February's Hotel P&L Analyzer -- How profitable were hotels in February?

Because headline RevPAR doesn't tell the whole story

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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

February: 120 bps of GOP margin growth on approximately +3.6% Total RevPAR. This follows January, which had 0 bps of growth on approximately +2.8% Total RevPAR and YE 2018 GOP margins of +20 bps on Total RevPAR of +3.3%. **For 2019, we continue to see margins at flat to -75 bps.** *Additionally in this note we discuss the positive impact of ancillary revenues to profits and our view that the sustainability of these fees may be challenged in a down lodging cycle.*

As a reminder, this monthly analysis of P&L metrics (data source: HotStats) covers nearly a thousand high-rated full service hotels in the U.S. (Luxury and Upper Upscale hotels, both privately and publicly owned). Our latest takeaways post-February results are presented below:

February margins were modestly up (+120 bps) given +4.4% ADR growth. Compared to a low occupancy month like January, February occupancy was 76.0% (occupancy was -40 bps y/y). More than 100% of the 3.9% Rooms RevPAR growth was generated from rate growth. **The delta to the 120 bps of profit growth was in our view largely from the continued headwinds from labor costs, which hoteliers both public and private indicate is growing at +3-4% y/y (assume the high end of the range for union markets).** Contributing to the modestly positive results is the strong profitability generated from incremental room rates and cost efficiencies by hotel operators.

- **We believe that in order for EBITDA margins to remain flat, Rooms RevPAR must rise ~ +2.5-3.5% for many full-service hotels.** (Our high-level math on this 2019 range remains: take the 2018 RevPAR range and add about 50 bps. And for 2020, we anticipate needing another 50 bps. We do not foresee dramatic wage increases in 2019/2020, just steady labor cost growth y/y. And to be clear, we do not expect most REITs will see +3% RevPAR growth in 2020.)
    - One disclaimer: each REIT has different dynamics particularly given market-specific considerations, renovations/portfolio changes, etc.

Updates to our 2019 margin forecast: We have not adjusted our margin growth forecast and we are maintaining our estimate of margins being generally flat to -75 bps in 2019. We do not see the relatively strong RevPAR growth in February being representative of much of the rest of the year. We assume low single-digit RevPAR growth for this HotStats data set, although we have a somewhat more positive bias

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on this data set for 2019 than our macro RevPAR projections in our RevPAR Monitor given that this 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.

- As we have previously noted, Upper Upscale urban hotels in markets with challenged 2019 citywides (Boston, Chicago, and Washington, D.C. for example) are likely to underperform in aggregate while stronger 2019 citywide markets of San Francisco and Las Vegas amongst others are likely to see better results. **A number of hoteliers have anticipated weaker citywides and focused on in-house group demand and transient to replace the lost business.**
- **The Lodging REITS in our coverage appear to continue to be able to hold some expenses at more modest increases than we anticipated. We believe this bodes well for U.S. full-service hotels generally speaking.** Our forecasted weighted average Adjusted EBITDA margin y/y change in 2019 for the Lodging REITS in our coverage is -15 bps in 2019. We believe the REITS have guided somewhat conservatively and anticipate this weighted average will go up in 1Q.

As we discussed briefly last month, we believe that an EBITDA loss "mitigator" is stronger growth from "Other Revenues". Due to the contribution to profitability, we expand upon this topic in this note. We believe this topic is of merit given that in our review of the HotStats data, the Rooms RevPAR as a percentage of Total RevPAR has fallen 60 bps over the last year, indicating to us a rise in food and beverage and in particular "Other Revenues". We believe the "Other Revenues" figure has grown given our review of REIT P&Ls and through discussions with private hotel owners. This line-item tends to be highly profitable and we believe is contributing to why EBITDA margins are staying flattish despite significant labor cost growth.

- **We believe hoteliers have been increasingly aggressive about pushing daily room fees where possible. Some of these charges seem to have come as a replacement for a rise in room rates;** we find that some guests when booking a hotel (or vs. shared accommodations) tend to focus on the room rate at the deficit of determining a proper value for the total amenities/services provided in one's stay. As such, we believe daily fees have grown as a way for hoteliers to keep room rates competitive while charging guests for services that might at one point either been part of the room rate expense or were charged a la carte.
- **We believe that guest acceptance of the fees differ.** Individual business travelers (or those with negotiated rates with their corporation) are less likely to accept the fees as an add-on cost. Groups are also likely to have a negotiated rate which may or may not include the daily fee. Leisure guests may be most likely to balk at the expense given the incremental cost (for a $400 room, a $40 daily fee is still +10%), but these guests may also be more likely to use what is in a daily fee.
- In terms of determining the fee charge and profitability therein, we believe there can be variance on approach. We have heard that some hoteliers (particularly major franchisors) require the value of the services must be 2x or greater the daily fee charge; however, we do not believe that is being consistently applied across the industry. In terms of profitability, we believe the fees are generally high margin although variable.

In our view these fees are split by type of hotel:

- **Resort fees:** For truly leisure properties, daily resort fees have been commonplace for years. Generally because resort guests tend to stay "on property" more than a transient corporate/individual business traveler, we sense there is greater rationale for hoteliers to package in resort fees. These fees often include bicycles, access to water equipment, local transportation, valet parking, etc.
- **Urban destination/amenity/facility fees:** We have noted that some hotels located in cities have also incorporated daily fees. The value proposition for these fees is in our view far more mixed. We have noticed in our travels that some hotels apply very borderline amenities to justify the fees -- such as a free newspaper in the lobby and access to a gym and pool. For business travelers, some of these services will never be used; these same travelers are more likely than not to be familiar that these fees were once part of the room rate.
  - Therein lies one of the issues with the ancillary room charges. **We believe there is inconsistency among hoteliers about what should be part of the daily rate and what should not. Some hoteliers sell this package more effectively than others. Some hoteliers in our view do a very poor job justifying these fees.**

Our views on these fees in a down lodging market - resort fees more likely to stay; urban fees may not. We expect hotel guests will be more likely to protest fees when occupancy rates are lower and the consumer power rises vs. the hotels. This viewpoint is supported by the various hotel industry executives (public/private) we have spoken to on this topic, although no one has been able to say definitively how hotels will be able to make up margins if these fees start to diminish. Still, we encourage REIT investors to stay abreast of the trends in ancillary fees as both a positive and negative impact to margins. **We have a negative bias on margin impact due to the potential reduction/elimination of some daily lodging fees in the event of a lodging downturn.**

Monthly Profitability Metrics

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.

December profitability: Modest RevPAR growth resulted in a slight decrease in y/y margin.

- **4Q:** Operating Department margins were ~ -15 bps in 4Q and GOP margins were ~ -50 bps.

Industry Metric	Dec 2018 y/y	YTD		Dec 2018	YTD	FY2018	2018 y/y	FY2017
Occupancy	-50	30	bps	66.9%	77.7%	77.7%	30 bps	77.4%
ADR	3.1%	2.5%	%	$219	$225	$225	2.5%	$220
RevPAR	2.4%	2.8%	%	$147	$175	$175	2.8%	$170
Total Revenue PAR	3.1%	3.3%	%	$257	$289	$289	3.3%	$280
Total Dept. Profit % Total Rev.	40	10	bps	56.7%	60.0%	60.0%	10 bps	59.9%
Total Hotel Labor Costs % Total Rev.	110	20	bps	38.3%	35.5%	35.5%	20 bps	35.3%
Total GOP PAR	1.9%	4.1%	%	$82	$108	$108	4.1%	$104
Total GOP % of Total Rev.	-40	20	bps	32.0%	37.4%	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.

November profitability: Flattish RevPAR growth resulted in y/y margin loss.

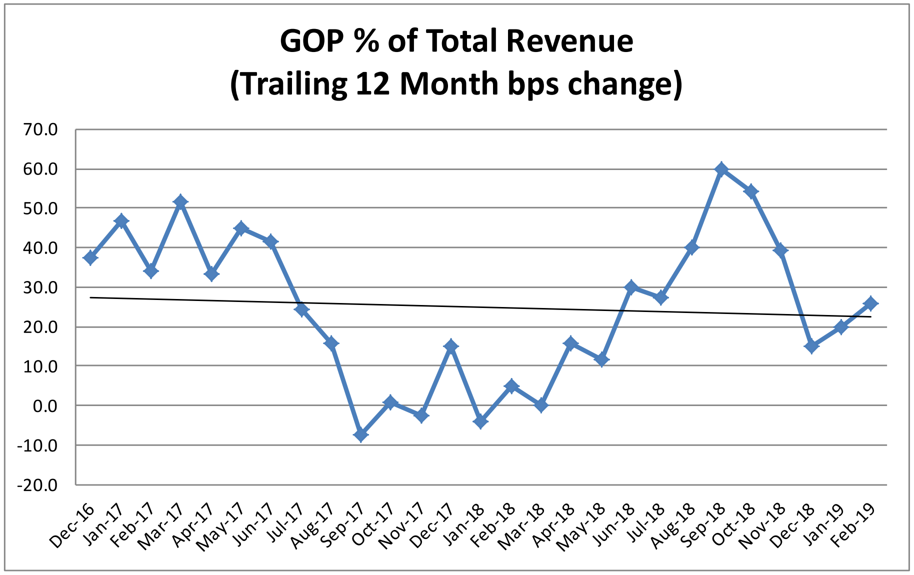
Industry Metric	Nov 2018 y/y	YTD		Nov 2018	YTD	FY2017	2017 y/y
Occupancy	-120	20	bps	74.2%	78.6%	77.2%	50 bps
ADR	1.6%	2.2%	%	$221	$225	$219	1.1%
RevPAR	0.1%	2.5%	%	$164	$177	$169	1.9%
Total Revenue PAR	0.3%	3.1%	%	$279	$292	$278	2.5%
Total Dept. Profit % Total Rev.	-90	10	bps	57.2%	60.0%	59.6%	-10 bps
Total Hotel Labor Costs % Total Rev.	120	10	bps	37.4%	35.4%	35.5%	180 bps
Total GOP PAR	-3.9%	3.8%	%	$95	$110	$103	3.0%
Total GOP % of Total Rev.	-150	20	bps	33.9%	37.8%	37.0%	10 bps

Source: STRH Research, HotStats
All dollar figures are in USD.

October profitability: Moderate RevPAR growth contributed to a slight increase in margin.

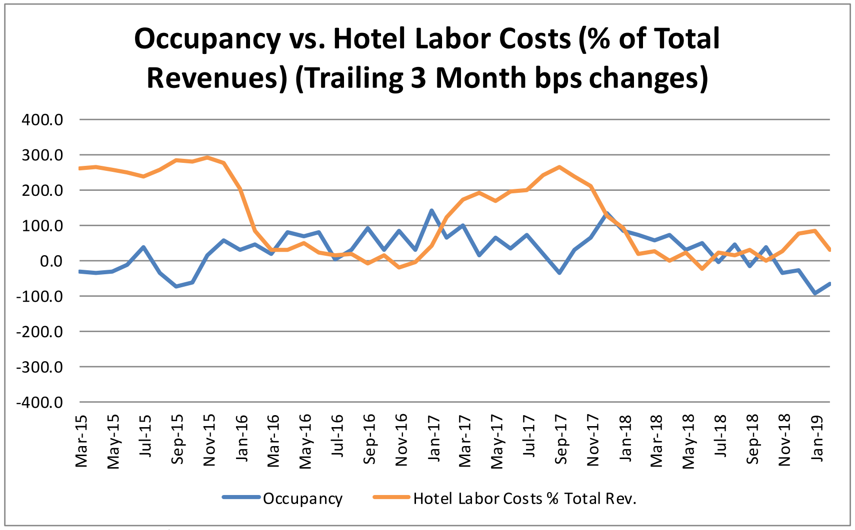
Industry Metric	Oct 2018 y/y	YTD		Oct 2018	YTD	FY2017	2017 y/y
Occupancy	90	30	bps	82.0%	79.0%	77.2%	50 bps
ADR	2.9%	2.2%	%	$241	$226	$219	1.1%
RevPAR	3.9%	2.7%	%	$198	$178	$169	1.9%
Total Revenue PAR	4.1%	3.4%	%	$329	$293	$278	2.5%
Total Dept. Profit % Total Rev.	40	10	bps	63.0%	60.2%	59.6%	-10 bps
Total Hotel Labor Costs % Total Rev.	0	0	bps	32.2%	35.2%	35.5%	180 bps
Total GOP PAR	4.7%	4.5%	%	$140	$112	$103	3.0%
Total GOP % of Total Rev.	20	40	bps	42.5%	38.2%	37.0%	10 bps

Source: STRH Research, HotStats
All dollar figures are in USD.

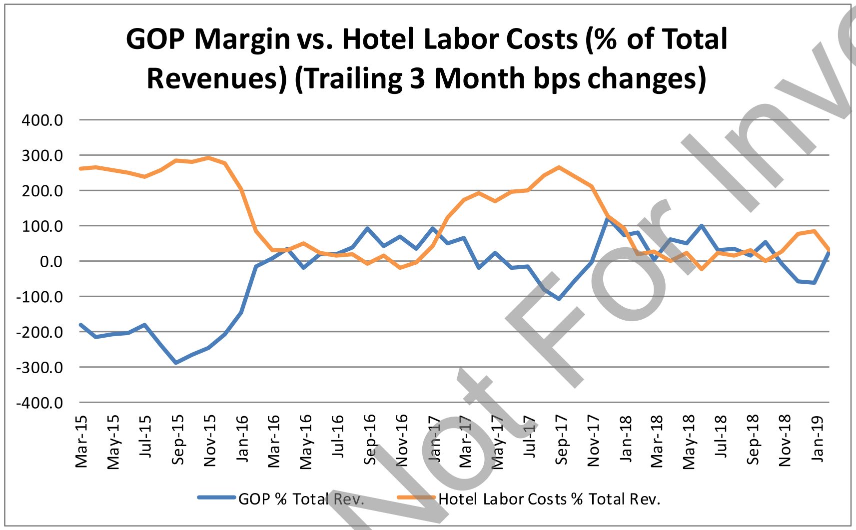


Source: STRH Research, HotStats

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



Source: STRH Research, HotStats



Source: STRH Research, HotStats

How we view property-level margins in 1Q19: Over the past few years, in a low RevPAR growth environment, hotel labor costs have had a highly significant influence on EBITDA margins. The correlation between labor costs as a percentage of hotel revenue and GOP as a percentage of total revenue is approximately -80%. **Thus, the ability for hotel owners and managers to keep labor cost increases as low as possible will be critical in 2019.**

- **Consideration for 1Q19 earnings:** Among our REIT coverage, our aggregated Adjusted EBITDA Margin estimate (weighted average by market cap.) is +25-75 bps y/y growth for 1Q19 (ex-San Francisco hotels it would be closer to 0 to -100 bps with particular weakness in markets with a difficult Hurricane Harvey/Irma comparable).
- **San Francisco is likely to have one of if not the strongest quarters of the year in 1Q and we believe the rate-influenced RevPAR growth will flow measurably to margins.** The combination of strong citywide groups and some high-rated conferences should be a strong tailwind for hotel margins in San Francisco. This growth comes in part at the expense of citywide demand in some other markets as discussed above.
- 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 in 1Q19.**

As a reminder, one piece of good news for hotel owners is that lower margins can result in a slowdown of new hotel development (HotelNewsNow), at least for full-service hotels. However, we note that the highest-rated hotels often take the longest to go through the approval and development process, therefore we believe any warning signs on margins will likely play a factor for hoteliers that are very early in the development process and not necessarily for hotels that are well into the planning stages (thus, hotels that are scheduled to open in 2019 are still likely to open).

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