Marcus & Millichap

National Report

Hospitality Research

Midyear 2016

Investors Intensify Efforts as Hotel Sector's Pace of Growth Eases

Outlook positive as cycle shifts gears. The U.S. hospitality sector is in a new phase that will nonetheless continue to provide opportunities to improve property performance and enable owners to realize return objectives through a transaction. Slower rates of growth have supplanted the substantial gains recorded earlier in the cycle. In many markets, the occupancy rate is declining, often as supply growth outpaces more modest gains in occupied rooms than one year ago. As an infusion of new stock comes online in a number of markets in the near term, the U.S. economy provides a sufficient tailwind to support additional travel and demand increases. U.S. payrolls continue to grow and job openings, representing a pipeline of potential business travelers, hover near an all-time high. Positive trends in employment, and the ensuing lift it provides to consumer confidence, remain vigorous forces supporting hotel performance, but potential headwinds also exist. These include further stock market volatility and slower growth in corporate profits, which could lead to cuts in corporate travel budgets, and the potentially suppressive effect of a strong U.S. dollar on foreign inbound travel.

Capital inflows support a liquid investment market. A modest increase in transactions occurred over the past year. The yield on the 10-year U.S. Treasury resides near some of the lowest levels in decades. In addition, short-term lending benchmarks most closely tied to the actions of the Federal Reserve remain low while the central bank defers its next move, marking another positive development for hotel capital markets. In the investment marketplace, sales of branded hotels account for roughly two-thirds of hotel transactions. Upper midscale inns, which include Hampton Inn and Holiday Inn concepts, mark a point on the chain scale ladder where large and small investors converge, and they continue to command the greatest attention. In the full-service tier comprising upper upscale and luxury hotels, single-asset purchases remain a primary target for investors. Interest in independent properties is also keen as soft-brand initiatives proliferate and some investors weigh the capital outlays required in brand-imposed property refreshes against the benefits of brand affiliation. Meanwhile, approaching loan maturities on CMBS issued before the economic downturn may prompt additional listings of older assets in the coming months. Many of the maturing CMBS hotel loans were initially underwritten at higher leverage than is currently available to borrowers.

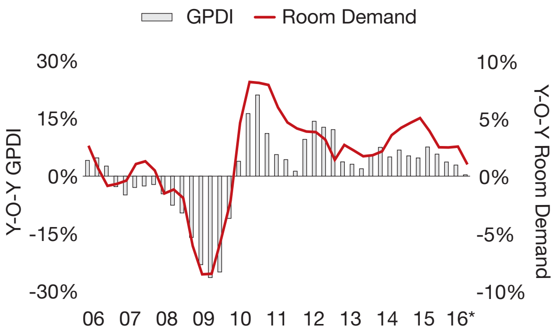
National Outlook

- **New Occupancy Peak in Sight.** Annual occupancy in U.S. hotels will advance 30 basis points this year to 65.8 percent, the highest annual level on record. RevPAR growth will come under additional pressure as available rooms increase. The projected 4.5 percent gain this year will be driven almost entirely by higher ADR.
- **Economic Expansion Continues, Fueling Hotel Sector.** Through the first half of the year, U.S. employers remain on pace to hire 2.1 million workers in 2016. The stable labor market and the emergence of the millennials as a potent economic force will drive consumption trends and support GDP growth in the 2 percent range this year.
- **Construction Pipeline Full.** Roughly 100,000 rooms are slated for completion this year, comprising primarily select-service hotels, but a topic of potentially greater interest may be the 210,000 rooms nationwide that are planned and in conceptual stages. As the hotel cycle matures and the performance of recently completed hotels becomes known, many construction lenders may hesitate to fund additional projects.

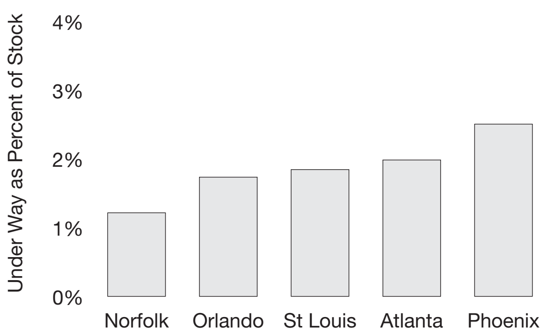
Metrics	2015	2016*
Occupancy	65.5%	65.8%
Demand Growth	2.9%	2.0%
Supply Growth	1.1%	1.6%
Average Daily Rate	$120.05	$124.97
Annual Change	4.5%	4.1%
RevPAR	$78.67	$82.24
Annual Change	6.3%	4.5%
Revenue Growth	7.4%	6.2%

* Forecast

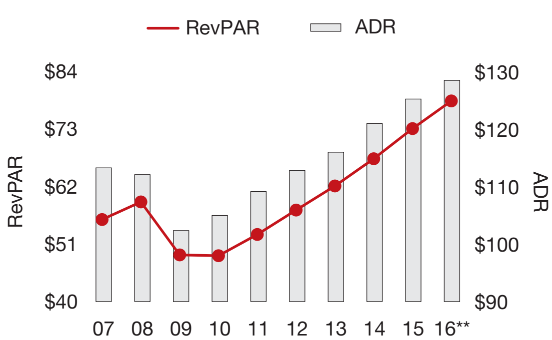
Business Spending Slows



Smallest Construction Pipelines



Annual ADR & RevPAR Rising



* First Quarter
** Forecast

National Economy

The steady growth of the U.S. economy is driving improvements in U.S. hotels. An average of nearly 200,000 jobs were added monthly over the past 12 months, increasing the pipeline of potential travelers for business and providing paid time off benefits for leisure trips. However, the increases in occupancy, ADR and RevPAR have moderated greatly from the high levels posted earlier in the cycle, leaving a smaller cushion to absorb any unanticipated disruptions to travel and room demand. While the consumers appear in sound shape to fuel economic growth due to consistent gains in spending, indicators of business travel remain challenging to read. Gauges of manufacturing and service sector activity are in expansion territory, an unequivocally positive sign. Gross private domestic investment, a proxy for business spending that tracks room demand, has lost momentum, however, adding an element of uncertainty to the outlook for business travel. The slower rate of growth primarily reflects a drop in purchases of equipment for oil-and-gas extraction, and hotels in energy-producing regions are indeed feeling the effects of a slowdown. Spending by expanding office-using establishments is rising modestly, but travel budgets appear to be flat. Recent earnings calls by hotel companies highlighted slowing growth in transient business travel.

Occupancy Trends

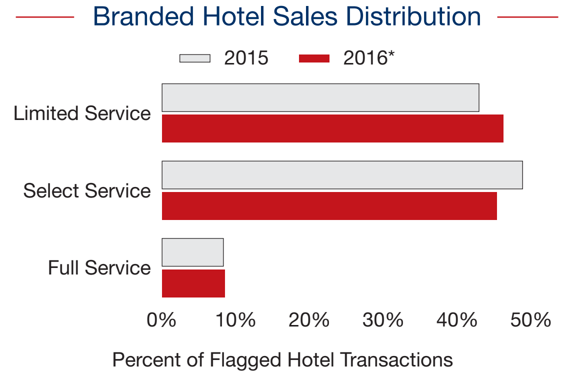
Travelers filled a record number of rooms in the first half of 2016, prompting a rise in the U.S. occupancy rate to 65.1 percent during the period. The 1.5 percent increase in available rooms in the first two quarters reflects mostly new property openings but also counts hotel expansions and re-openings. Nearly half of the 25 largest markets posted a decline in occupancy in the first half, primarily as a consequence of greater growth in available rooms. Large markets countering the trend and posting an increase in occupancy in the first two quarters include those with vibrant mixes of leisure and business demand drivers, including the robust Dallas market, Los Angeles, New York City and Washington, D.C. Significant pipelines of hotels under construction will continue to weigh down prospects of occupancy growth in several markets in the near term. However, other markets with comparatively subdued construction enjoy prospects of higher demand-driven occupancy. Markets with relatively light hotel development include Orlando and Atlanta, in addition to San Diego and San Francisco, where supply constraints, high land costs and tight housing markets often work against hotel development.

Revenue Trends

Revenue performance was mixed in the first half of 2016. Even as occupancy reached an all-time recorded high for the period, additional guests in rooms have not significantly translated into greater pricing power and substantially higher RevPAR. ADR and RevPAR each increased 3.1 percent during the first half of the year and the trailing-12-month growth rates for each metric continued to ease from peak levels registered earlier in the cycle. Markets outside the 25 largest outperformed their larger counterparts during the first half, partly reflecting lower negotiated rates for foreign tour groups in some of the large international gateways, including New York City. Other anomalies include the superior performance of independent hotels, where RevPAR rose 4.0 percent year to date to surpass the 2.7 percent bump in upscale and upper midscale inns, the top performance among affiliated hotels. Luxury hotels posted only nominal gains in revenue measures, perhaps reflecting a migration of travelers to the lower-priced accommodations that have become more prevalent in most markets.

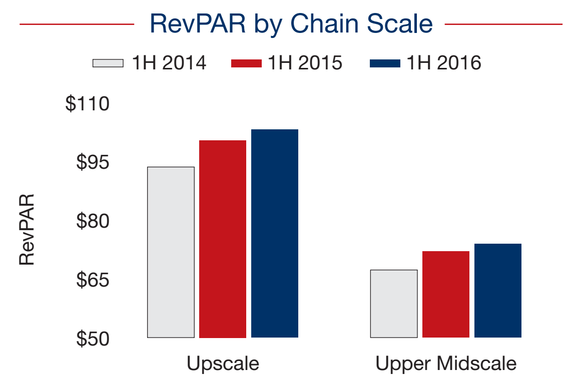
Investment Trends

Ongoing flows of debt and equity and opportunities to enhance property performance are supporting a vibrant hotel investment market, driving a slight acceleration in transaction velocity over the past 12 months. Flagged limited-service properties, which comprise the economy and midscale chain scales, posted the most significant jump in deals over the past year, illustrating the presence of small private capital and their ability to access acquisition debt. Hotels at this end of the chain scale ladder could offer some operating advantages in the near term due to limited competition from new supply and an overall ADR that fits a wide range of travel budgets. In the next-highest tier, the share of flagged hotel deals attributable to select-service inns decreased modestly over the past year on a drop in upscale transactions. The upscale tier includes popular brands Courtyard by Marriott and Hilton Garden Inn and comprises the largest share of rooms under construction. Supply growth has slowed the pace of RevPAR gains and will continue to prompt longer due-diligence periods by prospective buyers to gauge the impact of new competition. Sales of upper midscale assets, meanwhile, rose over the past 12 months, with Holiday Inn concepts and Hampton Inn the brands closing most frequently.



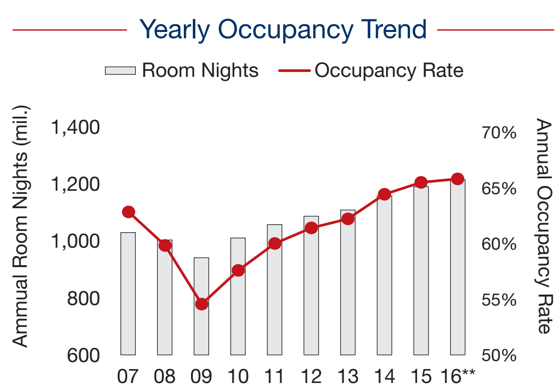
Industry Segment Spotlight: Select Service

Select-service hotels, consisting of the upper midscale and upscale chains, retain immense appeal among investors and developers for their profitability, lean operations and flexible designs that can be fit into a range of markets and locations. These virtues by themselves could support a further expansion of the select-service construction pipeline, already the largest in the industry, over the coming months. As evidence of the steadfast popularity of the select-service model, the number of planned rooms climbed to more than 80,000 over the past year. The expansion occurred at a time when RevPAR growth clearly slowed, a development that may yet encourage construction lenders to re-evaluate proposals and deny funding for specific projects that offer diminished prospects of fulfilling performance projections. After rising more than 6 percent in the first half last year, upscale RevPAR grew in the high-2 percent range in 2016. In the upper midscale segment, where occupancy often accounts for a larger share of RevPAR growth, RevPAR year to date grew at an identical pace.



2016 National Forecast

The U.S. economy has proved resilient throughout this cycle, hurdling numerous obstacles ranging from a federal government shutdown to financial markets' susceptibility to periodic bouts of volatility. Events abroad also periodically weigh on the outlooks of U.S. business and consumers, and the effects of the Brexit vote have clearly yet to entirely play out. However, a decline in travel from the U.K. and countries in the Euro zone could become more evident in bookings at U.S. hotels in the coming months. Against the backdrop of a choppy pattern of domestic economic growth and international uncertainty, the U.S. hotel sector will post modest gains in all key performance measures this year. Room demand will grow 2.0 percent in 2016 to offset an increase in construction, yielding a 30-basis-point rise in annual occupancy to 65.8 percent. Revenue measures will gain traction through the peak summer travel season and early fall, with ADR and RevPAR forecast to gain 4.1 percent and 4.5 percent, respectively. Over the near term, rising completions will slow occupancy growth and further compress gains in RevPAR.



* Trailing 12 months to 1Q
** Forecast

Marcus & Millichap

Capital Markets

By WILLIAM E. HUGHES, Senior Vice President, Marcus & Millichap Capital Corporation

- The unanticipated outcome of the Brexit vote disrupted the Federal Reserve's campaign to normalize monetary policy. As expected, the central bank did not elect to raise its short-term lending benchmark at its July meeting, and prospects of a rate increase in September have also diminished. A flight-to-safety bid into the 10-year U.S. Treasury in the days following the outcome in the U.K. lowered the yield on the 10-year to the mid-1 percent range and reduced the 10-year Treasury swap rate.
- Spreads on CMBS widened in the wake of Brexit but retraced to near pre-vote levels in the ensuing days. CMBS lenders continue to compete with local, regional and large national banks in the hotel sector. The minimum loan threshold starts at $5 million, and rates begin at roughly 325 basis points above the 10-year U.S. Treasury swap rate for top brands in the largest markets, and select well-sponsored transactions in secondary markets. Terms are five or 10 years, and leverage is capped at 70 percent.
- Banks continue to monitor the concentration of hotel loans on their books as demand in some segments of the economy wanes. Local and regional banks will loan a maximum of $10 million for hotel transactions, while large national banks can provide up to $30 million. Leverage on senior debt can reach 65 percent for the best transactions. Loan terms vary from three to seven years at rates that typically range from 250 to 300 basis points above the corresponding U.S. Treasury yield or the U.S. prime rate. Non-recourse financing is also provided to qualified borrowers in select circumstances.

Recent Marcus & Millichap Transactions

Hotel Name	State	Rooms
Holiday Inn/Express Fargo Portfolio	ND	387
Holiday Inn	LA	334
Fairfield Inn & Suites Portfolio	CO	225
Hotel	WI	180
Red Roof Inn DFW Airport North	TX	156
Comfort Inn	UT	155
Hampton Inn Nashville Downtown	TN	154
Howard Johnson	IL	152
Aloft Cool Springs Nashville	TN	143
Quality Inn & Suites Pensacola	FL	142
Clarion Inn & Suites	FL	140
Courtyard Fairfield Napa Valley Area	CA	137
Oak Mountain Lodge	AL	130
Econo Lodge Six Flags Arlington	TX	130
Days Inn	LA	123
Best Western Savannah Gateway	GA	120
Hampton Inn Atlanta Airport West	GA	119
Holiday Inn & Suites Lima	OH	116
Whitten Inn	SC	107
Airport Inn & Suites	OK	100
Best Western Plus King's Inn & Suites	AZ	100
Quality Inn Bedford	IN	97
Holiday Inn Express & Suites	FL	95
Hampton Inn & Suites	FL	94

National Hospitality Group

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