June Hotel P&L Analyzer: May down 12,570 bps y/y on -92.9% Total RevPAR

Op. ex & other costs materially reduced in May but hotels still deep in the red

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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

Based on "big data" observations from higher-rated U.S. hotels (data source: HotStats): May: -12,570 bps of GOP margin growth on -92.9% Total RevPAR (Rooms RevPAR + outside-of-the-room spend). By comparison, April was down 22,290 bps y/y on -95.0%.Total RevPAR May results were materially better than April (as expected) given tremendous cost-cutting measures were enacted and many hotels closed.

Forecasting 2Q20 EBITDA (and pretty much any future period) for the REITS remains challenging. We estimate y/y EBITDA margins for Upper Upscale/Luxury hotels that remained open throughout 2Q to be -8,000 to -12,500 bps. As a measure of relativity, historically our estimated ranges have been approx. 100bps. **REIT margins may actually be worse given closed hotels and corp G&A costs.** By comparison our ests for 2Q20 for the most part are at the lower-end or below this range as we attempt to factor-in the impact of closed hotels.

May hotel margins were extremely negative, as expected given very low hotel occupancy in full-service hotels. Margin results presented below do not factor in hotels that remain closed, a further headwind for many Lodging REITS, private hotel owners, and the collection of incentive management fees for some of the Lodging C-corps (especially MAR, H, and HLT). Nevertheless, we **view the HotStats' results from May as our starting place for margin analysis post-COVID-19. Every month of data going forward has great relevance both from the sheer performance stats (an intraquarter tracking of margins) and the trajectory of improvement in hotel performance to sustainable break-even and EBITDA stabilization (which we discuss at the end of this note).** Just as hoteliers had to fight for margin improvement before the downturn (when hotels were running near-record profitability albeit with flattish RevPAR and fast-rising labor costs), hoteliers now have to fight for "lower margin loss" under low occupancy and bare-bones operations.

Why is May far more relevant vs. April or prior months?

1. Margins were vastly "less bad" in May. Through conversations with HotStats following our review of their data, we assume significant cost-cutting measures were enacted both at the operating expense level (most of the hourly staff) and with undistributed expenses (sales and marketing, maintenance, etc.). **We do not expect pre-COVID-19 labor and operating models will come back for years and possibly not ever, even when hotels return to normal occupancy levels. As such, hotel P&L analysis may have been permanently reset.**

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2. **Post-pandemic costs are starting to be reflected in the data.** Cleaning costs and some utility costs (water for laundry) may be rising, as HotStats noted to us. While we view the math of additional cleaning costs to remain in flux as hoteliers determine best practices -- and we expect material variability by property and property type -- RLJ (RLJ, Sell, Miller) discussed a neutral effect on an industry webinar last week (deeper cleaning in lobby and rooms between stays but with foregone daily housekeeping during some stays) (Walker & Dunlop). We await what Pebblebrook (PEB, Hold, Miller) may discuss on this week's update call but PEB's team recently noted some guests still desiring daily housekeeping (we would argue daily housekeeping may be more desired at resorts and for some family leisure trips vs. the corporate traveler) (Pebblebrook). Further, **we await what could be an industry-wide implementation of daily housekeeping charges** that could offset additional cleaning costs.
3. **Net-net we view the May stats as a better starting place/baseline vs. April when hotels were in the process of shutting down** (and perhaps more accurately, hoteliers were figuring out how to either shut down hotels or stay open with spartan operations).
4. A trajectory to **sustainable "break-even"** margins (we discuss further below)

Diving into the May results: for now we compare "open hotels" for both April and May. Margins for closed hotels adds a headwind to owners that are property- and owner-specific. Further, due to the closure of some hotels in the U.S. (primarily highest-priced and urban hotels), we continue to evaluate HotStats' macro data set instead of our prior custom data set.

Key Statistics From HotStats Data (Month/Month and Year/Year Variance)

	May-20	Apr-20	Variance vs. April 2020	May-19	Y/Y Variance	Apr-19	Y/Y Variance
Occupancy	11.3%	7.6%	370 bps	79.9%	-6,860 bps	81.1%	-7,350 bps
ADR	$122	$116	5.0%	$222	-45.0%	$227	-48.8%
Rooms RevPAR	$14	$9	56.2%	$178	-92.2%	$185	-95.2%
Total RevPAR	$20	$14	40.3%	$284	-92.9%	$289	-95.0%
Departmental Profit % Total Revenue	19.0%	-34.6%	5,360 bps	60.6%	-4,160 bps	62.1%	-9,670 bps
GOP % of Total Revenue	-87.3%	-183.0%	9,570 bps	38.4%	-12,570 bps	39.9%	-22,290 bps

Source: STRH Research, HotStats

- **The good news is that departmental profit was positive in May 2020. However, digging deeper, department profit was positive off of very low revenues suggesting very low/trimmed hourly staffing.** Given that departmental profit reflects guest-facing revenue generation, our interpretation is low revenues were matched with low hourly labor expenses -- and in some cases executive management serving guests (for example a general manager or director of sales whose salaries are reflected in undistributed expenses between departmental profit and gross operating profit/GOP).
- **While there was much positive progression in GOP margins in May vs. April, absolute margins are still decidedly negative. We do not expect much progress in REIT margins returning to profitability soon given that per STR, June occupancy for open U.S. Upper Upscale/Luxury hotels was 28.7% through 6/20. RevPAR was still down 73.8% y/y.** The HotStats data is somewhat different than the STR sample (our currently inactive HotStats custom set

correlates very well with STR Upper Upscale) but nevertheless we see a slow climb for REIT margins given the combination of closed hotels, highly limited individual business travel, and virtually no group demand.

- **HotStats noted that the pent-up leisure demand from Memorial Day may also be a factor in the material sequential gains in margins in May. We would expect this relative tailwind to continue into June.** What is less clear is the noisy impact from hotels reopening in late May and June (headwinds from new competition and inefficiencies upon reopening) and the potential re-closures/low leisure demand from states that may have initially benefited from early re-openings or more lax government standards on social distancing and mask wearing. We think of leisure markets/demand in much of the Sun Belt.

Modeling 2Q20 / Our Best Take On 2Q EBITDA Margins:

One of the common questions we receive on the Lodging REITS relates to forecasting EBITDA margins for the rest of 2020. We find the best answers come from hoteliers that "tell it like it is" (both public and private execs) who suggest month-to-month forecasting is the only reasonable approach at this point. Without any base of group demand or corporate travel and with leisure bookings both last-minute and easily cancellable, **we use the May HotStats results as a proxy for how June margins may unfold and note that all forecasting beyond one month out is highly speculative and subject to material revision.**

- **For that reason, and with most of 2Q RevPAR "in the books", we currently forecast 2Q20 y/y EBITDA margins for hotels open throughout 2Q20 to be -8,000 to -12,500 bps.** Our math is driven by stronger occupancy and lower cost pressures in June providing an overweight vs. April and May. We estimate Upper Upscale/Luxury hotels open through 2Q20 will run approximately 30% occupancy in June with no major improvement on room rates except perhaps around the Independence Day holiday period (similar to Memorial Day, we would not be surprised to see extended leisure trips given many affluent travelers who may stay at Upper Upscale/Luxury properties for vacations are still working from home and have more remote work flexibility). We estimate June y/y EBITDA margins for these hotels between -12,500 bps and -5,000 bps (admittedly a wide range but some leisure oriented hotels are running stronger occupancies and could create positive noise in the aggregated statistics).
- **We expect REIT margins to be generally worse than the above estimates due to the impact of closed hotels, corporate costs, etc. We are especially interested to see how many of the REIT management teams that have not cut corporate base salaries to this point will announce such decisions in 2Q earnings.**

Beyond 2Q20: Make your best guess! We'll figure it out day-by-day/week-by-week/month-by-month.

Not a single public lodging company that we are aware of is willing to make a strong case for 2H20 performance expectations. Ryman (RHP, Hold) is the closest exception given group bookings pushed into the back of the year -- but even for Ryman we would consider the wide resumption of large meetings in 2020 at best wishful thinking especially now with both Florida and Texas dealing with spikes in COVID-19 cases.

We would view a 0.75-1.50x differential between RevPAR and margin y/y growth/loss as reasonable at this point until we are convinced that labor costs have come down materially in a sustainable matter. We still assume that some furloughed on-property employees will eventually be let go permanently given no clear resumption in normal occupancy without a clearly effective vaccine. Layoffs are occurring at the corporate level in C-corps -- we see no reason why similar or more material costs will not happen at the hotel property level.

What is sustainable in operations today? We do not consider today's operations to be the case. General managers running the front desk and directors of sales taking care of housekeeping are not long term sustainable. These examples are real today. As such, we still consider margin movement to be volatile. We do not "believe" property-level managers are superhuman and eventually the extra hours and adjusted focus on essential operations vs. management responsibilities cannot sustain for many more months. However, we maintain "faith" in improving occupancy over the course of the year that will result in the rehire of some hourly staff as hotel executives lead their properties towards a new normal even albeit with a different rhythm than pre-COVID-19. We do not anticipate the hotel profit "blues" to change anytime soon.

Our take on sustainable "break even" margins:

We would caution investors that the term "break even" is thrown around a lot today by management teams, consultants, and other lodging industry personnel. Break even can be at the GOP level, EBITDA level, operating department level, etc. Property "break even" does not equate to corporate "break even". Some management teams add a profit level to their break even metrics (even if said profit level is not specified). Such varied definitions adds complication for buy- and sell-side modeling and communication.

We view the most appropriate definition of sustainable break even incorporates costs inclusive of debt service and taxes, the resumption of on-property management teams in their traditional roles, the return of group demand, corporate G&A more normalized, and REITS with the majority of hotels open. Until we get to this point, we do not think investors should be convinced that the all-important dividend will be normalized. While REIT stock prices may rebound before **sustainable** normalization, excluding the success of a vaccine we encourage investors to not put too much stock in management teams noting break even performance for specific hotels in the next few months. **In past lodging downturns, RevPAR and EBITDA recoveries have averaged 3-5 years, not 3-5 months. We encourage investors to not be swayed by one-off successes with select hotels in a portfolio. Profitability for the REITS has a long way to go.**

Companies Mentioned in This Note

Hyatt Hotels Corporation (H, $47.30, Hold, C. Patrick Scholes)
Hilton Worldwide Holdings Inc. (HLT, $71.16, Hold, C. Patrick Scholes)
Marriott International, Inc. (MAR, $80.94, Hold, C. Patrick Scholes)
Pebblebrook Hotel Trust (PEB, $12.93, Hold, Gregory Miller)
Ryman Hospitality Properties, Inc. (RHP, $31.81, Hold, C. Patrick Scholes)
RLJ Lodging Trust (RLJ, $8.79, Sell, Gregory Miller)

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