

VIDEO SERIES

Briefing



Five Factors Driving The Hospitality Sector

An executive summary of the PrivcapRE video series
"Investing in Hospitality Real Estate"



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Five Factors Driving The Hospitality Sector

Key Findings

1. Capital is flowing into hospitality
2. There are three key fundamentals to look out for
3. Premium and select-service properties provide long-term investment performance
4. Data is the best defense against hospitality disruptors
5. Rebranding and renovation should be considered before a deal is done

The Panelists



John McCourt
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Mit Shah
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Cheryl Boyer
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1 CAPITAL IS FLOWING INTO HOSPITALITY

The robust growth in the hospitality sector has sparked interest from investors, both domestic and international. “It’s attracting capital from sources who may have shied away from the asset class in the past,” says John McCourt, an audit partner at RSM US LLP. “Even [from] as far [away] as China where they’ve eased restrictions on outward investing. And from what we’re seeing from our own client base, there are several hospitality transactions happening at the moment.”

Cheryl Boyer, the chief operating officer at Fulcrum Hospitality LLC, agrees with McCourt. However, she thinks the kinds of transactions driving the market are focused on ultra-luxury properties. “In New York City alone we’ve seen iconic brands change hands, like the Waldorf-Astoria and The New York Palace,” she says. She believes that investors are looking at a long-term hold on those properties, indicating continued growth in the asset class.

McCourt also expects demand to be driven by macro-level sources. “The amount of debt that needs to be refinanced is a key driver, and over the next three years there are a lot of leveraged assets out there that will need to be refinanced, and that can be a catalyst for transactions,” he says.

2 THERE ARE THREE KEY FUNDAMENTALS TO LOOK OUT FOR

Investors, first and foremost, want to know the underlying drivers pushing a real estate food group before committing to one, and in hospitality, fundamentals matter the most.

While the Average Daily Rate and Revenue per Available Room (RevPAR) are the industry standards when it comes to indicators of performance, Fulcrum Hospitality’s Boyer says it’s imperative to dig deeper than just the indices. “One of the things we look at are operating fundamentals,” she says. “How [much] are the hotels occupied? What rates are they able to charge and what is driving the growth in RevPAR? The economic recovery has been moving very well, and we’re having another great year of top-line performance and, hopefully, profit.”

RSM’s McCourt says there’s reason to remain optimistic for the next three years. “RevPAR in 2014 was up 8 percent



Lodging Is Very Specialized Business

Mit Shah
Noble Investment Group

Unlike other real estate asset classes, lodging is a real operating business, says Noble Investment Group’s Mit Shah. The most successful lodging real estate owners today, he says, have an operating acumen where it pertains to revenue management and making sure you have the right general manager on the property.

“Lodging is a very specialized business,” he says. “It’s not a real estate class that you say, ‘Cap rates on retail and office are getting too low, let me just go over to lodging because it’s trading at 200 basis points higher.’”

You not only have to find hotels in the right locations in the best markets, but you have to find the right brand, says Shah. “You’ve got to make sure that you’re in tune with the brand, and what they’re doing to protect value today, but also looking five, 10 years from now as you’re trying to execute your business plan.”

Protecting value can include loyalty programs, but it also means paying attention to the next generation of traveler who might not use rewards programs at all. “They may want the same amenities, but they’re entering the business through online programs that may not be associated with one brand,” he adds.

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Value Creation Can Take On Many Forms

Cheryl Boyer
Fulcrum Hospitality

Value creation can take several different forms when you're talking about a hotel, including rebranding and renovating. New owners should immediately start looking at what can be improved on from the second they close, says Fulcrum Hospitality's Cheryl Boyer.

"Changing brands isn't always the answer," she says. "Sometimes you have to change the management company. Maybe it's the property itself that needs a landscape makeover, or you may want to [reconceptualize] food and beverage and add function space. The list goes on and on."

There are potential untapped areas that can create value in a lodging property, and once those decisions have been made and the improvements are in the works, formulating an investment thesis on how you're going to increase the value of the property over the next five to 10 years and executing a business plan becomes the priority.

Boyer says many private equity investors will back proven developers instead of taking an operational stance on an acquisition. "Sometimes it's a programmatic investment," she says. "Because in some markets you're evaluating if you're at replacement cost, or if you are better off building new."

from 2013, and in 2015 it's expected to grow between 5 and 8 percent, and the outlook on supply is anticipated to meet the demand for rooms during 2017," he says.

But Noble Investment Group CEO Mit Shah says just riding the wave of good times is not enough to be successful. "In times like today where the fundamentals are outstanding, you could argue that just buying an asset and being focused on the rising tide is enough," says Shah, "but the most successful lodging real estate owners today are the ones that have a real operating acumen for revenue management and operational management."

Shah believes that the hospitality industry as a whole has not been growing great operating leaders at the rate that it did in the past, and terms this lack of leaders "the most critical that it's ever been."

3 PREMIUM AND SELECT-SERVICE PROPERTIES PROVIDE LONG-TERM INVESTMENT PERFORMANCE

Although fancy brand names do not guarantee superior performance, Shah is confident that the long-term performance of upscale properties belies their ability to produce results through down cycles. "The thing that we like most about the select service and upscale categories is that we think it's secular, not cyclical," he says. "If you look at the majority of well-located top brands in the upscale, select-service, and extended-stay categories, they have been cash-flowing through the energy crisis of 1998, [through] the dot-com bust of 2000, after 9/11, and through the Great Recession, because of their strong operating models. We've been through a lot of cycles over 22 years, and we've always seen this sector perform and generate cash flow even in the worst of times."

Offering insights into the drivers for premium brands, Boyer says that "the mid-tier corporate travelers tend to fill rooms midweek. We're seeing that segment of the business is very strong right now. We observe it in air-traffic trends. Across the board, there is strong demand on the corporate side. Then the leisure segments and local business comes in on the weekends."

Boyer adds that, from an investor perspective, "this segment had a great ramp-up post-downturn. It's also the relatively young age of the product and the good level of upkeep that attracts consumers. Today there is also

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opportunity for private equity to invest more capital, and solidify the position of those hotels in various markets.”

4 DATA IS THE BEST DEFENSE AGAINST HOSPITALITY DISRUPTORS

The rise of the sharing economy has made Airbnb a force for the hospitality industry to contend with in just a few short years. However, as Airbnb grabs headlines, it's the companies with big data that might be best positioned as to be game changers.

“I don't think that it's going to have quite the disruption effect that a lot of people are anticipating,” says McCourt, who argues that many seasoned travelers don't have the appetite to switch from more traditional lodging. “Airbnb is a very successful company. However, I don't think the hotel industry is going after the same customer.”

Boyer believes Airbnb's greatest opportunity is in big markets where hotels get filled to capacity and travelers have to look for alternative lodging. “Airbnb inventory in markets like New York and San Francisco opens the market to a different type of customer, or offers an alternative lodging product to families that want to be together in an apartment versus an individual hotel room,” she says. “But that's less of an issue in the secondary markets that only get [filled] to capacity during local events.”

As demand for new services and amenities increases, companies that are able to gain superior customer insight might be the true disruptors to the traditional hospitality business. Shah sees the true power in big data. “The [online travel agencies] such as Expedia, Orbitz and Travelocity have been threats,” he says, “however, the sleeping giants are actually Google and Amazon. Their collection of data gives them the potential of truly getting to know consumer behavior. This is both a very interesting and scary proposition for what it could mean in terms of how hotel rooms are booked into the future.”

Both Shah and McCourt point out how smart operators are already keen on a data-driven mentality, gathering customer insights that help drive engagement and improve amenities. McCourt shares an anecdote that shows how social media can shape customer interaction. “Operators are using social insights from Facebook



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and Twitter or Instagram to find little tidbits about their guest's preferences and working to fulfill them," he says. "For instance, if a customer expresses on social media that they're a wine connoisseur, the operators might instruct staff to stock a bottle of wine as the guest checks in."

5 REBRANDING AND RENOVATION SHOULD BE CONSIDERED BEFORE A DEAL IS DONE

After the global financial crisis, investors have focused on due diligence. But hospitality may require unique insights when compared to food groups such as office or residential.

"A lot of investors and lenders are doing a lot better job of going through due diligence," RSM's McCourt says. "They're taking it very seriously and there is no longer a reliance on the fact that they think somebody else has done the diligence."

Understanding where the property is and where you think you can take it over the time of your investment is also one of the keys of due diligence, says Fulcrum's Boyer. "Are there opportunities to develop a business plan whereby you're changing the brand or the management company?" she asks. "Maybe you're investing capital to renovate and reposition the hotel. What's the thesis that's going to take the asset from where it is to grow the revenues, profit and value of that hotel over your whole horizon? The most important thing— at least fundamentally—on the due diligence side is trying to figure out how you are going to do that."

Shah says looking at the asset's income stream, and figuring out how to move it from X to Y, is a good starting point. "You have to be able to do it without relying on market growth," he says. "Even though most of the pundits will say that we have 5 percent of RevPAR growth on the horizon, you can't go into an asset assuming that will be the case." ■



Winning The Youngest Class Through Experience

John McCourt
RSM US LLP

With Airbnb in all of the headlines as the biggest disruptor in the hospitality sector, RSM's John McCourt says the biggest threat to operators and developers is ignoring the Millennials and Generation Y.

"It used to be that hotels would pour all of their capital into the guest rooms and everything was focused on making guests' stays the most comfortable inside the room," he says. "Now, what you're seeing are these huge, open-space lobbies where people can gather and then flow into different restaurants or bars as they make their way to their rooms."

McCourt also points to more established brands that create properties aimed at younger generations, like Canopy by Hilton. "That's one way to bring in those younger generations, and it's a great effort," he says. "Marriott is working with firms like Liquid-Space to build out work areas that are akin to a start-up business office, so that's an outside-of-the-box way of thinking."

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