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Views on the Hotel Sector

HOTEL OVERVIEW

The economic landscape for hotel demand continues to display positive growth with solid fundamentals anchored by a continuation of the business and consumer based expansion that has been in place the past few years. Hotel demand has been sufficiently robust that supply is responding, albeit at relatively low levels (outside of a few markets) that is below the historic pace of deliveries. Occupancies and room rates have eclipsed previous peaks and occupancies are likely close to a new cyclical peak. However, positive pressures on room rates remain solidly in place keeping healthy pressure on RevPAR growth. As the cycle continues to mature, we anticipate RevPAR growth to fall more in line with the historic average growth rate of 3.5% over the next two to three years.

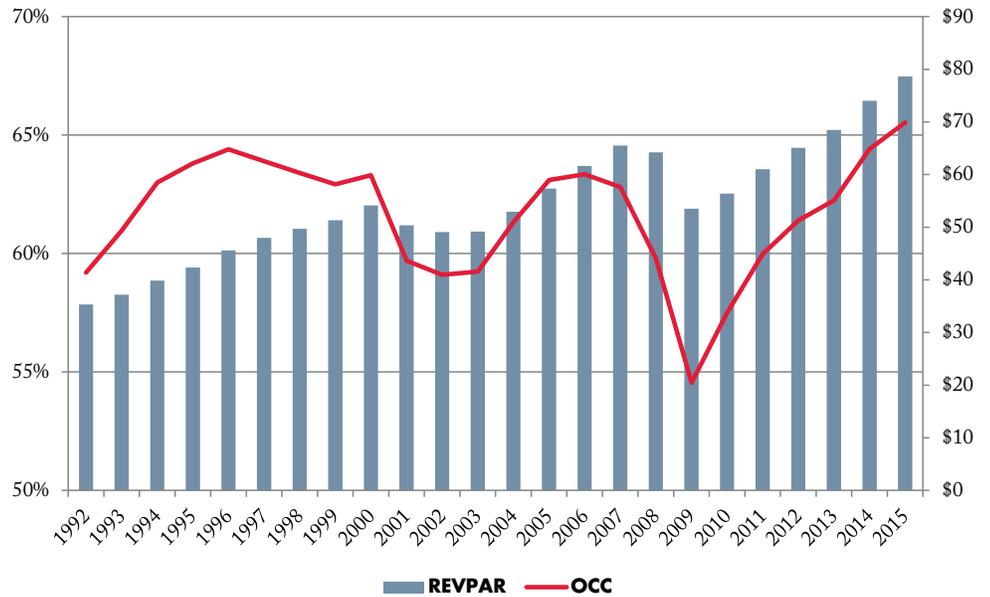
The capital markets appear to be taking a less favorable view towards hotels than the underlying fundamentals suggest. More specifically, the public market (REITs) and the debt markets are pricing hotels as if an economic recession is imminent over the near term versus pricing for a downshifting in RevPAR growth as the cycle matures. This is creating some angst among sellers that have more immediate needs to transact, presenting an opportunity for private equity capital seeking good quality assets in top hotel markets at more attractive prices.

FUNDAMENTALS

- Aggregate fundamentals are performing well but will likely decelerate from the very robust growth throughout the current recovery as the cycle matures and supply responds to solid demand growth. Nationwide 2015 was a record-breaking year in terms of occupancy (65.5%) and average daily rate (\$120.34) – on both a nominal and inflation adjusted basis. After (2.0%) and (16.7%) RevPAR drops in 2008 and 2009, respectively hotels have since averaged 6.6% annual growth (peaking at 8.3% in 2014) ending 2015 with a solid gain of 5.5%. Q1 was a slower start to 2016 versus 2015 given global growth concerns and currency market volatility that impacted the equity markets and consumer confidence. Still RevPAR was up 2.7% versus last year on strong room rate

growth of 3.2%. Occupancies are likely closer to a new cyclical peak than room rates as supply is responding more broadly to the strength in underlying demand.

U.S. Hotel Performance: Occupancy and Revenue Per Available Room

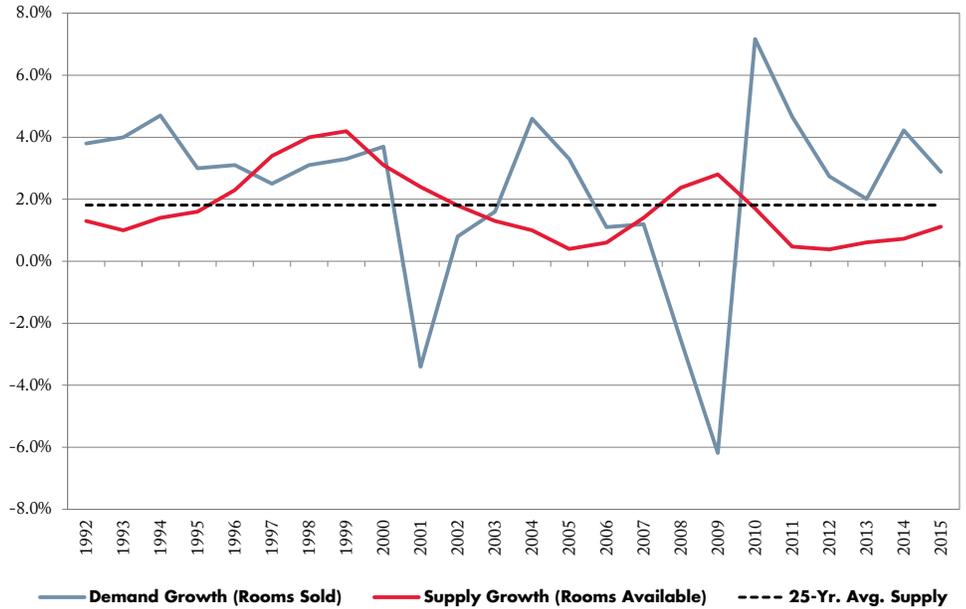


Source: Smith Travel Research

- Hotels have demonstrated the ability to recover fairly quickly from an economic downturn. Over the past two economic downturns including the tech wreck and the great recession, hotel RevPAR dipped between 10% and 22% but the peak-to-peak recovery in RevPAR (as shown above) was a relatively short four to five year cycle.
- To the extent economic conditions shift, the hotel sector appears better positioned to weather a downturn than the last cycle. The pipeline of supply has not ramped up to levels seen in the past and the expectation of a demand falloff appears less likely in the near term. To the extent room rates suffered a similar drop from its previous cyclical peak, room rates would fall to the levels achieved in 2013. Operationally, the ability to maintain rate is more impactful on profitability than occupancy and will help insulate the industry from the 35% - 50% NOI drop that was experienced during the Great Recession.
- Demand side fundamentals have been consistently strong with support from both the business and leisure traveler. Room demand was up 2.9% in 2015 nationally, not too dissimilar from the growth averaged over the past two years (2.0% in 2013 and 4.2% in 2015). Much like we have seen in the global trade markets, foreign demand for hotel rooms nationally is likely being affected by the currency, oil, equity market volatility and global dynamics that were more pronounced in the first quarter but have since stabilized. Aggregate first quarter room demand in Q1 2016 increased 1.0% over 2015 likely reflective of this environment.

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Room Supply and Demand Growth



- Aggregate hotel business on the books for 2016 is 4% ahead of this time last year suggesting solid room demand remains in place despite some headwinds from a stronger U.S. dollar and weaker corporate profits. Constraints on corporate profits are more concentrated overseas with better performance domestically adding support to the business traveler and U.S. based group business. Leisure travel continues to be supported by the healthy employment dynamics that support consumer confidence.
- Supply has been on the rise but remains well below historic averages and the aggregate pace of demand. New room deliveries expanded 1.6% in 2015 which remains below the 25-year average pace of 1.8% and 35% below Q1 '08 when supply growth peaked at 3%. Given the number of rooms currently under construction, we expect the pace of new deliveries will climb to roughly the long term historic average by the end of 2017.
- Across the larger markets (Top 50), the pace of room deliveries was marginally higher at 1.8% in 2015. However, there is a larger pipeline of rooms under construction in the larger markets totaling about 4.8% of existing inventory suggesting supply will move above the national average across the larger markets. More specifically, the bulk of construction is occurring in limited/select service space (66% of the current national pipeline) with a concentration of activity in the urban markets, most notably New York. Roughly one third of the U.S. hotel rooms under construction are concentrated in ten markets or half of the pipeline in the nation's top 50 markets. The overall impact from supply varies widely by market.

Hotel Room Construction by Market: Most Active Markets

Market	1Q16 Existing Hotels	1Q16 Existing Rooms	Rooms Under Const.*	UC* vs. Existing Inventory	Cumulative Share UC*: US	2015 Occupancy Rate
1 New York, NY	541	107,923	19,223	17.8%	11.0%	84.6%
2 Houston, TX	696	77,458	5,549	7.2%	14.2%	68.5%
3 Los Angeles, CA	929	97,906	5,498	5.6%	17.3%	79.7%
4 Dallas, TX	633	80,863	4,824	6.0%	20.1%	70.6%
5 Chicago, IL	731	112,831	4,474	4.0%	22.6%	69.9%
6 Miami, FL	365	51,905	4,326	8.3%	25.1%	78.1%
7 Austin, TX	282	34,103	4,226	12.4%	27.5%	73.8%
8 Washington, DC	688	110,240	4,103	3.7%	29.8%	70.7%
9 Seattle, WA	363	43,822	3,136	7.2%	31.6%	76.2%
10 Charlotte, NC	300	33,625	2,921	8.7%	33.3%	70.8%
Top 50**	18,403	2,340,807	111,380	4.8%	NA	72.4%
U.S. Total	54,484	5,105,604	174,996	3.4%	NA	65.6%

Source: Lodging Econometrics, Smith Travel Research, CBRE Hotels

* Room under construction to be delivered over next several years

** Occupancy is for Top 25

- Looking ahead, RevPAR is expected to expand between 3% and 5% over the two to three years with growth falling closer to the long-term average of 3.5% under a moderate economic growth scenario. Occupancy, having moved above its previous cyclical high is likely close to a cyclical peak given the pipeline but the volume of new potential product is not excessive. Room rates, also at new nominal peaks, continue to experience solid momentum on the back of a steady economic expansion.

CAPITAL MARKETS

- Overall, the hotel sector appears better positioned to ride through a potential softening in economics than what is being reflected in the capital markets, most notably the public REITs with lenders also taking a more cautious approach. Notable capital dislocations within the hospitality sector over the past several months have impacted pricing and liquidity despite healthy aggregate fundamentals. Hotel REIT prices began falling in the second half of 2015 and have continued to remain far below their 12 month highs caused by slowing projected RevPAR growth rates, select major market supply growth, and concerns about nearing the end of the current economic cycle.
- Both public and private REITs which had been the largest buyer group of hotels moved to the sidelines in the second half of 2015 becoming very selective if acquiring assets with most becoming more active sellers. Many public REITs have been using capital and sale proceeds to buy back stock while some are exploring opportunities to be acquired/merged with other companies.
- The other active participant in the capital market has been foreign buyer. Foreign buyers have been less abundant than they were a year ago, largely due to the strengthening dollar and, in some cases, due to stress within their home economies. This appears more pronounced economies where net wealth (both sovereign and private high-net worth) is more directly linked to energy; however Asian capital and select European countries are still transacting albeit on a more selective basis.

REIT Market Premium/Discounts

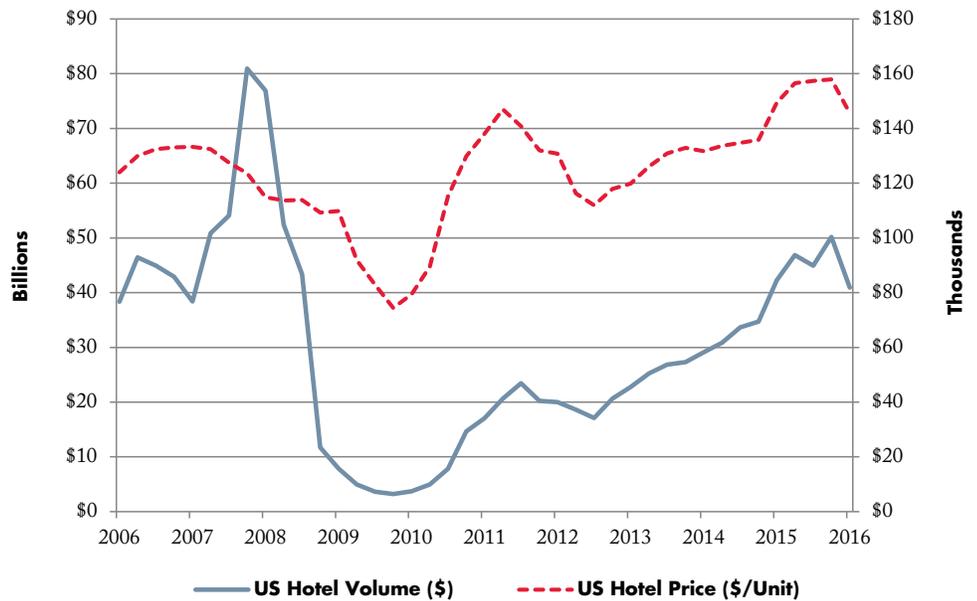
Sector	Total Return 2015 (%)	Dividend Yield (%)	Implied Value (\$) Per Unit-SF	Implied Cap Rate (%)	Prem/Disc to NAV (%)
Self Storage	39.7	2.8	352	4.1	32.0
Healthcare	(6.8)	5.7	N/A	6.2	10.9
Shp Ctr	5.1	3.5	289	5.6	0.9
Industrial/Mixed	2.1	3.8	90	5.9	(3.2)
Apartment	16.5	3.1	293	5.2	(4.4)
Office	(1.0)	2.9	597	5.5	(10.6)
CBD/Urban Office	(0.2)	2.5	695	5.1	(12.1)
Sub Office	(3.4)	3.9	218	7.0	(6.6)
Malls & Outlets	3.3	3.4	644	5.3	(13.5)
Lodg REIT	(22.8)	5.9	304	8.3	(24.1)
REIT Total/Wtd. Avg.	2.5	3.9		5.7	3.3

Source: Citi Research

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- With both REITs and select foreign buyers or more specifically the lowest-cost-of-capital hotel buyers (ie. highest price bidders) out of the market, private equity and non-traditional hotel buyers are now the most active investors. These buyers generally have higher required rates of returns and rely on leverage to achieve these returns. The hotel debt market, like the public REIT market, has become more cautious with the industry underwriting to slower growth and a nearing end of the current lodging cycle. CMBS lenders, historically the largest source of hotel debt, continue to come in and out of the market while life company underwriting standards have gotten much stricter. Banks and debt funds are currently the primary sources of hotel debt, and credit spreads have increased significantly while proceeds are generally lower. As a result, leveraged buyers need lower prices to achieve their return hurdles.
- The effects of this capital dislocation play out in numerous sales processes. A growing number of processes are failing and sellers are either pulling assets off the market or bringing them back out with lower pricing expectations. With hotel fundamentals still positive and at historic peaks (albeit with lower future growth expectations), this repricing is an opportunity to acquire high-quality assets in top markets at more attractive pricing than have been available in several years. The re-pricing and thinning liquidity affect is most apparent in several high-supply markets such as New York and Miami. At the same time foreign buyers have been less abundant than they were a year ago due to the strengthening dollar and in some cases due to stress in their home economies.

U.S. Hotel Transaction Volumes and Pricing



Source: Real Capital Analytics as of April 2016

Note: Q1 Estimates are preliminary

- There is currently significant inventory on the market but the key during this time of uncertainty is patience. There has been a notable widening in bid-ask spreads with sellers holding out for the potential return of either REITs or foreign capital given recent markets volatility. However, more recent signs of capitulation and some unwinding of expectations are occurring with deals re-emerging from an initial failed sales process.

SUMMARY

We see the economic landscape for hotel demand remaining positive over the next several years. This is anchored by our view of a continuation of the positive business and consumer based expansion that has been in place over the past few years. While not overly robust, the nation has maintained steady job growth of nearly 2.0% over the past several years. Hotel demand has been sufficiently robust that supply is responding, albeit at relatively low levels (outside of a few markets). That said the supply response does not appear to be excessive by current or historical standards. Occupancies and room rates have eclipsed previous peaks and occupancies are likely close to a new cyclical peak with new product under construction starting to deliver. However, positive pressures on room rates remain solidly in place keeping RevPAR growth well above historic averages. As the cycle continues to mature, we anticipate RevPAR growth to fall more in line with the historic average growth rate of 3.5% over the next two to three years. The hotel capital markets appear to be taking a less favorable view towards hotels than may be warranted given the underlying fundamentals. More specifically, public capital and the debt markets appear to be pricing hotels as if an economic recession is imminent near term versus pricing for a downshifting in RevPAR growth as the cycle matures. This is creating some angst among sellers with more immediate needs to transact and an opportunity for private capital like ours seeking good quality assets at attractive pricing.

Prepared by AEW Research, May 2016

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