying higher rates and service expectations are also generally higher.** We do not believe as many guests are as tolerant of COVID-related service shortfalls as was the case several months ago and particularly for resorts where room rates are several hundred dollars per night above 2019 levels.
- **Hotel companies are making intentional adjustments to service standards, such as the elimination/simplification of daily housekeeping** in many hotels (ex-luxury), mobile/humanless check-in, simplified breakfast buffets, among other areas.
- **Hoteliers are having challenges hiring.** Operating measures to permanently reduce staffing works against hiring initiatives or the culture of career growth.
- **Workers' rights groups are attentive to the labor changes in the industry** and some organizations will be negatively impacted by a lower overall industry labor force.
- **There continues to be a drumbeat of media articles focusing on the cost of travel going up and service/operating implications within the greater travel infrastructure (air, hotel, etc.)**

Graphically, we present labor cost trends in two ways: on a per available room (PAR) basis and per occupied room (POR). Some hotel roles exist regardless of demand (for example a general manager) and other roles are added back as demand recovers. In general we focus more on POR data but PAR data can be telling in a non-normalized operating environment.

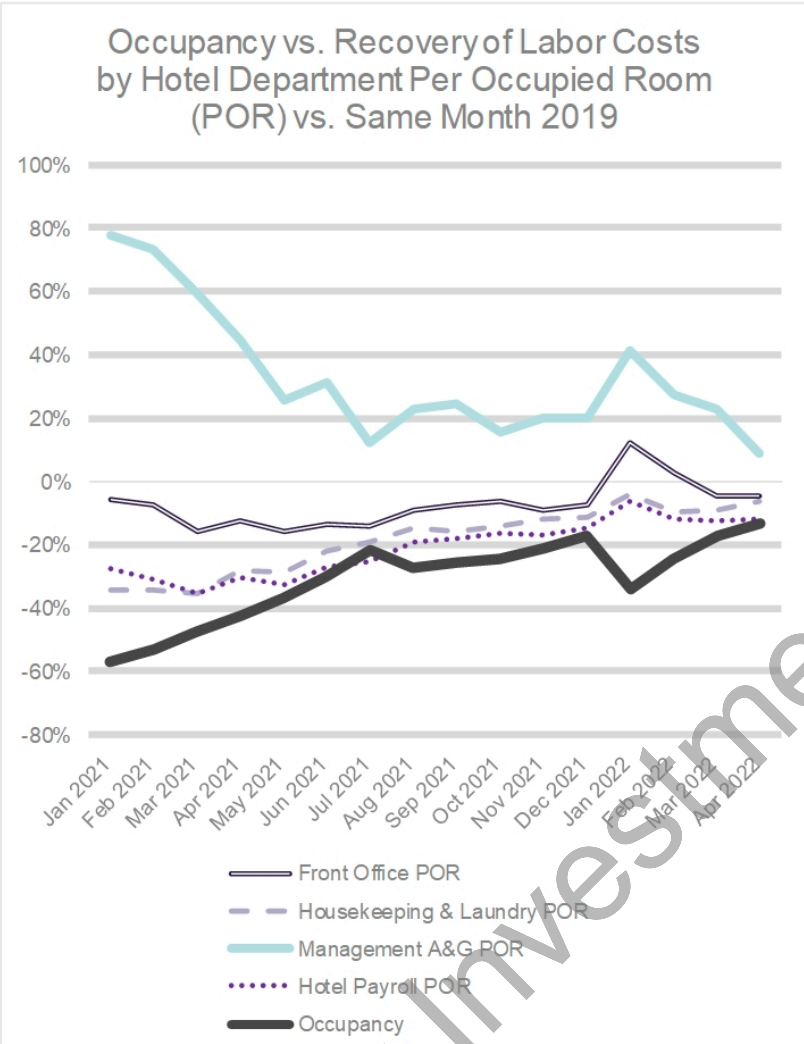
Labor costs PAR: In the below exhibit, we can see that on a PAR basis that the spread between the recovery of occupancy to 2019 and the hourly operating departments is narrowing, especially in front office and housekeeping/laundry roles. F&B is lagging but the spread is narrowing as well. Conversely, managerial costs are continuing to increase although generally at or modestly below 2019 levels. **While in normal times we might focus on PAR for "fixed" manager roles and POR for hourly roles, we may also be seeing incremental staffing costs ahead of the expectation of rising demand.**

- Given that robots cannot easily take over the responsibilities of cooking or serving food and drinks, it is interesting that F&B costs continue to lag. We could interpret the slower recovery of group demand and restaurant/lounge usage as a factor.



Source: Truist Securities Research, HotStats

Labor costs POR: While it is no surprise to see managerial costs POR trend down due to higher occupancy, it is notable that the hourly departmental costs remain above the recovery of demand and that trend has held even as fewer employees need to be hired given hotels are increasingly moving to near-normal occupancy. The POR trends may partly reflect the mid-single-digit to over 20% wage increases y/y we are seeing across the country.



Source: Truist Securities Research, HotStats

<u>Based on the above analysis and trends, we present below how we see profit recovery across the U.S. lodging industry:</u>

- **Types of hotels most likely showing absolute profits ahead of 2019:** Leisure markets (especially Southern and Sunbelt), resorts, lower-priced extended-stay, and some select-service, especially in smaller secondary/tertiary markets.
- **Next in margin recovery to 2019 levels:** Urban Southern/Sunbelt corporate markets, both full- and select-service, that are benefiting from shifts of business locations to lower labor cost markets. Additionally, we include operationally more flexible and smaller key count hotels in urban locations that can draw both leisure and corporate travelers (for example some of the DRH/PEB hotels).
- **Still slower to recover:** Large corporate-focused hotels (room counts >500) with significant meeting space/greater dependency on convention citywides and gateway markets such as the West Coast and NYC that traditionally have material international inbound demand from China.

Non-union markets are seeing relatively faster wage growth than many union markets -- for now. We are seeing double-digit wage growth y/y in many non-union markets versus the pre-pandemic negotiated low- to mid-single digit growth in some union hotels. Given rising cost-of-living and staffing shortages, we expect some wage and benefit readjustments as union contracts expire. **Union renegotiations will most likely be an eventual profit headwind to many of the full-service REITS and to a lesser extent the C-corps and select-service REITS. We view said headwinds will be more evident in 2024+.**

HLT: Valuation and Risks

We apply a blended multiple of 17.0x (11.5x for Owned/leased and 17.0x for Managed/franchised) to our 2023 adjusted EBITDA estimate to derive a price target of $151. This multiple is above the high end of the historical range of 10x-16x.

Risks to our rating and price target:
Upside risks include: Higher than expected pipeline growth, material RevPAR growth (macroeconomic improvement beyond expectations), material market share gains.
Downside risks include: Growth trajectory could disappoint. Pipeline growth could either slow down or projects scheduled for construction could be cancelled, which would diminish system growth for the firm and disappoint investors.

H: Valuation and Risks

Our price target of $121 for H is derived by applying a 14.0x target EV/EBITDA multiple (a blended average of the industry multiples for each business segment) to our estimate for 2024 EBITDA. Our valuation model for Hyatt assumes an owned-hotel 2024 EBITDA multiple of 12.5x and a franchise/management fee EBITDA multiple of 16.0x plus a 10% discount for time of money.

Downside risk: lodging recovery takes longer than expected. Planned dispositions take longer than expected. Material labor issues to owned hotels. Regional risks to the Caribbean including material new competitive supply growth. H pipeline growth slower than expected. Apple Leisure Group underperforms Hyatt's guidance.

MAR: Valuation and Risks

Our $182 price target is based on a 16.8x blended multiple on our 2023E EBITDA. In the parts, we assign a 13.0x multiple of EBITDA to the Owned segment and 17.0x fees EBITDA (the fees EBITDA also includes credit card branding fees, a 10x multiple business) to the managed/franchised business. The multiple is towards the higher end of the historical range of 9-18x.

Risks to our rating and price target:

Upside Risks: Significant U.S macroeconomic improvement results in large recovery in transient corporate and group/convention demand. Owned assets sell for premium prices relative to MAR expectations. Supply growth is stronger than expectations. Consolidation in the lodging industry benefits MAR.

Downside Risks: Deep macroeconomic recession. Geopolitical, inflation, and policy risks negatively impact lodging demand. Inability to grow pipeline in line with Street expectations.

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.

PLYA: Valuation and Risks

Our $11 price target is based on a 10.5x multiple on our 2023E EBITDA estimate. This represents a ~2.0x turn discount to our full-service oriented Lodging C-corp coverage.

Downside risks: Various market and country-specific demand shocks, hurricanes, sargassum seaweed detracting from guest stays, material supply growth, insufficient airlift, low transaction pricing on comparable resorts, inability to complete growth initiatives, and country-specific risks such as crime (emerging market portfolio).

Companies Mentioned in This Note

DiamondRock Hospitality Company (DRH, $10.78, Hold, C. Patrick Scholes)
Hyatt Hotels Corporation (H, $90.92, Buy, C. Patrick Scholes)
Hilton Worldwide Holdings Inc. (HLT, $142.29, Hold, C. Patrick Scholes)
Host Hotels & Resorts, Inc. (HST, $20.69, Hold, C. Patrick Scholes)
Marriott International, Inc. (MAR, $174.42, Hold, C. Patrick Scholes)
Pebblebrook Hotel Trust (PEB, $23.37, Hold, Gregory Miller)
Park Hotels & Resorts Inc. (PK, $18.77, Buy, C. Patrick Scholes)
Playa Hotels & Resorts N.V. (PLYA, $9.23, Buy, C. Patrick Scholes)
Ryman Hospitality Properties, Inc. (RHP, $95.40, Hold, C. Patrick Scholes)
RLJ Lodging Trust (RLJ, $13.97, Buy, Gregory Miller)
Sunstone Hotel Investors, Inc. (SHO, $12.35, Hold, C. Patrick Scholes)

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I, C. Patrick Scholes , hereby certify that the views expressed in this research report accurately reflect my personal views about the subject company(ies) and its (their) securities. I also certify that I have not been, am not, and will not be receiving direct or indirect compensation in exchange for expressing the specific recommendation(s) in this report.

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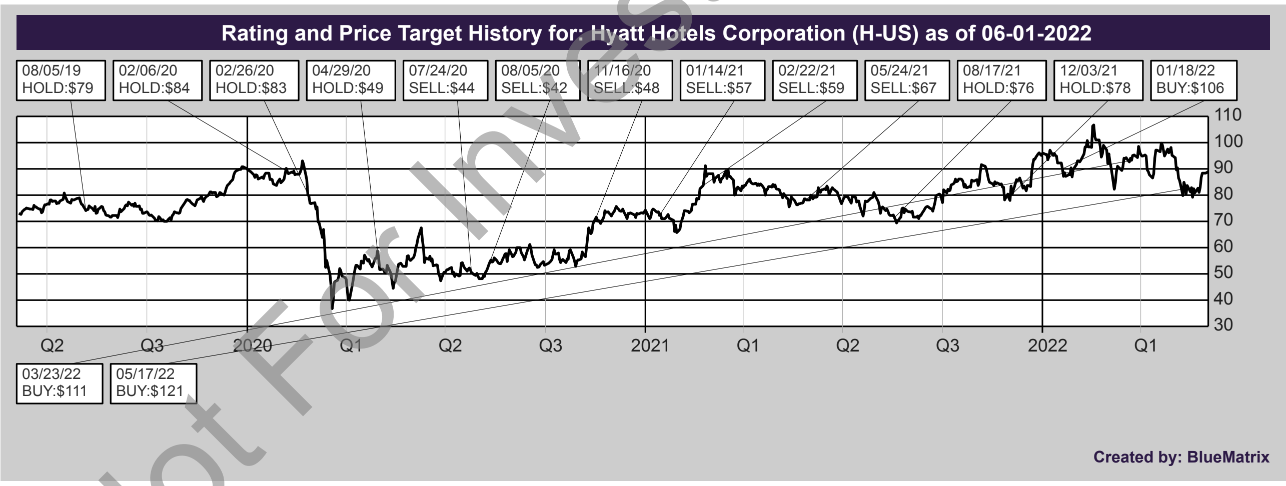

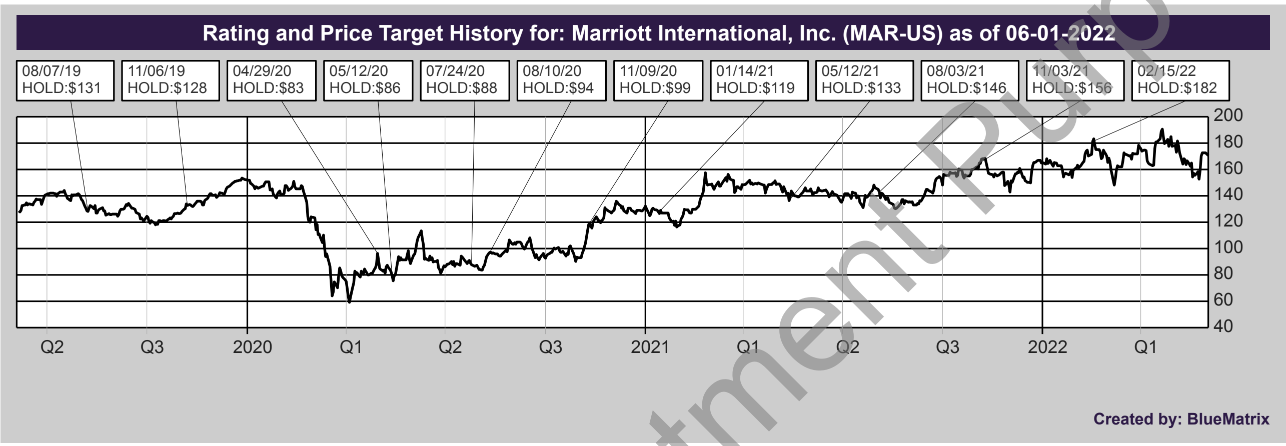

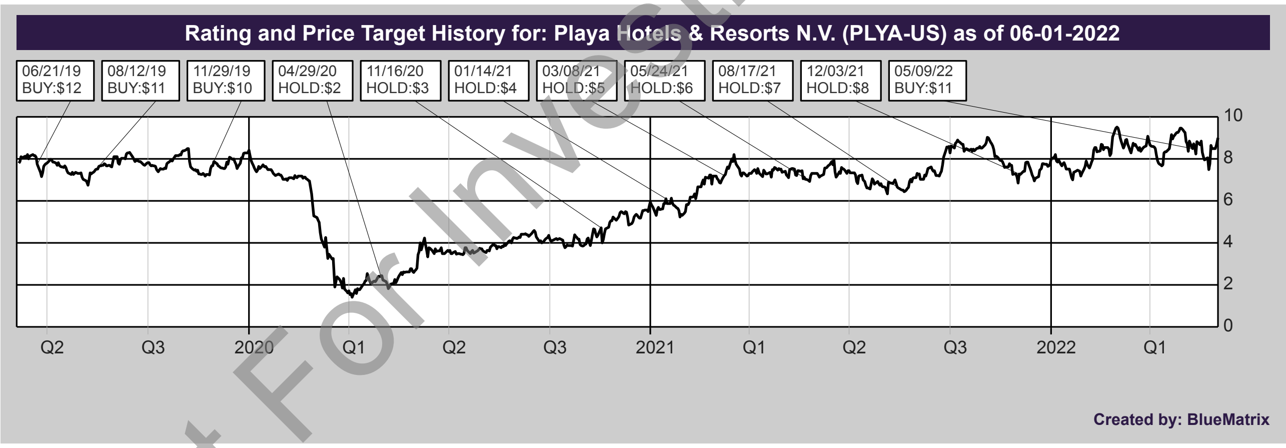

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Sell	1	0.13%	Sell	0	0.00%

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