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SPECIAL REPORT

U.S. HOTELS

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ABR

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EXECUTIVE SUMMARY

After the Great Financial Crisis of 2008 to 2009, the U.S. hotel industry experienced ten consecutive years of growth. According to the leading hospitality research firm STR, in 2019, this growth culminated with demand for rooms reaching a record 1.282 million room nights, an average daily rate of $131, and revenue per available room of $87. The average daily rate and revenue per available room figures were the highest ever benchmarked by STR and reflected the industry's strong recovery after the Great Financial Crisis.

At the beginning of 2020, industry projections were positive despite demand growth slowing in 2019, the potential for higher labor costs because of a tightening labor market, and increased competition from Airbnb and other home-rental companies. However, the industry's outlook changed suddenly in March when COVID-19 emerged. The COVID-19 global pandemic immediately disrupted the hotel industry and dramatically altered its landscape. This report assesses the state of the U.S. hotel industry by analyzing COVID-19's impact on industry fundamentals, the financial duress it has placed on hotel owners and operators, the potential for COVID-19 to cause lasting changes to hotel properties, and the industry's prospects for a timely recovery.

INTRODUCTION

According to STR, there are more than 54,000 hotel properties and 5 million guestrooms in the United States. STR categorizes hotels by "chain scale." Chain scales are based on the average room rates of the major chains and are divided into luxury, upper-upscale, upscale, upper-midscale (generally includes food & beverage options), midscale (generally excludes food & beverage options), economy, and independent segments. Independent hotels receive this classification regardless of their average room rate, food & beverage options, or other amenities they may offer. Independent hotels are privately owned and are not affiliated with other properties or a major hotel company, such as Marriott International or Hilton Worldwide Holdings.

In today's U.S. hotel industry, hotels are often owned by one entity and managed by a different entity. Many are managed by the management arm of a major hotel company, such as Marriott or Hilton, but the majority of U.S. hotels are franchised, whereby they are operated by an independent, third-party management company. To demonstrate, Company ABC may own a hotel building in New York, hire Management Company XYZ to manage it, and have a long-term franchise agreement with Marriott International that allows it to use one of Marriott's many brands, its reservation system and other services offered by Marriott. The major hotel companies own many different brands, or "flags", but rarely own the physical real estate associated with the hotel, such as the hotel building itself or the land that it sits on. Instead, leading hotel companies generally adhere to an "asset light" business model and generate revenue from managing and franchising hotels, instead of owning and leasing the property. For example, Marriott International is the largest hotel company in the world by room count with over 1.3 million rooms worldwide spread across roughly 7,300 properties and 30 brands in 134 countries and territories. However, according to Marriott's 2019 annual report, at the end of that year, across all of its hotels in the U.S. and abroad, it only owned or leased 1% of its rooms, while it had franchise agreements for 58% of them and management agreements for the remaining 41%. Similarly, Hilton, the second largest hotel company in the world with nearly 1 million rooms spread across 6,100 properties and 18 brands in 119 countries and territories as-of December 2019, also employs an asset light strategy and owns or leases just 2% of its rooms, manages 23%, and franchises the remaining 75%. The asset light model benefits both the hotel companies that license their brands to hotel owners and the hotel owners who pay a franchise fee to use the license.

Hotel owners, which can vary from individuals, to families, to investment firms, to institutions and other entities, want to maximize the value of their properties by gaining access to quality reservation and revenue management systems, popular loyalty programs, valuable marketing services, coveted purchasing networks, and a strong brand that they can use to differentiate and market their hotels. Access to a strong brand is especially important because studies have shown that most travelers prefer to stay in brand-affiliated hotels because they come with an expectation of quality. Hotel owners need help from the large hotel companies that own these brands, systems, and other tools to maximize the value of their properties. At the same time, the hotel companies that own popular brands and information systems need help from hotel owners to generate fee revenue, expand their footprint, and grow their loyalty programs without absorbing the risk or expense of owning the actual hotel.

Both parties are able to accomplish their goals with a franchise agreement. Under a franchise agreement, the hotel owner/franchisee pays the hotel company/franchisor a fee to use its brand, reservation systems, revenue management systems, loyalty programs, purchasing networks and other services for a prescribed period. The hotel company/franchisor specifies the products, services, standards, employment rules, and policies and procedures that the franchisee must use to remain in compliance with their agreement. With the industry median for franchise fees approaching 12%, hotels generate significant revenues from franchise agreements. For example, according to Marriott's 2019 annual report, it earned over $2 billion from franchise fees that year, accounting for 52% of its gross fee revenues and 37% of its total net revenues. Hilton's 2019 annual report reveals that it earned $1.68 billion from franchise fees in 2019, accounting for 75% of its gross fee revenues and 46% of its total net revenues.

TYPES OF HOTELS

In addition to being categorized by chain scale, hotels are further classified by their characteristics, offerings, and features. The primary asset classes for hotels are full-service, select-service, limited-service, extended-stay, and budget hotels. These hotels generate business from three main sources: business travelers, who are sometimes referred to as corporate transient travelers – transient demand refers to hotel guests who occupy less than 10 rooms per night; group business, which is defined as rooms that are sold in blocks of 10 or more; and leisure travelers, who are guests that are traveling for pleasure instead of business. An additional demand category called "SMERF" refers to demand from social, military, education, religious, and fraternal groups.

FULL-SERVICE HOTELS

Full-service hotels are typically located in urban centers, are luxury or upper-upscale, cater to business travelers, and are distinguished from other hotels by their lavish amenities. These generally include plentiful food and beverage options, such as multiple high-end restaurants. Additional amenities include large amounts of conference, meeting, and banquet space, lounges, bars, gyms and spas, extravagant pools, doormen, valet parking, extended room service, and laundry and concierge services. Full-service hotels' abundant amenities generate higher fixed costs, but they also help attract more selective customers and group business, and they allow for higher rates.

Full-service hotels generate some business from leisure travelers, but the majority of their bookings comes from business travelers and groups that need meeting space for special events, such as conferences, conventions, and weddings. The common thread among guests who stay in full-service hotels is that they are seeking the extra amenities and services that only full-service hotels offer.

Full-service hotels are the most expensive hotels to build and operate because of high land costs in their urban locations, and their larger size and higher fixed costs relative to other hotel types. Their large size is necessary to house the conference rooms, meeting rooms, banquet halls, and restaurants that their guests expect them to have. Their generous number of rooms (typically over 300), and the large staffs they use to operate the hotel and provide amenities also add to their operating costs. Examples of full-service hotels include W Hotels, Westin Hotels & Resorts, Ritz-Carlton, and Regent Hotels & Resorts.

SELECT-SERVICE HOTELS

Select-service hotels are positioned between full-service and limited-service hotels. They are generally upscale or upper-midscale, and their fixed costs are less than full-service hotels' because they have fewer (and sometimes smaller) rooms, fewer food and beverage options, and fewer amenities. However, they still offer some light food and beverage options, such as breakfast, a casual restaurant, bar, and a market or café with limited hours or a limited menu. Other amenities can include a fitness center, technology enabled rooms, pool, business center, and a modest amount of meeting space.

Select-service hotels were once located mostly in suburban locations, small towns, and around airports, but they are now found in larger, more dense markets as well. In 2014, the demand for select-service hotels in the top 25 U.S. markets grew at 5.6% and continued to grow at a higher rate than the national industry average of 3%. The elevated demand for these hotels led to additional development, resulting in double-digit supply growth in major markets from 2015 to 2019.

Demand for new select-service properties came from travelers and hotel owners alike.

TYPES OF HOTELS

Travelers like select-service hotels because the physical and operational standards that are required, protected, and enforced by the franchisor, give guests a high degree of confidence that they will be staying in a well-kept room, at a well-maintained property, with attractive amenities, at a reasonable price point, while also collecting valuable loyalty program points. Hotel owners like select-service properties because the building efficiencies and smaller staffs make them less expensive to develop, maintain, operate, and refresh (as required periodically by the major hotel companies through a property improvement plan) than their full-service counterparts.

Select-service hotels may also capture demand from both "move-down" guests during downturns and "move-up" guests when the economy expands. For example, when the economy contracts, companies may lean toward using select-service hotels instead of full-service hotels for business travel because of their lower rates. Similarly, when the economy expands, families who usually stay in budget hotels when traveling may upgrade to a select-service hotel instead. The ability to capture move-down and move-up guests during different economic periods gives select-service hotels a higher floor on room demand relative to full-service hotels during downturns, while also providing a higher ceiling on room demand relative to budget hotels when the economy expands.

While select-service hotels' posted rates might not be as high as those at full-service hotels, their smaller scale allows them to fill more readily and avoid the need to layer in discounted group or contract business simply to build a base. As a result, their net effective rates and higher occupancies result in RevPARs equal to or greater than their full-service counterparts. Combined with their lower cost bases, this reduces risk, generates higher margins, and greater returns on invested capital. This model can be particularly valuable when the economy contracts and is part of the reason select-service hotels have historically outperformed full-service hotels during economic downturns.

Examples of select-service hotels include the Courtyard by Marriott, Hilton Garden Inn, and Hyatt Place.

TYPES OF HOTELS

LIMITED-SERVICE HOTELS

Limited-service hotels can have some of the same characteristics and amenities as select-service hotels, and for this reason, they are sometimes included with select-service hotels in analysis and commentary. However, pure limited-service hotels are designed to be more budget friendly and offer fewer amenities than select-service hotels. They generally lack a dedicated revenue generating food and beverage component, such as a restaurant or café, and any food offerings they do have will be extremely limited. For instance, some limited-service hotels offer guests a light breakfast bar, but nothing else. Limited-service hotels also have fewer rooms and smaller staffs than select-service hotels. At "budget" limited-service hotels, a single employee may be responsible for multiple tasks, such as laundry and housekeeping. Budget limited-service hotels offer basic rooms at modest prices, while more robust limited-service hotels have more amenities, such as a small business center, party hall, fitness room, laundry room, pool, or small meeting rooms. Limited-service hotels with these offerings are more closely associated with select-service hotels.

Similar to select-service hotels, because they have fewer amenities, fewer rooms, smaller staffs, and offer either limited or no food and beverage options, limited-service hotels have lower operating costs than full-service properties. Many limited-service brands cater to extended-stay travelers and offer discounted weekly and monthly rates. Limited-service hotels are generally in the economy or midscale chain scale and examples of limited-service hotels include Comfort Inn, Motel 6, Days Inn, and La Quinta Inn.

EXTENDED-STAY HOTELS

Featuring amenities such as on-site laundry facilities and large "suites" with full kitchens, extended-stay hotels cater to guests who plan to stay for at least four days and may stay up to a month or longer. These are often business travelers and workers in the warehousing, logistics, medical, telecommunications, and construction sectors who are on extended assignments. Extended-stay hotels are also very popular with leisure travelers, either couples or families, who appreciate the extra space, the kitchens, and the complimentary breakfasts that are typically offered by these brands. Guests also use extended-stay hotels if they need a place to stay during home renovations, if they have just moved to a new area and do not have permanent housing, if they are visiting a warm weather location for an extended period during the winter months, and for other reasons as well.

Extended-stay hotels generally have amenities that are commonly found in select-service and limited-service hotels, such as a fitness center, small meeting rooms, and breakfast offerings. Extended-stay hotels account for approximately 8% of the total rooms in the U.S. and command the highest occupancy rates in the U.S. hotel industry. Examples of extended-stay hotels include Homewood Suites by Hilton, Residence Inn by Marriott, and Hyatt House.

BUDGET HOTELS

Budget hotels are small to medium-sized hotels that offer basic accommodations with few services at a low price point. Examples of budget hotels include Choice Hotels' Econo Lodge and Wyndham's Super 8.

TYPES OF HOTELS

MICRO-HOTELS

A more recent addition to the hotel industry is micro-hotels. These hotels cater to millennials, who at 73 million strong, are now the largest generation in the U.S. after overtaking the baby-boomers in early 2020. Micro-hotels have very small rooms and average only 140 sf, much less than the 330 sf or so that is the average U.S. hotel room size. Micro-hotels tend to be located in major cities and cater to millennials who prefer to be out and about exploring the local scene, instead of spending most of their free time inside the hotel. Examples of micro-hotels include Motto by Hilton and Moxy by Marriott. In addition to micro-hotels, there are other interesting trends that the industry is monitoring as well.

RECENT HOTEL TRENDS

Recent advances in technology, growing concerns about environmental issues, and the importance of owning a strong brand have led to new trends in the hotel industry.

TECHNOLOGY BASED TRENDS

Hotels rely on different information systems to book guests, drive occupancy, manage costs, and operate efficiently. A hotel's distribution strategy, which it uses to sell rooms, is heavily dependent on information technology (IT). Distribution channels include direct channels and indirect channels. An example of a direct distribution channel is a hotel's own website and an example of an indirect channel is a global distribution system. Global Distribution Systems (GDS) are consolidated reservation networks that are used by travel agents to reserve flights, hotel rooms, and rental cars in real time. Examples include Amadeus, Sabre, Worldspan, and Galileo. Hotels also use online travel agents (OTAs) and wholesalers to book guests. OTAs earn revenue by charging hotels a fee for each booking and include companies such as Priceline, Expedia, and Hotels.com. While hotels are generally happy to get a booking from any source, they prefer their customers book reservations using their own website instead of an OTA. This allows them to avoid paying OTA fees. In its 2019 annual report, Hilton included the growth of OTAs as one of the risk factors that could adversely affect its business. Wholesalers are third-parties who purchase hotel rooms in bulk at discounted rates and then sell them at a mark-up to travel agents and OTAs. Additional IT systems are also used to operate hotels. These include customer relationship management systems that are used for marketing, online education modules to train employees, and automated purchasing and staffing systems that alert employees to any issues that need to be addressed. The value of these systems increases if they are synced together to allow for seamless communication.

Information technology systems have been instrumental to the hotel industry for decades, but they are now benefiting from recent advances in artificial intelligence (AI). The storage, speed, and analyzing capabilities of AI driven technology allows hotel management companies to operate more effectively and optimize their pricing. With AI supported IT systems, hotels can collect more customer and competitor data than they previously could, they can analyze this data quicker and more accurately than they previously could, and they can determine the optimal rates to charge for rooms and services quicker and more accurately than they previously could. ModiHost is an example of an AI platform that some hotels are using to increase guest satisfaction with their stays, boost occupancy, and increase revenue. ModiHost does this by collecting large amounts of data on hotel guests, such as their previous orders, dining preferences, concierge requests, bookings, and other details from earlier visits. ModiHost then analyzes this data to predict which offerings a guest would enjoy the most and offers them these options as soon as they check in. In addition to greater use of AI, the following technology based trends are also gaining traction in the hotel industry:

- Mobile applications that allow guests to skip check-in, enter their rooms, control lighting, temperature, motorized windows and more.
- Virtual reality tours of guest rooms and common areas.
- Greater use of Smart TVs that are linked to the Internet so that guests can access movies and television shows from their own streaming devices.
- Greater use of thermostats, lighting, kitchen appliances, drapes, and other items that can be controlled by voice or smart devices.
- Replacing menus and books with QR codes that can be accessed with a mobile device.
- Using QR codes to allow guests to communicate with concierges through video chats and messaging platforms.

RECENT H0TEL TRENDS

- Soundproofing windows to filter out noise from traffic, airplanes, loud music, and other sources.
- Using smart mirrors that allow guests to perform different actions. For example, watching the news, checking the weather, exercising, requesting hotel services, and checking their social media feeds.

Over time, the industry expects many of these items to appear in more hotels as they become less expensive and guests increasingly express their desire for them.

GOING GREEN

In addition to technological trends, the hotel industry has been actively working to reduce its carbon footprint and be responsible stewards of the environment. To that end, the following environmental trends have become more prevalent as of late:

- Developing and renovating hotels so that they are compliant with Leadership in Energy and Environmental Design (LEED) building standards.
- Adding charging stations for electric vehicles.
- Making greater use of solar power from hotels own solar panels or by purchasing solar power from third-party providers.
- Conserving electricity by using motion sensors to control lights.
- Conserving water by using more efficient shower heads, faucets, and laundry machines.
- Conserving water and electricity by letting guests skip housekeeping in exchange for hotel credits or loyalty points.
- Creating and championing brands that embrace environmental initiatives, such as Marriott's Element brand.

BRAND PROLIFERATION

Brand proliferation is another trend that the hotel industry is experiencing. It used to be common for hotel companies to go years without launching a new brand. However, since 2013, five of the world's largest hotel companies have launched over 15 new brands and this trend is expected to continue as hotels compete for market share and business from the millions of millennials who travel for work and leisure.

Increasing the number of brands a hotel company owns either organically or through an acquisition has become an integral part of the growth strategy of some of the largest hotel companies in the world. This includes Marriott which became the largest hotel company in the world when it increased its room count to over 1.1 million by purchasing Starwood Hotels and its 11 brands for $13 billion in 2016. When Tina Edmundson, Marriott's Global Brand Officer was asked about brand proliferation in 2018, she responded by saying, "There is no such thing as too many brands."[i] To Marriott and other companies who are all-in on brand proliferation, the benefits of this strategy are clear and include increasing their market share and revenue, boosting their expertise across different types of hotels, growing their loyalty programs, and defending themselves against new entrants in their markets. Including Airbnb and other home-rental companies. Ms. Edmundson believes, and studies have shown, that many travelers choose which hotels to stay in based on the brand. Accordingly, the more brands a hotel company has, the more travelers it can appeal to, the more rooms it should be able to sell, and the more revenue and value it should be able to generate.

RECENT HOTEL TRENDS

Using brand proliferation to grow their loyalty programs is also extremely important to hotel companies because studies have shown that it can cost 5 to 7 times more to acquire a new guest than to keep a guest. Hotel loyalty programs can also boost occupancy rates during off-peak periods, help hotels collect valuable customer data, and contribute to marketing efforts. Notable hotel loyalty programs include Hilton Honors and Marriott Bonvoy. It can also be very difficult for hotel companies to cancel their brands because franchise agreements can last for decades and a single brand might be widely distributed across hundreds of different hotel owners and franchisees. Lastly, because the larger hotel companies do not have a lot of cash tied up in real estate under their asset light model, they have more resources to create additional brands for their portfolios.

While acknowledging the arguments in favor of brand proliferation, there are many hotel owners who dislike this trend and worry that it increases the likelihood of hotels with the same brand engaging in territorial disputes and cannibalizing each other. Brand proliferation's detractors also contend that the more brands a company has, the harder it is for that company to communicate and build relationships with its customers. However, Marriott and other leading hotel companies clearly see things differently, and for now, it appears that brand proliferation is a trend that is here to stay.

2020 - THE YEAR OF COVID-19

As the U.S. economy grew following the Great Financial Crisis of 2008 to 2009 (GFC), the hotel industry grew along with it. According to STR, from 2010 to 2019, the U.S. hotel industry recorded ten straight years of demand growth for the first time in history. Room night demand grew at a 26% clip from approximately 1 million room nights in 2010 to a record 1.282 million in 2019. The increase in demand spurred new developments and supply increased by 10% from 4.8 million rooms to 5.3 million during this period. However, because demand outpaced supply, occupancy increased by approximately 8% from 58% in 2010 to a robust 66% in 2019. Revenues also increased during this period as the average daily rate (ADR) grew by 34% from $98 to $131, the highest ever benchmarked by STR, and revenue per available room (RevPAR) rocketed upwards by 54% from $56 to $87, also the highest figure ever benchmarked by STR. Occupancy rates, ADR and RevPAR are key performance indicators in the industry. ADR is the average amount of revenue that is earned per occupied room and is calculated by dividing a hotel's total room revenue by the number of rooms sold. RevPAR is the amount of revenue that a hotel generates for each available room (vs. occupied room) and is calculated by dividing a hotel's total room revenue by the number of rooms available. When a hotel's RevPAR increases, it is generating more revenue for each room it operates.

Entering 2020, the hotel industry was keeping a watchful eye on occupancy rates, ADR, and RevPAR because while room demand grew in 2019, the rate of demand growth fell from 2.4% in 2018 to 2% in 2019. And, it was anticipated that in 2020 room supply growth would exceed room demand growth for the first time since 2009. The industry was also closely monitoring labor costs due to tightening in the labor supply caused by sustained job growth during the post-GFC recovery. Nevertheless, the industry got off to a good start in 2020 with occupancy rates, ADR, and RevPAR all increasing year-over-year (YOY) in January and February. However, this all changed quickly in March with the emergence of the novel coronavirus, COVID-19.

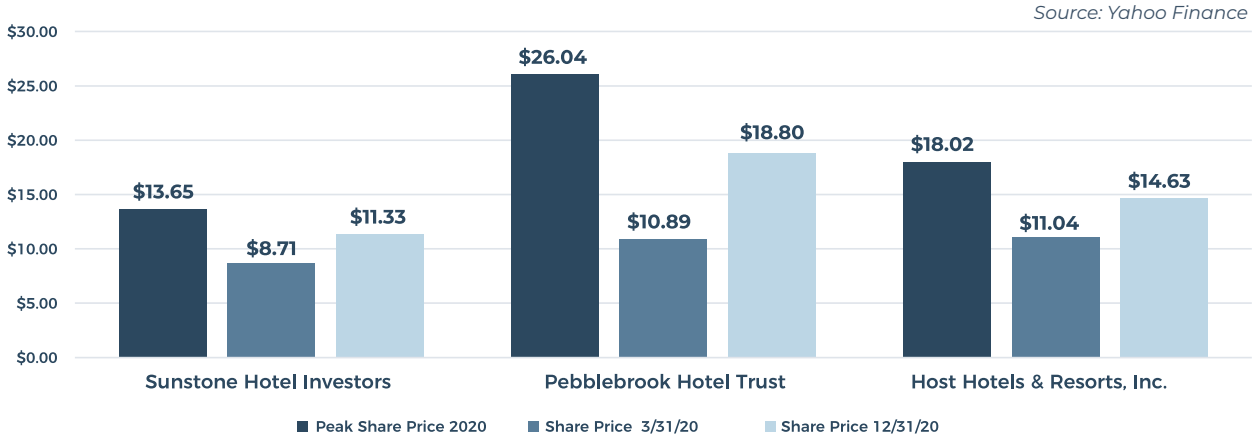
In response to the COVID-19 global pandemic the federal government restricted inbound travel from some countries while state and local governments issued stay-at-home orders, banned large gatherings, and closed hotels, restaurants, bars, entertainment venues, sports venues and other sites where people congregate. These actions caused the economy to enter a recession and led to a sudden and precipitous decline in hotel demand that has roiled the industry and caused significant financial losses.

COVID-19 DISRUPTS THE HOTEL INDUSTRY

The speed and depth of COVID-19's impact on the hotel industry has been substantial and is causing historic levels of financial duress. Even after positive vaccine news triggered a market rally at the end of 2020, the share prices of the leading hotel REITS Sunstone Hotel Investor, Pebblebrook Hotel Trust, and Host Hotels & Resorts still ended the year down from their 2020 peaks by 17%, 28%, and 19%. Similarly, the leading hotel companies Marriott International, Hilton Worldwide Holdings, and Hyatt Hotels also experienced declines with their share prices falling from their 2020 peaks by 13%, 5%, and 22%.

2020 - THE YEAR OF COVID-19

LEADING HOTEL REIT SHARE PRICES



LEADING HOTEL COMPANY SHARE PRICES

COVID-19's impact on the industry is also reflected in data from prominent research firms across a variety of metrics. The first shutdowns were initiated in March and according to STR, by April, occupancy rates had fallen 64% YOY to 25%, ADR fell a record 44% YOY to $73, and RevPAR fell 80% YOY to $18. The industry's performance improved slightly once states began to reopen their economies in the spring and domestic leisure travel increased in the summer, but an increase in new COVID-19 cases at the end of the year led to new restrictions and weakened performance in the sector. Overall for 2020, the U.S. hotel industry's occupancy rate was 44%, ADR was $103, and RevPAR was $45.

The occupancy rate and RevPAR are the lowest ever recorded by STR and ADR is the lowest figure reported by STR since 2011. The industry also set a record in 2020 with more than 1 billion unsold room nights. This is more than 30% greater than the 768 million room nights that went unsold in 2009 during the GFC. After 2020's hotel statistics were released, Jan Freitag, STR's senior vice president of lodging and insights referred to the U.S. hotel industry's 2020 performance as "the single worst in the 30-year history of STR."[ii]

The industry's financial losses are pushing many hotels towards bankruptcy and foreclosure. In a November 2020 survey from the American Hotel and Lodging Association (AHLA), 71% of hoteliers said they would not survive another six months without additional government support.[iii] Industry duress is further reflected in data from the financial research firm Trepp which reported that of the $90 billion dollars in hotel CMBS loans, nearly 20% were delinquent at the end of December 2020. This equates to roughly $18 billion in delinquencies, which is

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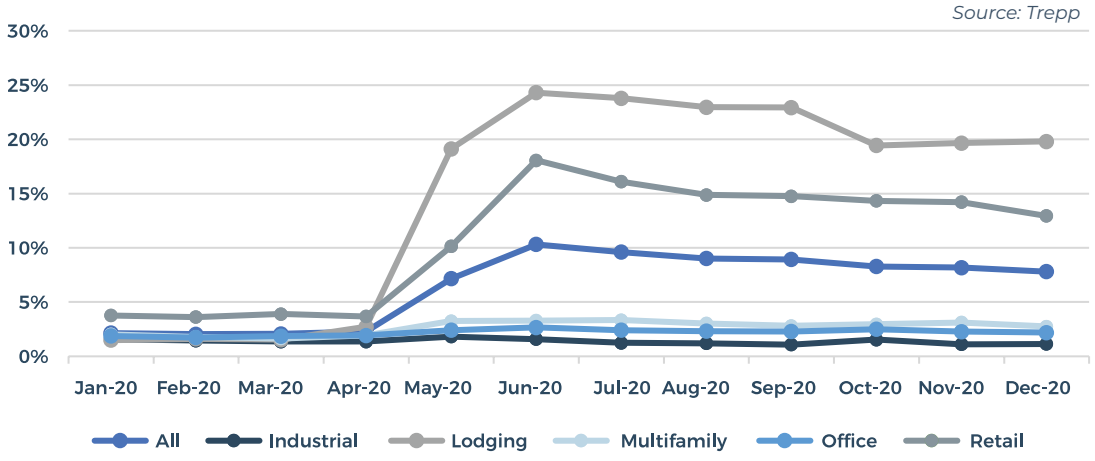
significantly greater than the $1.15 billion in delinquencies at the end of December 2019 and is nearly 30% higher than the $13.5 billion peak that was reached during the GFC. Trepp also reported that 24% of hotel CMBS loans were in special servicing at the end of December 2020, in contrast to 2% at the end of December 2019.

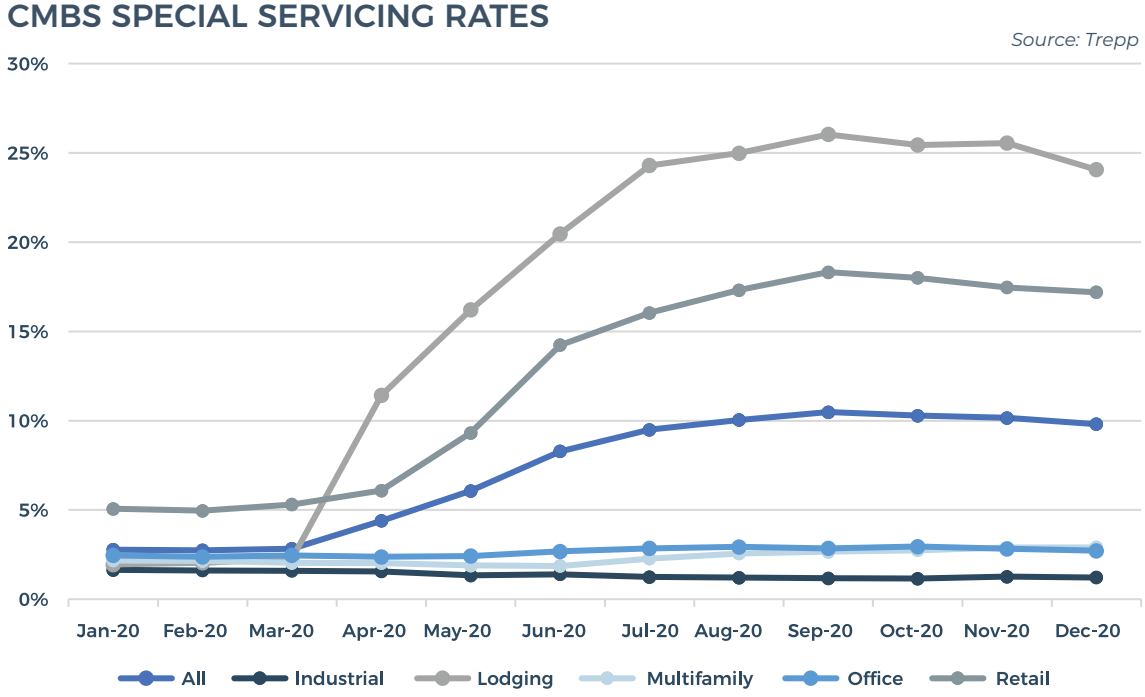
The special servicing rate is higher than the delinquency rate because a forbearance changes a loan's status from delinquent to current, but if the loan is stressed and is in special servicing, it can remain in special servicing even with forbearance.

Trepp is also projecting that more than a third of the hotel loans that were originated before COVID-19 could eventually be defaulted on and that default rates for hotel loans could wind up being more than 2.5x the default rate for retail assets, which have also been greatly impacted by COVID-19 and had 17% of their CMBS loans in special servicing at the end of December. In addition, according to NCREIF, the hotel industry recorded a -26% annual return in 2020, the lowest return of all the major real estate asset classes.

CMBS DELINQUENCY RATES (30+ DAYS)



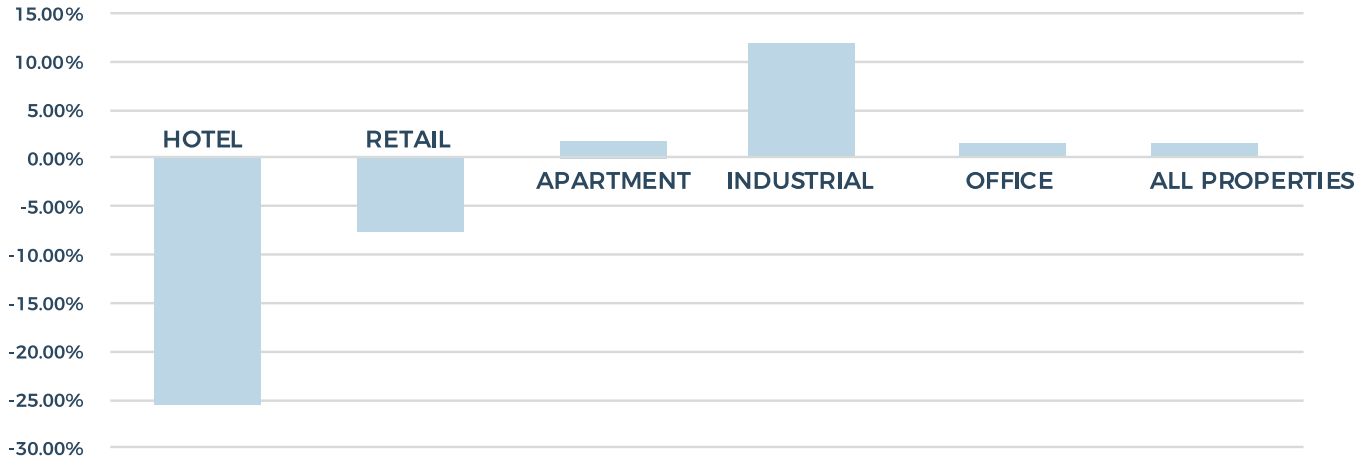
CMBS SPECIAL SERVICING RATES



2020 - THE YEAR OF COVID-19

NCREIF RETURNS - 2020 ANNUAL TOTAL

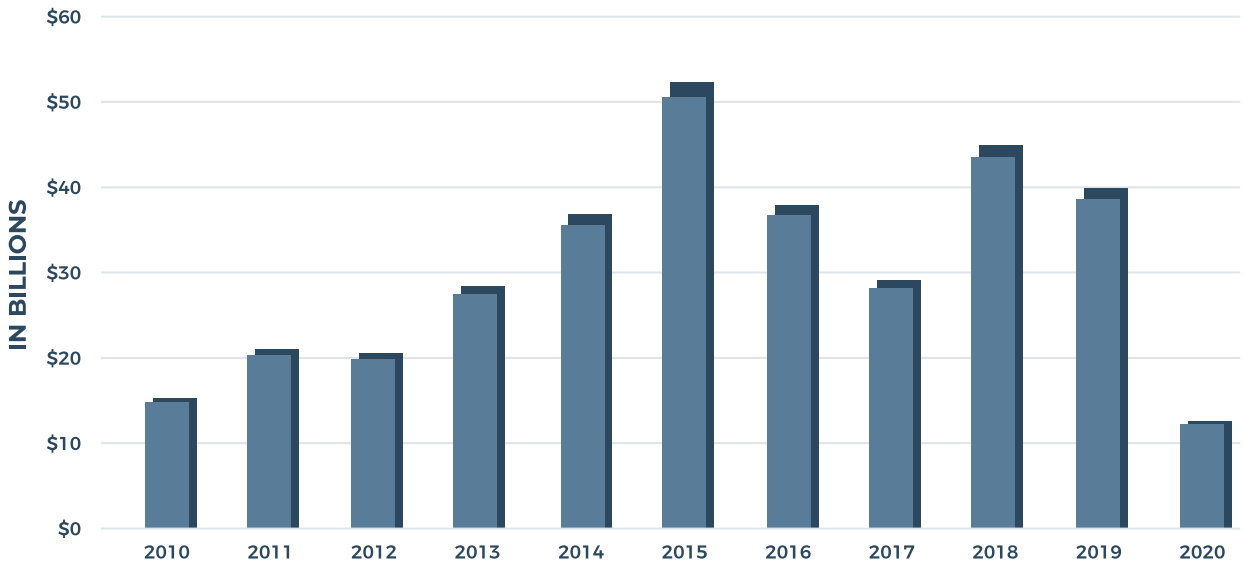
Source: NCREIF



The financial duress that hotels are experiencing, coupled with curtailed lending and buyers and sellers disagreeing on asset values led to a dramatic decrease in transaction volume in 2020. According to Real Capital Analytics (RCA), transaction volume fell by nearly 70% from approximately $39 billion in 2019 to $12 billion in 2020.

U.S. HOTEL INDUSTRY - ANNUAL TRANSACTION VOLUME

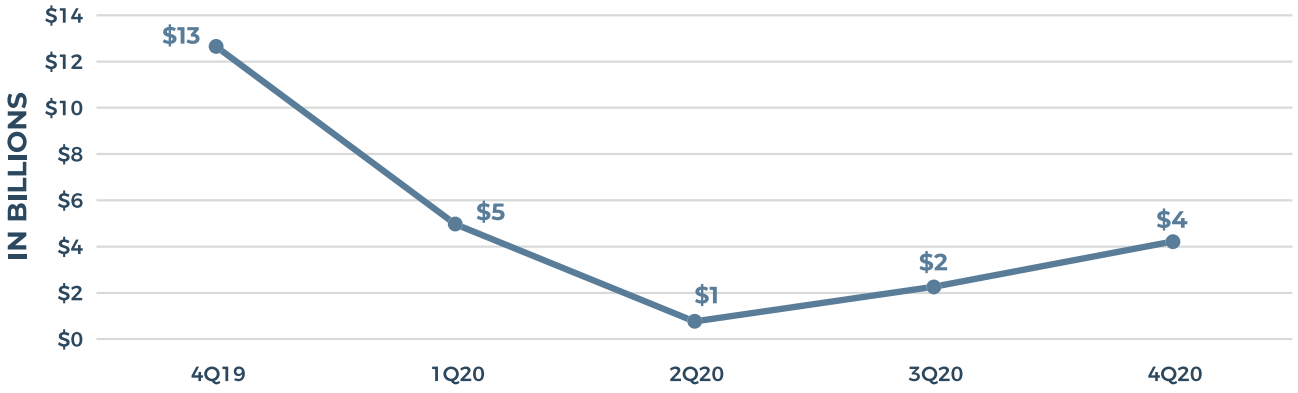
Source: Real Capital Analytics, www.rcanalytics.com



2020 - THE YEAR OF COVID-19

U.S. HOTEL INDUSTRY - TRANSACTION VOLUME BY QUARTER

Source: Real Capital Analytics, www.rcanalytics.com



ESCALATING DISTRESS

With the industry reeling from COVID-19's economic impact, investors are expecting a large number of distressed properties to eventually come to market as hotels continue to be financially challenged. There has been some distressed transaction activity already, particularly from properties that were stressed before COVID-19, but the amount of activity has been limited as of this writing. RCA reported that distressed asset sales accounted for only 6% of hotel sales in 2020. In contrast, distressed hotel sales accounted for roughly 60% of hotel transactions at the end of 2010.

Hotel owners are doing everything they can to "kick the can down the road" and avoid selling their assets at distressed prices, and AHLA believes the industry will also benefit from the additional support given to the Paycheck Protection Program in the COVID-19 relief bill that was signed into law in December. However, the level of distress is still expected to increase in 2021 as forbearance and other relief that lenders granted to borrowers runs out and court approval of foreclosures accelerates. Also, new lockdowns and restrictions that were implemented by states in 4Q20 in response to a dramatic increase in the number of new COVID-19 cases during the quarter are likely to cause additional cash flow shortages for hotel owners, a further decline in property values, and considerable losses of owner equity in these assets.

If this scenario occurs as expected, more distressed properties should enter the market, price discovery should accelerate and the number of distressed transactions should increase. With CMBS delinquency rates approaching 20% in December and special servicing rates exceeding 24% during the month, the potential number of distressed hotels that could be put on the market is substantial. Furthermore, according to data from CBRE that was released in November 2020, hotel values had fallen by an average of 20% at the time. The level of impairment varied depending on the type of hotel, geography, and other factors. Unsurprisingly, full-service hotels experienced the steepest drop in value at 27% while lower-tier hotels were at the other end of the spectrum at 15%. At the same time, while suburban/resort property values had fallen by 16%, values of hotels of all types in urban markets had fallen 27%.

2020 - THE YEAR OF COVID-19

There are currently billions of dollars of fresh opportunistic capital on the sidelines and a wide range of buyer motivations. For example, a buyer who has sought a particular asset in a major market that would otherwise not have come to market might be open to making an offer at a far lesser discount in order to close the bid-ask gap. Also, some owners of recently completed developments have considered selling these new properties at their basis to eliminate any exposure to recourse under the construction loans and avoid funding future operating costs. These sales have to-date proven difficult because buyers are expecting a more significant discount to compensate them for the risk they would be taking by purchasing new assets with no operating track record. Another consideration for buyers is the tax implications of a distressed purchase. Generally, someone who acquires a distressed hotel would attempt to reduce its property tax liability by appealing the property's assessed value, but with cities and states facing large budget shortfalls because of COVID-19, they may look to generate revenue by raising property taxes, which would negate any tax saving efforts by a distressed buyer. This is an additional risk that buyers are aware of and are factoring into their underwriting.

HOTEL ACTIVITY IN 2020

According to Kalibri Labs, in April of 2020, during the height of government mandated closures caused by COVID-19, some 15% of the total U.S. hotel room supply was closed for business. Fortunately, these closures were eventually lifted and there were some hopeful signs of a small recovery later in the spring as state and local governments began to ease COVID-19 restrictions and partially reopen their economies. This benefited the hotel industry to some degree, but only marginally. Occupancy, which had fallen to 25% in April, subsequently increased, but was only 37% at the end of December. A 32% decline YOY.

Because of concerns that COVID-19 spreads more easily in crowded environments such as cities and urban centers, greatly reduced business travel, and the cancellation of nearly every major business and entertainment event, hotels in smaller markets generally outperformed those in larger markets in 2020. During the summer, travelers who had been freed from stay-at-home orders shunned air travel, piled into their cars, and left home for vacations in rural and outdoor locations in smaller markets. According to the hospitality publication Skift, 81% of all trips taken in the U.S. in August were to the beach, national parks, small towns, or the countryside.

This shift in consumer traveling preferences caused hotels in major markets to struggle relative to their small market peers. For example, according to STR, while RevPAR for hotels located near interstate highways (which are predominantly economy and midscale hotels) was down only 25% YOY for the week ending September 12, RevPAR for urban hotels was down 73%. In addition, select-service, limited-service, and extended-stay hotels outperformed full-service hotels as consumers became increasingly price conscious and revenue from business travel and the large group events that full-service hotels cater to remained depressed.

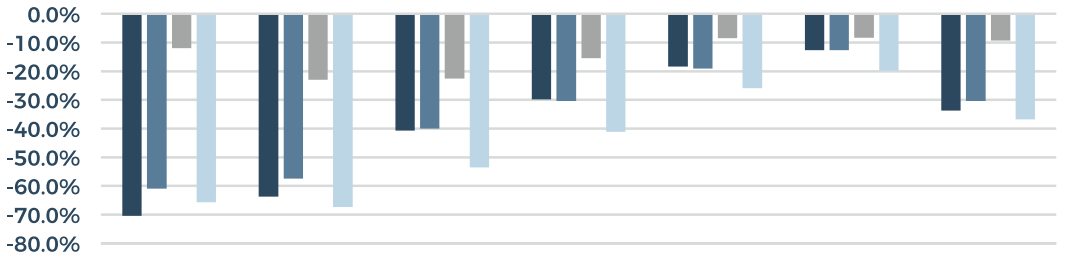
Commenting on the performance of extended-stay hotels a few months after the pandemic, Mark Skinner, a partner with The Highland Group hotel consulting firm, stated that "Across all metrics extended-stay hotels continue to perform better than the overall hotel industry six months following the start of the pandemic. Occupancy is now higher than during the low points in 2009 and is rapidly approaching parity with quarterly occupancy during the last recession."[iv]

In contrast to the performance of extended-stay hotels in 2020, luxury hotels are projected to experience the largest YOY decline in demand and occupancy of all hotel types during the year. Luxury hotels are also expected to take the longest amount of time to recover to pre-pandemic levels because they rely more on revenue from business travelers, group sales, events, and inbound international demand than lower priced select-service, limited-service, and extended-stay hotels.

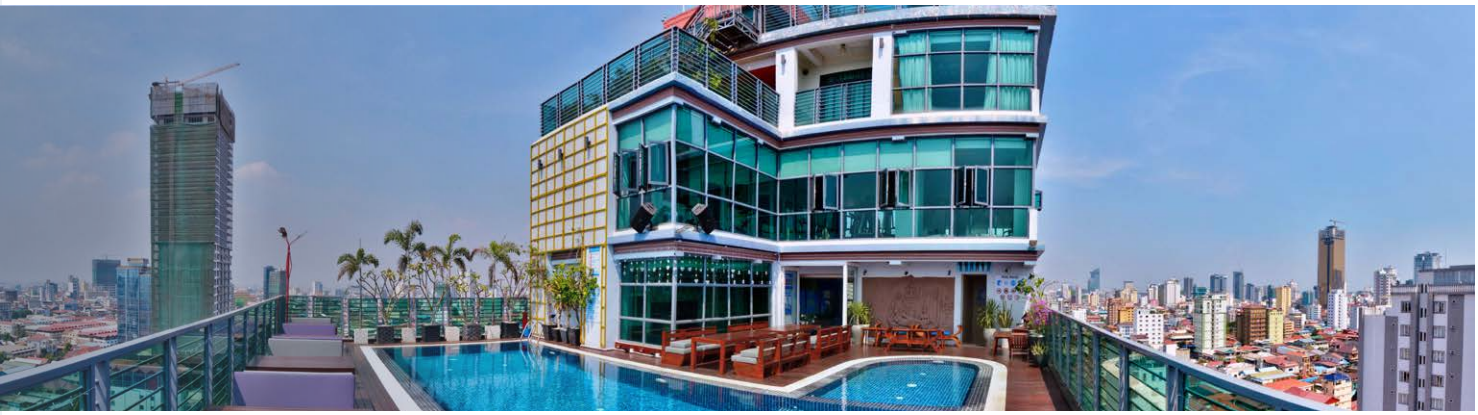
2020 - THE YEAR OF COVID-19

U.S. HOTEL INDUSTRY - PROJECTED CHANGE FROM 2019 TO 2020 DEMAND - OCCUPANCY - ADR - REVPAR

Source: PwC Hospitality Directions US, November 2020



	Luxury	Upper-Upscale	Upscale	Upper-Midscale	Midscale	Economy	Independent
DEMAND	-70.4%	-63.7%	-40.7%	-29.8%	-18.3%	-12.7%	-33.7%
OCCUPANCY	-61.0%	-57.5%	-40.0%	-30.3%	-19.0%	-12.6%	-30.3%
ADR	-12.0%	-23.0%	-22.5%	-15.5%	-8.5%	-8.3%	-9.3%
REVPAR	-65.7%	-67.3%	-53.5%	-41.1%	-25.9%	-19.8%	-36.8%



COVID-19'S IMPACT ON HOSPITALITY'S FUTURE

COVID-19's impact on the hotel industry will extend beyond the financial damage the virus has caused, particularly with respect to cleaning practices. Hotels are now using several new protocols to ensure the cleanliness of their properties and the safety of their guests. For example, hotels are cleaning rooms and common areas with greater frequency, requiring employees and guests to wear masks, using six-feet markers and one-way signs to facilitate social distancing, using plexiglass shields as another buffer against transmitting COVID-19, screening employees and guests for the virus with temperature checks, limiting the number of people in common areas, placing menus online to minimize contact between employees and guests, and making hand sanitizer readily available. Going forward, hotels are also expected to make greater use of mobile applications and other technologies that can facilitate contactless arrival, ultraviolet lighting that can kill germs and bacteria, discrete partitions in lobbies and common areas, high-caliber air filtration systems in rooms and common areas, and more in-room exercise equipment. Unfortunately for buffet lovers, many hotels may permanently close their buffet stations and turn to grab-and-go options instead. Perhaps the most widespread change that could occur with hotels is the increased use of an industry or government approved cleaning certification that alerts guests that the hotel they are staying in adheres to specific cleanliness standards and protocols.

Currently, the Global Biorisk Advisory Council (GBAC), a division of the Illinois-based International Sanitary Supply Association (ISSA), issues a GBAC STAR certification to facilities that have met GBAC's cleanliness and safety standards. In addition to GBAC's certification, AHLA recently created the industry-wide initiative "Stay Safe" which may turn out to be a precursor to an AHLA certification. The Stay Safe initiative encourages hotels to enhance their cleaning efforts across the entire property, to use high-grade cleaning products that adhere to CDC guidelines, to encourage social distancing and reduced person-to-person contact, and to effectively communicate its safety protocols to its guests. Major hotel companies have also launched their own cleaning and safety programs. Marriott created a Marriott Global Cleanliness Council to advise its hotel operators on policies and procedures that will enhance the safety of their properties. Hilton launched a Hilton CleanStay with Lysol Protection program that is similar to Marriott's Global Cleanliness Council and focuses on social distancing and enhanced cleanings of guest rooms and public areas, and Hyatt launched a Global Care and Cleanliness Commitment initiative that is aligned with GBAC's STAR certification and accreditation program. Other hotel companies are rolling out similar programs. Additional post-COVID-19 industry changes could include designing conference rooms, meeting spaces, and common areas so that they open to the outdoors, and creating virtual meeting rooms with green screens, webcams, and high-quality broadcasting equipment that hotels can rent to companies for remote work arrangements and virtual meetings. COVID-19 is also expected to have a lasting impact on other members of the hospitality industry.

In the spring of 2020, the U.S. airline industry was severely disrupted by widespread government travel restrictions that were enacted in response to COVID-19. This contributed to U.S. air travel falling by roughly 95% from over 2 million daily travelers to less than 100,000 at the time. When this happened, many airlines accommodated customer requests for full refunds or waived their cancellation fees. However, not every airline did this and many customers had to pay cancellation or change fees for trips they could not take or had to reschedule. For this reason, in the future, air travelers are expected to make greater use of travel insurance instead of relying on premium credit cards to protect themselves against large cancellation or change fees. Similar to hotels, airlines are also making greater use of deep cleanings, enhanced filtration systems, and cleaning and safety certifications. The same can be said of the rental car industry, which has also stepped up its cleaning, safety, and certification efforts. In the coming years, any reasonable action that helps customers feel safe and secure will be considered by all members of the hospitality industry as they work to recover from the damage caused by COVID-19.

COVID-19'S IMPACT ON HOSPITALITY'S FUTURE

Another impact of COVID-19 is the proliferation of remote work arrangements. COVID-19 has caused large numbers of the labor force to work remotely since the pandemic began. The potential implications for the hotel industry are significant because business travel is a primary driver of hotel demand, particularly for luxury hotels. In 2019, business travel accounted for approximately 50% of demand for upper tier hotels. Accordingly, the industry is evaluating the impact that a sustained increase in remote work will have on demand. While the use of remote work accelerated with the emergence of COVID-19, remote work in and of itself, is not a new phenomenon and there have been studies conducted on these arrangements that are helpful in analyzing its impact in a post-COVID-19 world.

According to a study from Oxford Economics,[v] the average company in the U.S. would reduce its profits by 17% in the first year if it eliminated business travel. Also, for every $1 that businesses invest in travel, they realize $12.50 in incremental revenue from selling products and services, closing transactions, fundraising, marketing and networking, and other revenue generating activities. Supplementing this study is a report from CBRE stating that more than 20% of business dealings would be eliminated without in-person meetings.[vi] CBRE also notes that qualitative benefits to business travel include in-person interaction, the ability to detect body language clues that cannot be discerned over virtual channels, and the ability to engage in spontaneous conversations that generate positive ideas for businesses. There is also the possibility that the increase in remote work caused by COVID-19 will spur more business travel in the future as people seek opportunities to reengage in-person with colleagues, clients, and partners. The research in this area seems to indicate that while remote work does provide value, it cannot replace the equally important value that is created from in-person meetings and communication. Particularly with respect to mentoring employees, and building trust and relationships between business partners.

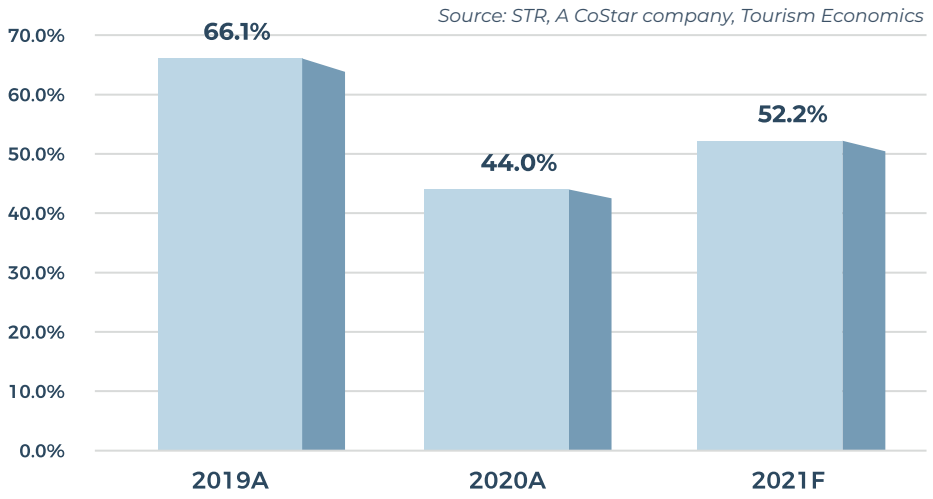
THE RECOVERY

Prior downturns in the hotel industry, after the tragic events of 9/11, and the malaise of the Great Financial Crisis, are instructive as prognosticators attempt to predict the pace of recovery. While the depth of this downturn is far greater, this is offset somewhat by the singular nature of the cause, and the relative health of so much of the rest of the U.S. economy. There is widespread belief that the industry will return to health, with varying opinions regarding the timing of the ramp.

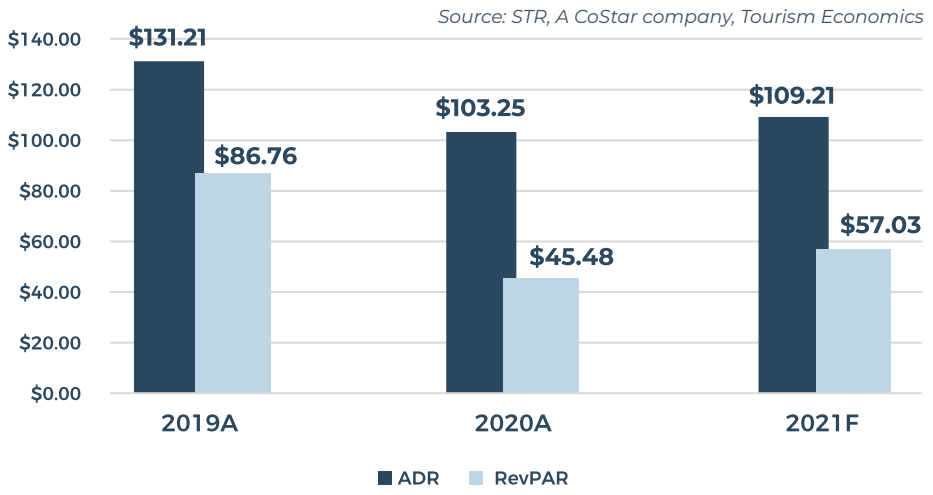
The industry as a whole is expected to return to pre-pandemic levels by 2024, while some markets and asset classes could recover by 2023. For example, CBRE has projected that economy and mid-scale chains could return to pre-pandemic RevPAR levels by late 2022, upper midscale and upscale chains should return to pre-pandemic RevPAR in 2023 or 2024, and upper-upscale and luxury chain hotels should return to pre-pandemic RevPAR in 2024 or 2025.

STR and Tourism Economics expect demand to increase significantly during the second half of 2021 with a broader release of COVID-19 vaccines and a gradual rollback in travel and gathering restrictions. STR and Tourism Economics are forecasting that additional demand will lead to occupancy increasing by 19% in 2021, ADR increasing by 6%, and RevPAR increasing by 25%, with RevPAR returning to pre-pandemic levels industry-wide in 2024.

U.S. HOTEL INDUSTRY - OCCUPANCY FORECAST



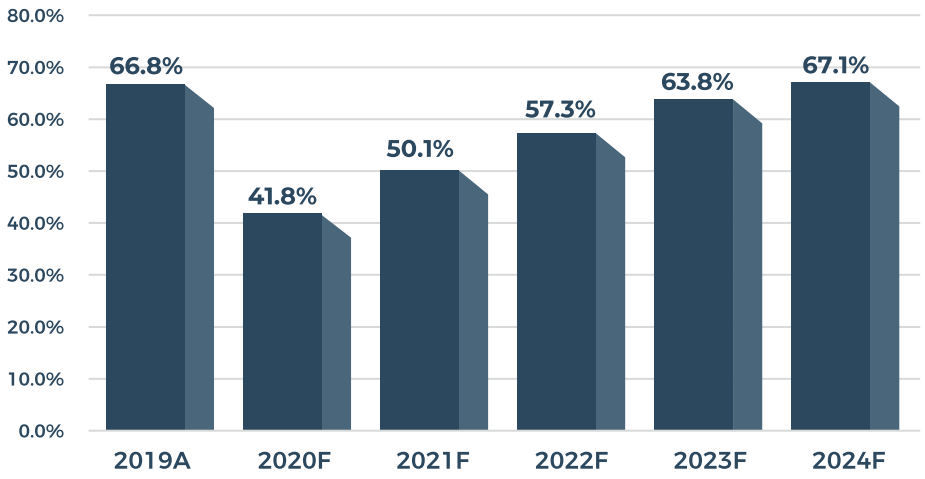
U.S. HOTEL INDUSTRY - ADR AND REVPAR FORECAST



THE RECOVERY

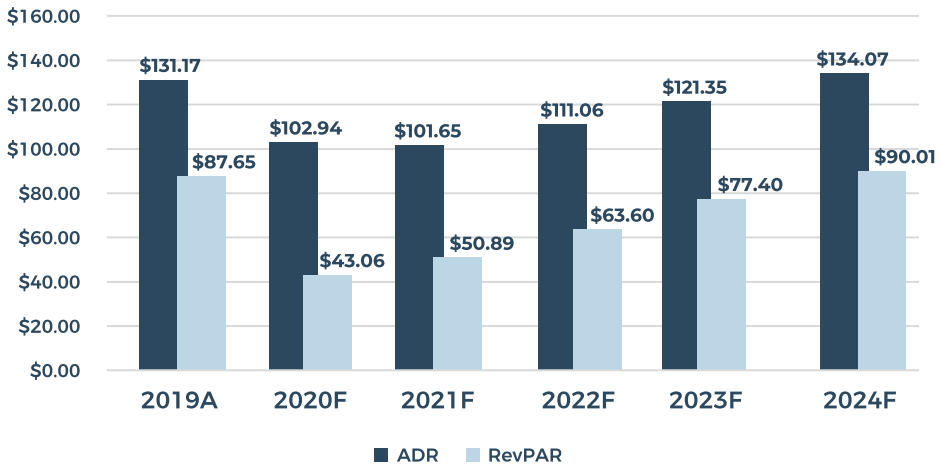
CBRE's projections are similar and it is forecasting that revenue will rebound strongly in 2021 and 2022, that total demand could return to pre-pandemic levels by 2023, and that industry-wide occupancy rates, ADR, and RevPAR are likely to return to pre-pandemic levels in 2024.

U.S. HOTEL INDUSTRY - OCCUPANCY FORECAST



Source: CBRE, Q3 2020 U.S. Lodging Forecast

U.S. HOTEL INDUSTRY - ADR AND REVPAR FORECAST



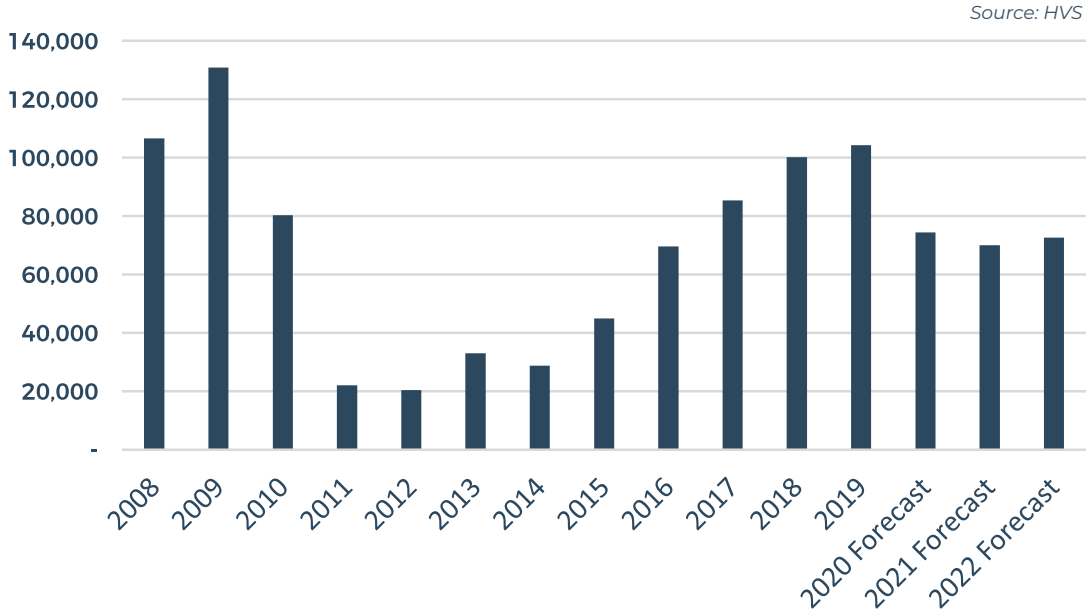
Source: CBRE, Q3 2020 U.S. Lodging Forecast

THE RECOVERY

CBRE is also projecting an increase in cap rates to 9.5% by mid-2021, which would be 90 basis points higher than their pre-pandemic rate of roughly 8.6%, before ultimately returning to the mid-8% range later in the recovery period.

In addition, the hospitality consulting firm HVS is projecting lower supply growth in the future as developers will be cautious in starting new projects due to the virus' impact on industry fundamentals. [vii]

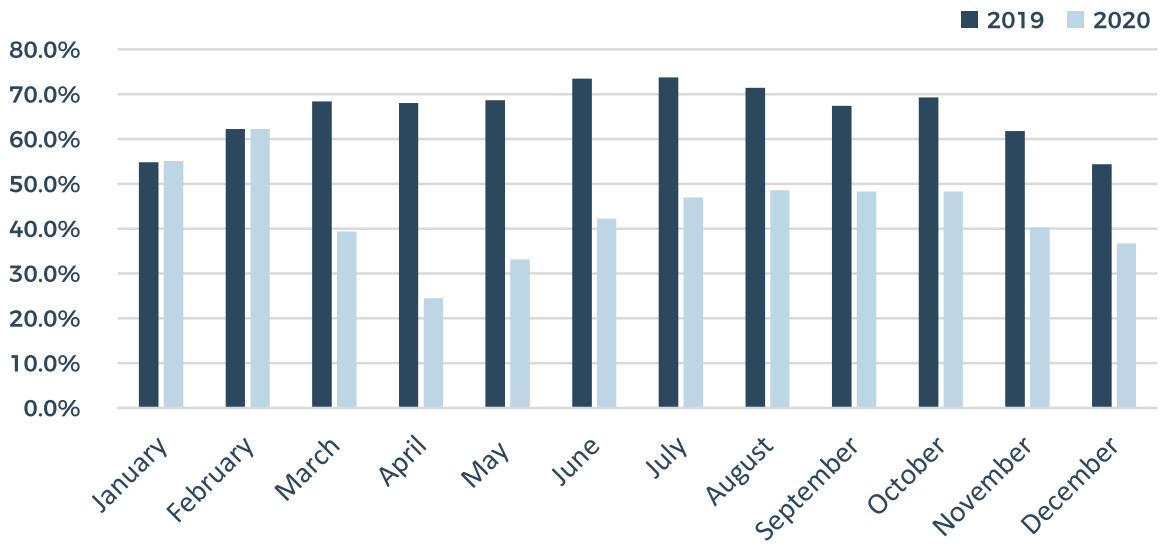
U.S. HOTEL INDUSTRY - HISTORICAL AND PROJECTED SUPPLY GROWTH



APPENDIX

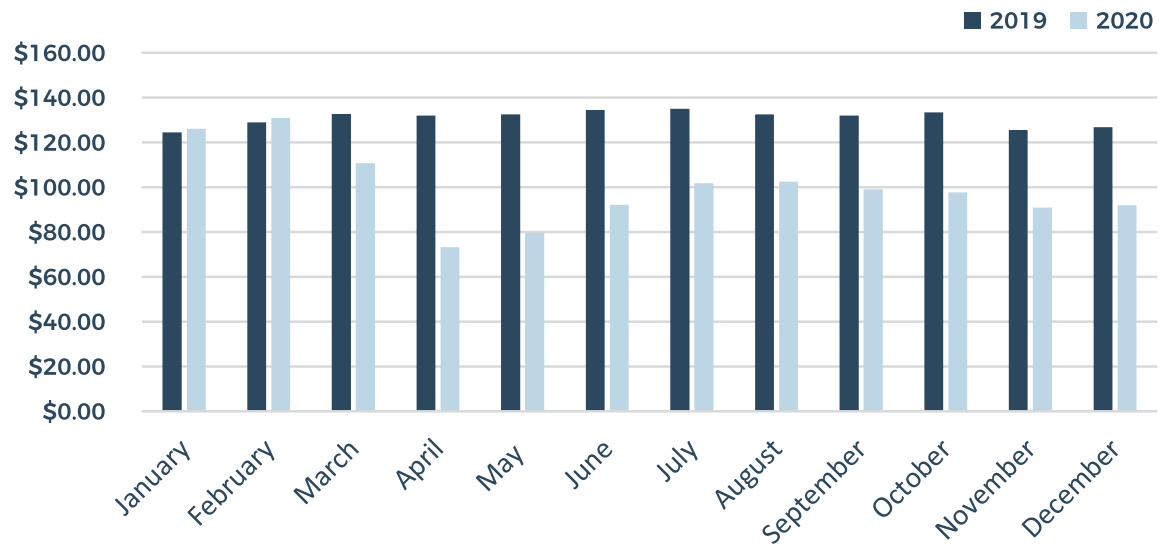
U.S. HOTEL INDUSTRY OCCUPANCY - 2019 VS 2020

Source: STR, A CoStar company



U.S. HOTEL INDUSTRY ADR - 2019 VS 2020

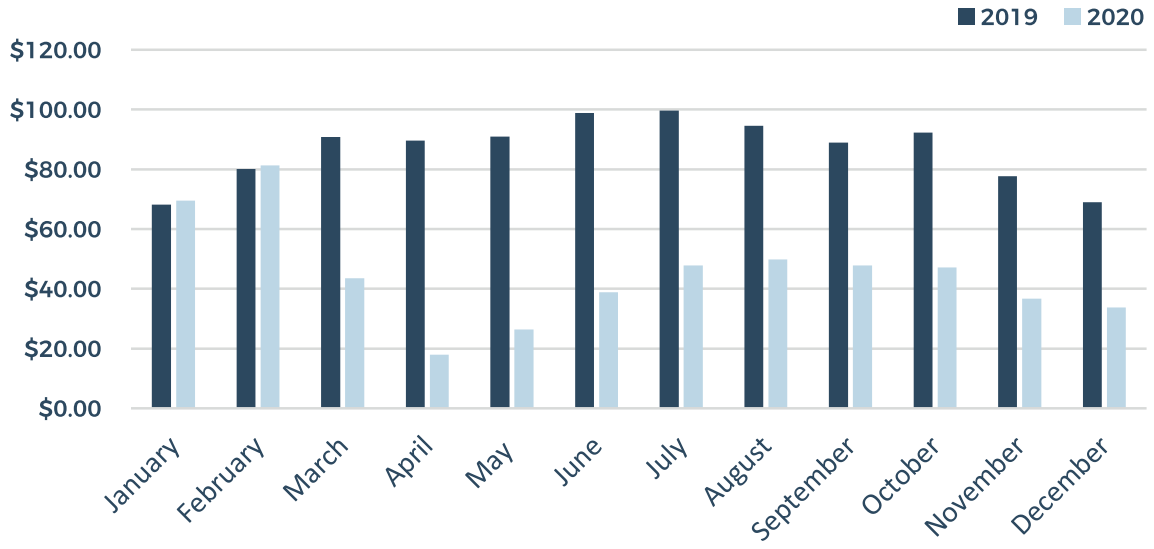
Source: STR, A CoStar company



APPENDIX

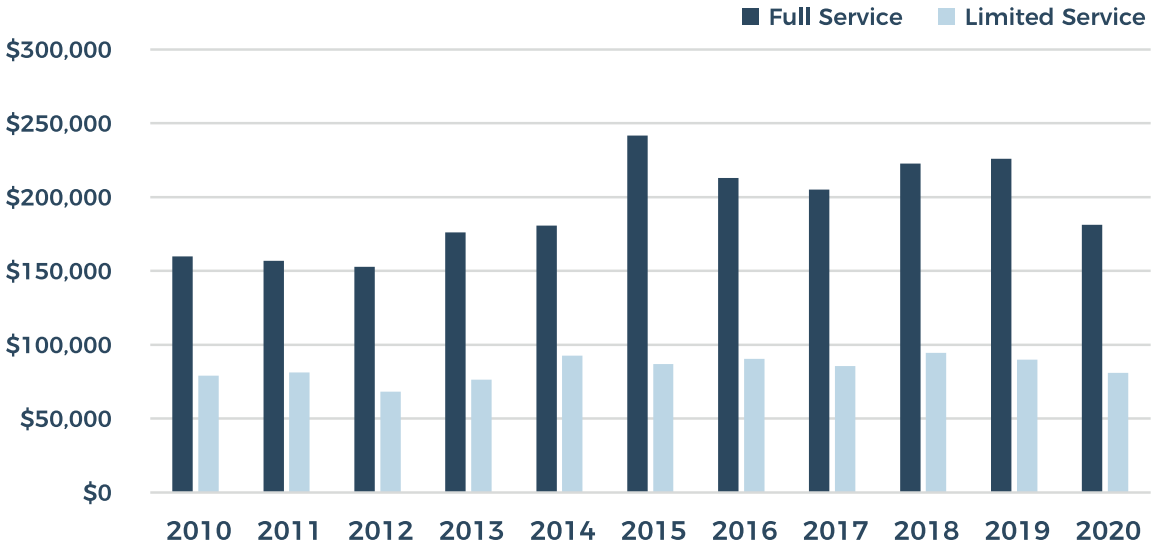
U.S. HOTEL INDUSTRY REVPAR - 2019 VS 2020

Source: STR, A CoStar company



U.S. HOTEL INDUSTRY - AVERAGE PRICE PER UNIT FULL-SERVICE AND LIMITED-SERVICE

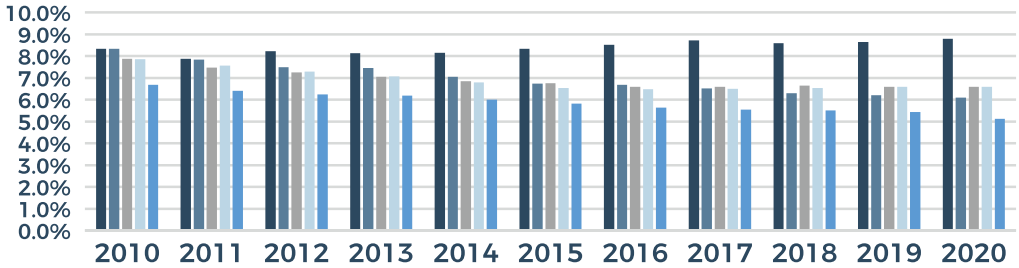
Source: Real Capital Analytics, www.rcanalytics.com



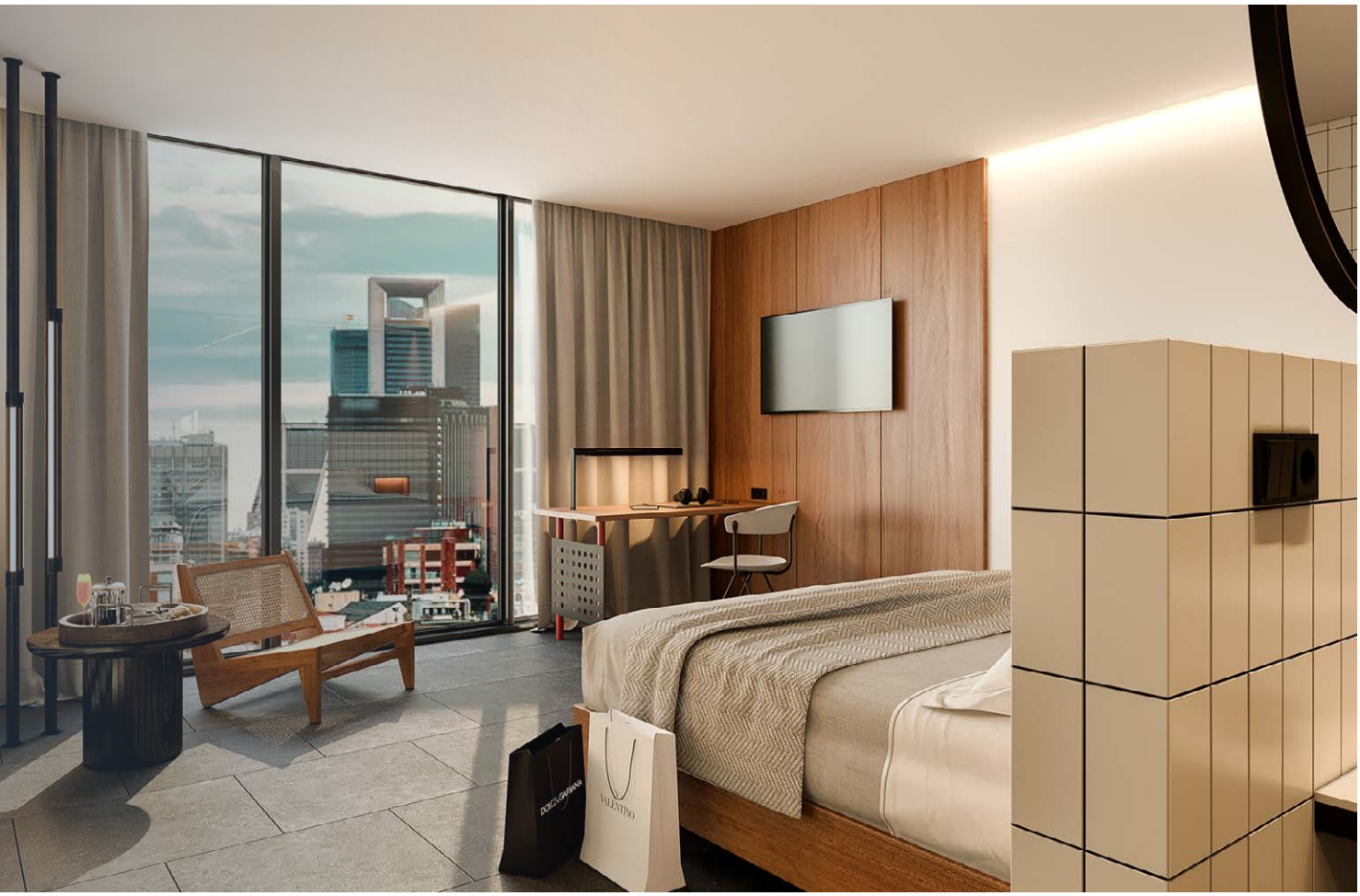
APPENDIX

ANNUAL CAP RATES

Source: Real Capital Analytics, www.rcanalytics.com

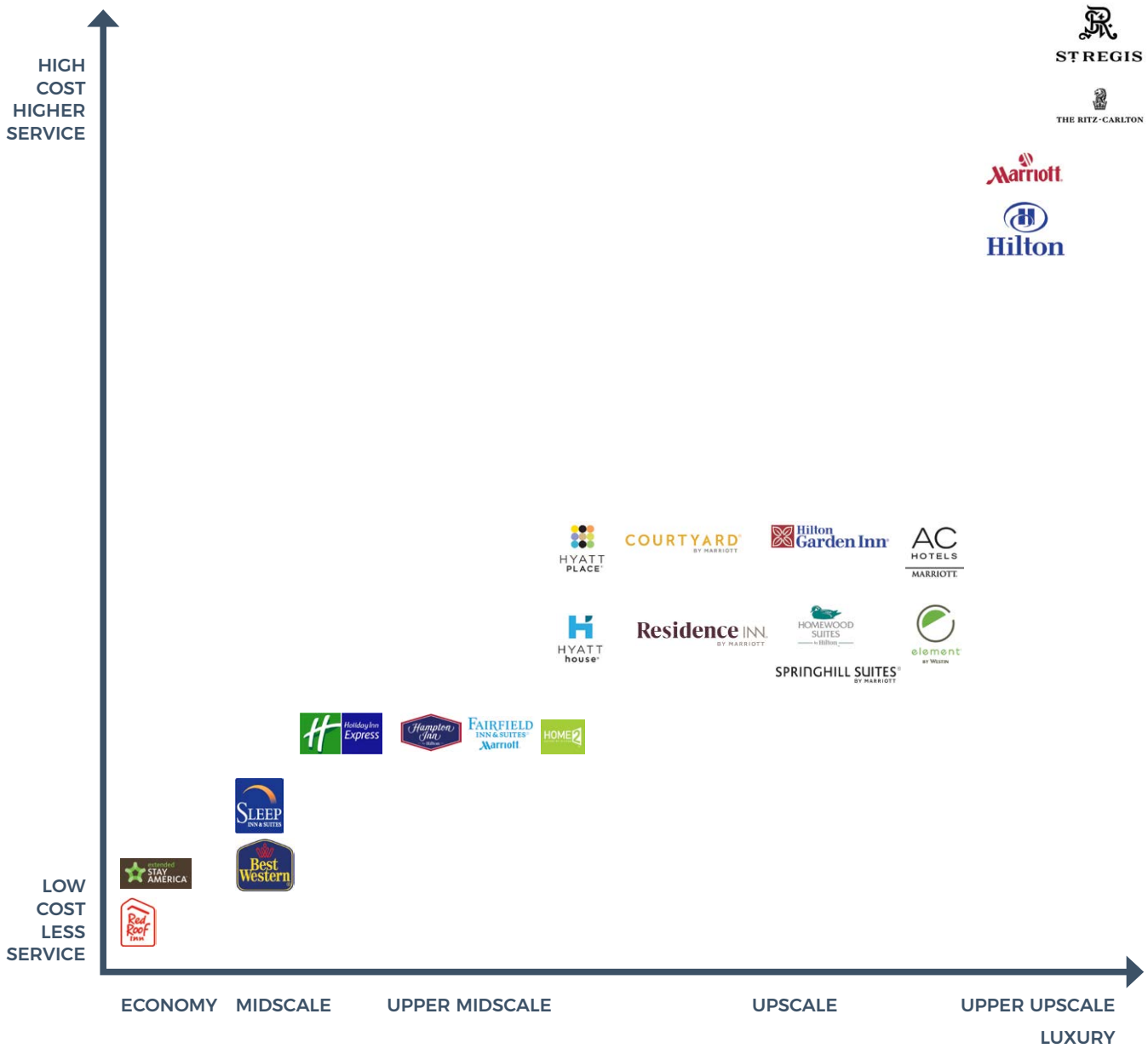


	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
HOTELS	8.3%	7.9%	8.2%	8.1%	8.2%	8.3%	8.5%	8.7%	8.6%	8.6%	8.8%
INDUSTRIAL	8.3%	7.8%	7.5%	7.5%	7.1%	6.7%	6.7%	6.5%	6.3%	6.2%	6.1%
OFFICE	7.9%	7.5%	7.3%	7.1%	6.9%	6.8%	6.6%	6.6%	6.6%	6.6%	6.6%
RETAIL	7.9%	7.6%	7.3%	7.1%	6.8%	6.5%	6.5%	6.5%	6.5%	6.6%	6.6%
APARTMENT	6.7%	6.4%	6.2%	6.2%	6.0%	5.8%	5.6%	5.5%	5.5%	5.4%	5.1%



APPENDIX

SELECT SAMPLE OF HOTELS BY CHAIN SCALE



END NOTES

[i] *Ting, D. (2018, May 7). Can Hotel Companies Have Too Many Brands? https://skift.com/2018/05/07/can-hotel-companies-have-too-many-brands/.*

[ii] *McCracken, S (2021, January 20). 2020 Sets Record for Worst Performance by U.S. Hotels. https://www.costar.com/article/385409699.*

[iii] *https://www.ahla.com/press-release/survey-71-hotels-wont-survive-another-six-months-without-further-government-covid.*

[iv] *Sell, G. (2020, November 30). Serviced apartment and extended stay industry trends for 2021. https://www.servicedapartmentnews.com/features/serviced-apartment-and-extended-stay-industry-trends-for-2021/.*

[v] *The Return on Investment of U.S. Business Travel. Prepared by Oxford Economics U.S.A.*

[vi] *CBRE Viewpoint: U.S. Hotels, https://www.cbre-ea.com/docs/default-source/ea-viewpoint-reports/cbre-ea-viewpoint-u-s-hotels_oct-2020.pdf?sfvrsn=2.*

[vii] *https://www.hvs.com/article/8910-us-hotel-development-cost-survey-2020.*

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