Hospitality Trends 2015

Observations from the Annual EY Texas Hospitality Roundtable
About this report

- EY surveyed representatives from the hospitality sector in Texas, including real estate investment trusts (REITs), private-equity firms, institutional investors, developers, brand representatives and asset managers, and invited these individuals to a roundtable to discuss the survey results and industry trends.

- Our survey and discussions focused on investments, transactions, capital markets, development and brand trends affecting the Texas and broader US hotel markets.

- All respondent and participant names have been kept confidential, and their responses were used only in combination with others to protect anonymity.

EY would like to thank the individuals who took the time to complete the survey and who attended the 2015 Annual EY Texas Hospitality Roundtable.

For questions about this survey or the Annual EY Texas Hospitality Roundtable, please contact Katie Miller at katie.miller2@ey.com or Peter Brogan at peter.brogan@ey.com.
Acquisition pricing is nearing all-time highs as competition for assets grows

Hotels are trading for per-room prices at, and in certain cases in excess of, pre-recession levels – especially in gateway cities such as New York, Los Angeles and San Francisco. This demand has primarily been driven by an influx of foreign capital from sovereign wealth funds and institutional and private investors. The $1.95b, all-cash sale of the Waldorf Astoria Hotel to Beijing-based Anbang Insurance Co Ltd. and the $343m sale of The New York EDITION to the Abu Dhabi Investment Authority are two of the foremost examples of this shift.

Additionally, market participants not formerly active in the hotel space are turning to this asset class as they look to diversify their portfolios. This reflects the overall market demand for lodging investment opportunities and demonstrates how increased demand is driving up asset pricing.

Rising prices are indicative of general investor confidence that the current lodging cycle has multiple years to run before reaching its peak. However, when asked where we stand in the cycle, our survey respondents did not indicate this same level of certainty. As shown in Exhibit 1, the majority of respondents felt that we were either within one year of the peak of the lodging cycle or already at the peak. Despite concerns that the peak is in sight, hotel development does not show signs of slowing down.

Exhibit 1
Where are we in the current lodging cycle?

<table>
<thead>
<tr>
<th>Years from Peak</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>One year from peak</td>
<td>23%</td>
<td>25%</td>
</tr>
<tr>
<td>Two years from peak</td>
<td>31%</td>
<td>33%</td>
</tr>
<tr>
<td>Three years from peak</td>
<td>46%</td>
<td>42%</td>
</tr>
<tr>
<td>Four years from peak</td>
<td>46%</td>
<td>42%</td>
</tr>
</tbody>
</table>

Source: EY

“People have been saying we are one to two years from the peak of the lodging cycle for the past four years.”

Development has emerged as an attractive alternative to acquisitions

For investors seeking to expand their portfolios, asset price increases are leading to a shift toward development as an alternative to acquisitions. Additionally, the rising interest in development is leading to new participants as well as former participants entering the development space, including institutional investors.

The majority of survey respondents indicated they were pursuing development over any other strategy in 2015 and 2016. Development is appealing as it allows investors to circumvent competition for existing assets and high per-room prices, and further allows for the opportunity to enter underserved markets and sub-markets with the newest product – often leading to an increase in market share. While development may be less expensive in certain markets compared to acquisitions, attendees noted that construction costs are also on the rise – specifically in the form of labor and construction materials.

Exhibit 2

- Which of the following describes your investment strategy thus far in 2015?
- Which of the following do you anticipate your investment strategy to be in 2016?
Oncoming supply is a concern for market participants

Although many participants indicated plans to pursue development strategies in the near-term, the majority of survey respondents stated that they were also concerned about the effects of new supply on their current portfolios. When asked “which of the following describes your attitude toward oncoming hotel supply?” the majority of respondents indicated concerns that new supply would have a negative impact on both their portfolios’ performance and the performance of the total US lodging market (Exhibit 3).

Exhibit 3
Which of the following describes your attitude toward oncoming hotel supply?

- □ New supply will impact properties in my portfolio 38%
- □ New supply is a threat to the US lodging industry 31%
- □ New supply will not impact my portfolio 19%
- □ New supply is not a threat to the US lodging industry 12%

Source: EY

Financing is available, yet LTVs are below pre-recession highs

Lenders have not forgotten the lessons of the last economic downturn. With the past recession still on the minds of traditional lenders, coupled with new banking regulations that emerged as a result of the financial collapse, banks are lending with more conservative loan-to-value (LTV) ratios. Before the recession, hospitality transactions were often financed with LTVs of 80% or higher. However, when surveyed, all respondents described structuring recent deals with 60% to 70% debt and 30% to 40% equity.

Exhibit 4
For hotels acquired in the past 18 months, which most closely resembles the capital structure of the deal?

- □ 60% LTV 30%
- □ 65% LTV 20%
- □ 70% LTV 50%

Source: EY

Though LTVs appear below pre-recession levels, low interest rates have led to the availability of financing on competitive terms, with multiple banks often competing to provide the debt piece to an attractive deal.

Additionally, while LTVs are lower, there are some market participants who are seeking to finance their investments with additional debt. As a result, private equity is growing as a source of direct lending, specifically in the mezzanine and junior debt spaces.

“Development was a bad word for seven years; now we are back in the business.”
Millennials continue to be the driving force behind changes in the industry

The millennial traveler is on the mind of hoteliers. The largest hotel companies are racing to meet the expectations of this well-traveled, tech-savvy generation with the announcements of new lifestyle brands that incorporate local art, design and cuisine into hotels where the common spaces are the focal points and take precedence over the in-room amenities. New technologies are being rolled out in properties globally, including mobile check-in, using mobile devices to replace room keys and the ability to make requests of hotel staff through apps and texting services.

Millennial travelers are anticipated to “disrupt” the hospitality industry over the next decade more than any other group. When asked, nearly all survey respondents stated that millennial travelers have forced them to rethink their business model more than any other group (Exhibit 5).

Exhibit 5
Which of the following groups have made you rethink your existing business model?

- Millennials: 82%
- Baby Boomers: 9%
- Other: 9%

Source: EY

Although millennial travelers are top of mind for many in the industry, there is widespread skepticism about the number of new brands recently announced to cater to millennials and other groups. When surveyed, the majority of respondents indicated that they believe too many new brands are entering the market. As the majority of these new brands are select-service in nature, concerns about market share erosion amidst new brands with larger parent companies persist. Intensified competition within an increasingly competitive landscape remains top of mind.

Furthermore, not all market participants are planning to develop or reflag properties as new millennial-minded lifestyle brands in the near term. When asked about their plans to invest in new lifestyle brands, our survey respondents were fairly split (Exhibit 6).

Exhibit 6
How likely are you to develop or invest in new lifestyle brands in the coming year?

- Not likely at all: 17%
- Somewhat unlikely: 25%
- Unsure: 8%
- Somewhat likely: 8%
- Very likely: 42%

Source: EY

As new brands grow and gain traction in the market, these views may shift. However, until new concepts prove out as successful, wide adoption may be slower. Some market participants noted that new millennial-focused brands will need to compete for market share with locally focused independent hotels, for which many millennials have shown an affinity. Additionally, the sharing economy, e.g., apartment rentals, is also viewed as a threat to the success of new brands; when surveyed, 67% of respondents indicated that they viewed the sharing economy, which primarily caters to millennials, as a threat to their properties’ performance (Exhibit 7).

Exhibit 7
Do you view the sharing economy as a threat to your properties’ performance?

- Yes: 67%
- No: 25%
- Unsure: 8%

Source: EY
Operator performance and cost containment are top of mind

From an operational standpoint, labor costs remain a major concern for those in the industry. When asked to identify what is having the greatest impact on their bottom line, the majority of survey respondents selected labor costs (Exhibit 8).

Exhibit 8
Which of the following costs have the greatest impact on the bottom line?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Labor costs</th>
<th>Technology</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>77%</td>
<td>8%</td>
<td>15%</td>
<td></td>
</tr>
</tbody>
</table>

Source: EY

National trends toward a higher minimum wage (led by major gateway cities such as Los Angeles, Seattle and New York), increased benefit expenses stemming from the Affordable Care Act, and the recently announced push for a higher eligibility threshold for employees qualifying for overtime pay are all concerns for many hoteliers. As rising labor costs appear to be an inevitable and competition from new supply intensifies, owners are placing more scrutiny on their selected operators and their performance to maximize return on investment. When surveyed, a number of respondents indicated that they have either performed an operator review or considered a management company change in the past 12 months (Exhibit 9).

Exhibit 9
Which of the following strategies have you considered over the past 12 months?

<table>
<thead>
<tr>
<th>Percentage</th>
<th>Operator review/management company change</th>
<th>Alternative markets/sub-markets</th>
<th>New product classes/brands</th>
</tr>
</thead>
<tbody>
<tr>
<td>50%</td>
<td>28%</td>
<td>22%</td>
<td></td>
</tr>
</tbody>
</table>

Source: EY

Margin pressure due to rising labor costs is only one factor that will affect investors’ returns in the coming years. Rising interest rates, election-year uncertainty, global economic concerns and rising acquisition prices due to competition for assets remain top of mind for owners. Given the controllable nature of operating costs, management companies can expect to receive increased review and pressure from hotel owners moving forward.
Key considerations

- Competition for assets, especially in gateway cities, is driving acquisition prices to near-record levels.
- Many industry participants are turning to development as an alternative to acquisitions to enter new markets without overpaying for assets.
- Despite the shift to development-focused strategies, many still view oversupply as a threat to their own portfolios and the US lodging industry alike.
- While debt is cheap and readily available, loan-to-value ratios remain below the last cycle’s peak, and new participants are entering the lending space.
- While millennial travelers and their expectations are top of mind for many, new millennial-focused lifestyle lodging brands will face competition for market share from locally focused independent hotels and the sharing economy.
- National trends toward increasing labor costs are placing operators under increased scrutiny from owners.
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