Real Estate Hotels

Select-Service Bullishness, Open Debt Markets Highlight Lodging Conference

- **After 15 meetings with private hotel companies at the annual Lodging Conference in Phoenix, we remain long-term bulls on the hotel industry but acknowledge the likelihood of near-term bumpiness through 1Q13.** Though the tone of our meetings was significantly more positive than those we held a year ago, each of the participants highlighted common themes that suggest investors should maintain a cautious approach for now. Even as concerns over the European debt crisis fade slightly, the overwhelming growth rates in national debt have made hotel leaders philosophically worried about the ultimate consequences on private industry. With that said, RevPAR growth expectations for next year appear to have a floor of 5% and large lenders remain conservative in their underwriting, which should keep new supply growth in check for the next several years and expand the longevity of the cycle, in our view.
- **Group bookings remain short-term oriented.** The cautiousness of business leaders nationwide appears to manifest itself in the unwillingness of meeting planners to book large group events over a year in advance. Group rooms compression has not appeared to become an issue yet (though the number of meetings are up, the size of the meetings are down), and questions linger as to whether we are now headed into a structural shift whereby group books of business cease to exist at the same levels of prior years. Until that happens, a cap will be on ADR growth, in our view.
- **Select-service all the rage.** Though there remains dispute as to whether select-service portfolios trading at 7.0% cap rates are "frothy," most industry participants agreed that we are in the midst of a secular consumer shift towards the product. Portfolio deals can fetch as much as a 150 bps premium above one-off select-service transactions, suggesting the valuation of select-service portfolios for REITs such as INN and HT could actually be understated.
- **Private equity remains yield-focused.** With cash-rich private equity funds looking to fill 10%-12% unleveraged IRR targets and unable to compete for assets in gateway markets, secondary market acquisitions have become an "epic" buy. The debt markets are wide open for strong sponsors with a track record; common financing terms we heard were ~65% LTV for five-year paper at sub-5% yields. The takeaways for public REITs: non-core asset sales should continue finding willing buyers at decent cap rates.
- **No signs of new construction pickup (yet).** Though available financing for existing properties with compelling "stories" or stabilized cash flows is attractive, a widespread uptick in developing financing for new construction remains absent. Adaptive re-use projects with historic tax credits or EB-5 financing are examples of some creative tactics developers are finding around the lack of traditional financing.

Please refer to Appendix - Important Disclosures and Analyst Certification

David Loeb
dloeb@rwbaird.com
414.765.7063

Jonathan Pong
jpong@rwbaird.com
414.765.3552

Michael J. Bellisario
mbellisario@rwbaird.com
414.298.6130

Transaction Environment Tidbits

- **Attractive markets** with tailwinds for cap rate compression include San Francisco, Miami (South Beach as well as Downtown), West Los Angeles, Manhattan, Philadelphia and Boston.

- **Lukewarm markets** where brokers and private equity investors are spending longer to debate include Downtown Los Angeles and San Diego. The recently approved funding for a football stadium in Downtown Los Angeles has enhanced investor interest in the area, but the sentiment we glean is that the sustainability of demand and outlook for ADR growth remains questionable given the youth of the revitalization initiative in the area. In San Diego, airlift from core East Coast markets is a concern despite a near-perfect convention market with an excellent convention center, large and small hotels very nearby, and year-round 70-degree weather.

- **REITs have been active bidders for select-service assets in top-tier markets**; the Courtyard Miami that Hersha purchased also had bidding interest from at least three other REITs.

- **Private equity investors are increasingly** looking for select-service assets in secondary markets where financing (~65% LTV, <5% cost for five-year paper) is attractive and yields (8.5%-10.0% going-in cap rates) are conducive to funds meeting their IRR requirements (we heard up to 20% levered IRR and 10%-12% unlevered IRR as common hurdle rates). With private equity priced out of the full-service, top-tier market play, we believe there remains significant runway for cap rate maintenance (as low as ~7.5% cap rates, in some cases) or compression (in urban gateway markets). However, deal size is a concern for PE groups, who generally want to put out large blocks of equity matched with larger blocks of debt; this has led to significant premiums paid for portfolios of assets. Some portfolios where the assets would trade individually in the 8.5%-10.0% cap rate range have traded at 7.0%-8.5% caps.
  - **Public REITs** have also been seen at more bidding tables for assets outside of top markets than in prior quarters, according to some private industry sources. Though the inherent investment objective of a REIT trends towards acquiring "forever real estate," we believe some companies that have not traditionally acquired assets solely within top-15 markets are reevaluating their investment criteria in light of compressed cap rates in top markets and the availability of overlooked deals in secondary markets.

- **Private brands are focused on acquisition opportunities of sub-100 room boutique assets,** which are attracting minimal competition from REITs.

- **2013 RevPAR growth being underwritten at 3%-5% in most cases.** Although most executives we spoke to expect stronger RevPAR growth in the industry than what they underwrite in their due diligence process of potential acquisitions, the conservative manner in which potential acquisitions are being projected once against suggests this is a rational market nowhere near the "bubble" mentality of the last upcycle.

- **Cap rate compression** between select service assets in secondary markets versus primary markets are now ~150 bps tighter today than they were two years ago. Though one contact said that the "trade is gone" for secondary market select-service purchases (at least in bulk) and distressed sales that sell at a discount, the carry trade thesis remains intact given the low-yield environment. One private equity investor noted that the smallest deal size the firm would transact would be in the $100 million range (with a $30 million equity outlay) -- suggesting portfolio deals where brain damage is minimized could sell at a premium (one contact mentioned as much as a ~150 bps premium for portfolio deals relative to one-off deals).

- **Deep-turn repositioners continuing to push for opportunities, but window beginning to close.** Most industry participants believe the lodging cycle is in the fourth or fifth inning of the cycle and the repositioning trade of buying a B- asset and turning it into a B+ asset remains popular in some circles, but the buying window for operationally challenged deals is starting to close. As buyers consider their exit opportunity, they are becoming less inclined to hold for an extended period of time as the cycle moves towards its latter stages and future fund liquidity needs are considered. This sets up for an interesting dynamic as we evaluate future REIT purchases and whether those assets with perceived deep-turn upside can be had for higher cap rates without the same private equity bidding pressure.

Financing Spigot Open, but Underwriting Conservative

- **Lender activity continues to be dominated by the large balance sheet-driven names** (Wells Fargo and Bank of America in particular). Terms are attractive -- in addition to the sub-5% coupon, five-year term loans with up to 70% LTV, lenders are increasingly willing to underwrite new originations in markets outside the top 25, though the bias towards gateway coastal markets is still prevalent.

- ***Other financing-related tidbits from the conference*** *lead us to believe debt is rational and conditions on the ground suggest we are far from reaching overly aggressive lending practices. For instance:*
  - Construction debt remains recourse to the developer and difficult to obtain
  - Lenders are underwriting at least 10% going-in debt yields, stabilizing to 13.5%
  - Preference towards top-25, urban, upscale & above hotels with RevPAR penetration above 100
  - Boutique hotels in top markets are an attractive segment (preferred over luxury hotels)
  - Hotel interest rate premiums are at 150-200 bps above other real estate classes
  - Balance sheet lenders are waiting for the CMBS market to recover before underwriting new construction loans
  - One large lender remarked that it does not underwrite NOI growth for new originations on stabilized properties (the lender acknowledged that it could lose out on deals as a result but that the practice keeps its risk premium down)

Group Business Trends Remain Sluggish

- **Rate growth still sluggish for group meetings -- "Cost containment" the operative word.** We met with a large group meeting procurement planner during the conference and learned that while the number of group meetings are up and there has been some improvement in the bookings pace, we remain far from peak conditions and it remains unclear as to whether meeting planners will ever book events as far in advance as in the past. Bottom line, travel policies continue to tighten and pricing power is constrained for every component of group event (rooms, F&B, ancillary equipment rentals).

- **On the positive side,** consumption is growing faster than bookings (suggesting pricing power is holding) and there have been no cancellation inquiries. The number of group meetings have also grown, though bookings have been more geared towards the short-term variety, holding back operators' ability to push rate more aggressively.
- **Las Vegas is getting much smarter about attracting group business, at the expense of the rest of the country.** As we feared, Las Vegas has geared up to capture group business, and the market is succeeding at gaining share. Las Vegas' gains may be masking better group booking trends than are perceived from analyzing public non-gaming hotel companies (with virtually no exposure to the market) and STR data which excludes Las Vegas. There is a strong group recovery underway in Las Vegas, as casino operators, the city and the CVB work together to attract groups to fill their ample capacity and to allow for hotel-style yield management of remaining room inventory.
- **Flexibility of meeting planners forcing hotels to adapt, lock-in lower-rated business.** One interesting comment we heard from a group meeting planner is that "hotel revenue managers lose their bonus for missing on rate, but lose their job for missing on occupancy." Meeting planners of large corporations have been more willing than in prior years to be flexible with dates, venues, and

locations of group events. With general business confidence lacking among large corporations who would otherwise provide a base of business on the books, revenue managers at hotels have been unwilling to push rate (for both short-term group and transient business) for fear of losing occupancy.

- **Lower-rated association meeting planners taking advantage.** With hotel operators risk-averse, meeting planners from lower-rated associations have been booking group slots up to *eight* years in advance, a dynamic unique to this cycle and indicative of the lack of long duration group meeting bookings that have been booked with preferred industries.

- **Fallout from GSA hotel scandals have hurt.** Government-mandated cutbacks on travel have caused either outright cancellations of conventions or resulted in drastically scaled-down versions of previously planned events. According to our source, some meeting planners of government-sponsored events are waiting until after the election to make decisions once clarity on the convention policy is achieved.

- **Industries that continue to spend on group meetings include technology, insurance, retail, and pharma.** We believe this bodes well for the hotel industry in San Francisco and Boston in particular.

Appendix - Important Disclosures and Analyst Certification

Robert W. Baird & Co. Incorporated and/or its affiliates expect to receive or intend to seek investment banking related compensation from the company or companies mentioned in this report within the next three months.
Robert W. Baird & Co. Incorporated may not be licensed to execute transactions in all foreign listed securities directly. Transactions in foreign listed securities may be prohibited for residents of the United States. Please contact a Baird representative for more information.
Investment Ratings: Outperform (O) - Expected to outperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months. **Neutral (N)** - Expected to perform in line with the broader U.S. equity market over the next 12 months. **Underperform (U)** - Expected to underperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.
Risk Ratings: L - Lower Risk - Higher-quality companies for investors seeking capital appreciation or income with an emphasis on safety. Company characteristics may include: stable earnings, conservative balance sheets, and an established history of revenue and earnings. A - **Average Risk** - Growth situations for investors seeking capital appreciation with an emphasis on safety. Company characteristics may include: moderate volatility, modest balance-sheet leverage, and stable patterns of revenue and earnings. **H - Higher Risk** - Higher-growth situations appropriate for investors seeking capital appreciation with the acceptance of risk. Company characteristics may include: higher balance-sheet leverage, dynamic business environments, and higher levels of earnings and price volatility. **S - Speculative Risk** - High-growth situations appropriate only for investors willing to accept a high degree of volatility and risk. Company characteristics may include: unpredictable earnings, small capitalization, aggressive growth strategies, rapidly changing market dynamics, high leverage, extreme price volatility and unknown competitive challenges.
Valuation, Ratings and Risks. The recommendation and price target contained within this report are based on a time horizon of 12 months but there is no guarantee the objective will be achieved within the specified time horizon. Price targets are determined by a subjective review of fundamental and/or quantitative factors of the issuer, its industry, and the security type. A variety of methods may be used to determine the value of a security including, but not limited to, discounted cash flow, earnings multiples, peer group comparisons, and sum of the parts. Overall market risk, interest rate risk, and general economic risks impact all securities. Specific information regarding the price target and recommendation is provided in the text of our most recent research report.
Distribution of Investment Ratings. As of September 28, 2012, Baird U.S. Equity Research covered 678 companies, with 52% rated Outperform/Buy, 47% rated Neutral/Hold and 1% rated Underperform/Sell. Within these rating categories, 13% of Outperform/Buy-rated, 8% of Neutral/Hold-rated and 11% of Underperform/Sell rated companies have compensated Baird for investment banking services in the past 12 months and/or Baird managed or co-managed a public offering of securities for these companies in the past 12 months.
Analyst Compensation. Analyst compensation is based on: 1) The correlation between the analyst's recommendations and stock price performance; 2) Ratings and direct feedback from our investing clients, our institutional and retail sales force (as applicable) and from independent rating services; 3) The analyst's productivity, including the quality of the analyst's research and the analyst's contribution to the growth and development of our overall research effort and 4) Compliance with all of Robert W. Baird's internal policies and procedures. This compensation criteria and actual compensation is reviewed and approved on an annual basis by Baird's Research Oversight Committee.
Analyst compensation is derived from all revenue sources of the firm, including revenues from investment banking. Baird does not compensate research analysts based on specific investment banking transactions.
A complete listing of all companies covered by Baird U.S. Equity Research and applicable research disclosures can be accessed at http://www.rwbaird.com/research-insights/research/coverage/research-disclosure.aspx .
You can also call 1-800-792-2473 or write: Robert W. Baird & Co., Equity Research, 24th Floor, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.
Analyst Certification. The senior research analyst(s) certifies that the views expressed in this research report and/or financial model accurately reflect such senior analyst's personal views about the subject securities or issuers and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
Disclaimers
Baird prohibits analysts from owning stock in companies they cover.
This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.
ADDITIONAL INFORMATION ON COMPANIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST
The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available.
Baird is exempt from the requirement to hold an Australian financial services license. Baird is regulated by the United States Securities and Exchange Commission, FINRA, and various other self-regulatory organizations and those laws and regulations may differ from Australian laws. This report has been prepared in accordance with the laws and regulations governing United States broker-dealers and not Australian laws.

Other Disclosures
The information and rating included in this report represent the Analyst's long-term (12 month) view as described above. The research analyst(s) named in this report may at times, discuss, at the request of our clients, including Robert W. Baird & Co. salespersons and

traders, or may have discussed in this report, certain trading strategies based on catalysts or events that may have a near-term impact on the market price of the equity securities discussed in this report. These trading strategies may differ from the analysts' published price target or rating for such securities. Any such trading strategies are distinct from and do not affect the analysts' fundamental long-term (12 month) rating for such securities, as described above. In addition, Robert W. Baird & Co. Incorporated and/or its affiliates (Baird) may provide to certain clients additional or research supplemental products or services, such as outlooks, commentaries and other detailed analyses, which focus on covered stocks, companies, industries or sectors. Not all clients who receive our standard company-specific research reports are eligible to receive these additional or supplemental products or services. Baird determines in its sole discretion the clients who will receive additional or supplemental products or services, in light of various factors including the size and scope of the client relationships. These additional or supplemental products or services may feature different analytical or research techniques and information than are contained in Baird's standard research reports. Any ratings and recommendations contained in such additional or research supplemental products are consistent with the Analyst's long-term ratings and recommendations contained in more broadly disseminated standard research reports.

UK disclosure requirements for the purpose of distributing this research into the UK and other countries for which Robert W. Baird Limited holds an ISD passport.

This report is for distribution into the United Kingdom only to persons who fall within Article 19 or Article 49(2) of the Financial Services and Markets Act 2000 (financial promotion) order 2001 being persons who are investment professionals and may not be distributed to private clients. Issued in the United Kingdom by Robert W. Baird Limited, which has offices at Mint House 77 Mansell Street, London, E1 8AF, and is a company authorized and regulated by the Financial Services Authority. For the purposes of the Financial Services Authority requirements, this investment research report is classified as objective.

Robert W. Baird Limited ("RWBL") is exempt from the requirement to hold an Australian financial services license. RWBL is regulated by the Financial Services Authority ("FSA") under UK laws and those laws may differ from Australian laws. This document has been prepared in accordance with FSA requirements and not Australian laws.

Ask the analyst a question

Click here to unsubscribe