JF CAPITAL ADVISORS

JF CAPITAL THOUGHTS: HOTEL SUPPLY AND DEMAND OBSERVATIONS IN A COVID-19 ENVIRONMENT

April 30, 2020

Historical Supply Growth

Over the past several years, hotel rooms supply growth has accelerated and has reached or exceeded long term average supply growth of 2.0%. Excessive amounts of new supply well above 2.0% has entered markets like New York and Nashville. Coupled with the available supply from Airbnb and other alternative accommodation providers, new supply growth has recently exceeded 4.0% annually.

Reopening of Closed Hotels

Many hotels, especially big-box group hotels, may not reopen that quickly, if at all:

- Many large group-oriented hotels may be converted to other higher margin, less volatile uses such as multi-family; especially for those with substantial amounts of meeting space and challenging union agreements.
- Hotels in highly seasonal markets may not reopen until the following year.
- Hotels near university campuses may not reopen until the universities reopen.
- Reopening a closed hotel involves a significant investment for recruiting, training, payroll, sales and marketing, room cleaning/preparation, inventories, clean-up of balance sheet accounts, and working capital; it may also require re-inspection and re-testing of fire and life safety systems by brands and the local municipalities.
- Reopening hotels in this environment will also include employee training and incremental expenses for safety and sanitization procedures.

Hotel demand is heavily influenced by GDP growth, capacity utilization, and consumer confidence. The US is experiencing substantial declines in GDP and capacity utilization which will have short-term and medium-term impacts on occupancy and ADR.

Each demand segment will recover at its own pace:

- **Leisure Transient:** Leisure transient demand will rebound due to pent up consumer demand; despite this rebound, leisure travelers will be value oriented due to concerns about the economy. Drive-to resorts will be favored destinations. Inbound international travel is expected to recover very slowly. Ongoing health concerns will restrain leisure travel as certain destinations including those with significant population density will continue to be considered dangerous.
- **Business Transient:** Business transient demand will recover with downward pressure on ADR and some restrictions on travel imposed by corporate

management due to financial, health and liability concerns; this will be further restrained by employees who are uncomfortable with potential exposure and health risks related to travel. International travel is expected to recovery very slowly.

- **Group:** Group business demand will recover last and with substantial ongoing recessionary headwinds reducing overall room nights, rates and F&B spend. Group will suffer from lingering health related issues, continued restrictions on the size of events, and ongoing social distancing guidelines, as well as significant financial pressures and concerns. Group business and large events likely will not re-emerge meaningfully until convention centers, stadiums and ballparks reopen for major events. This will likely occur after a COVID-19 vaccine is widely available.
- **Contract:** Contract business such as airline crew will return as airlines re-launch their operations. This business will recover slowly and in-line with increases in air travel. International crew business will be restrained for some period of time. Crew business, which usually commands low ADR's, will have the opportunity to negotiate ADR's lower, and will demand significant other concessions.

Hotel Closures

Prior to the COVID-19 pandemic, STR released interesting data showing the number of hotels closed each year:

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Over the past 15 years, the number of hotel closings have been trending downwards, though relative to the entire stock of rooms inventory, the number of closures has been minimal. Higher end hotels have generally been shut down only for conversion to residential condominiums. However, due to the impact of the Coronavirus, the number of permanent hotel closures will increase substantially in 2020 and 2021 (some of these closures will be permanent). We expect this historical limited-closure trend to reverse and for there to be many more hotel closures over the next few years. This is especially true for larger group and convention-oriented urban hotels in union markets.

New Construction

Given the difficulty in accurately projecting future growth, and overall economic uncertainty, construction lending for new hotels will slow considerably, reducing future hotel room supply growth.

- Historically, hotel rooms supply growth across the United States has averaged approximately 2.0% a year, though higher in some of the major markets.
- Many hotels under construction will require loan-rebalancing by lenders to address higher carry costs, slower expected ramp-up in operating performance and the need for additional reserves.
- For the next several years, new hotel rooms supply growth is likely to be well under 1.0% as lenders and developers will find the underwriting and cost basis for most new hotels to be challenging.

The hotel industry is not over-built, it is under-demolished. A lot of existing hotel product is obsolete and may finally be converted to other, more profitable, uses.

Home-Sharing as a Competitor

Airbnb and other home-sharing accommodations, has grown substantially over the past decade, adding significant amounts of competitive supply in many markets.

- It is unclear how customers will respond to Airbnb from a health, sanitation and safety perspective, as a result of the COVID-19 implications.
- Airbnb's future is unclear, as it had planned to execute an IPO, though as a result of the current environment, raised $2.0 billion of expensive high-yield capital including warrants at a depressed valuation; additionally, Airbnb announced a pivot to more long-term stays and less focus on short-term transient.

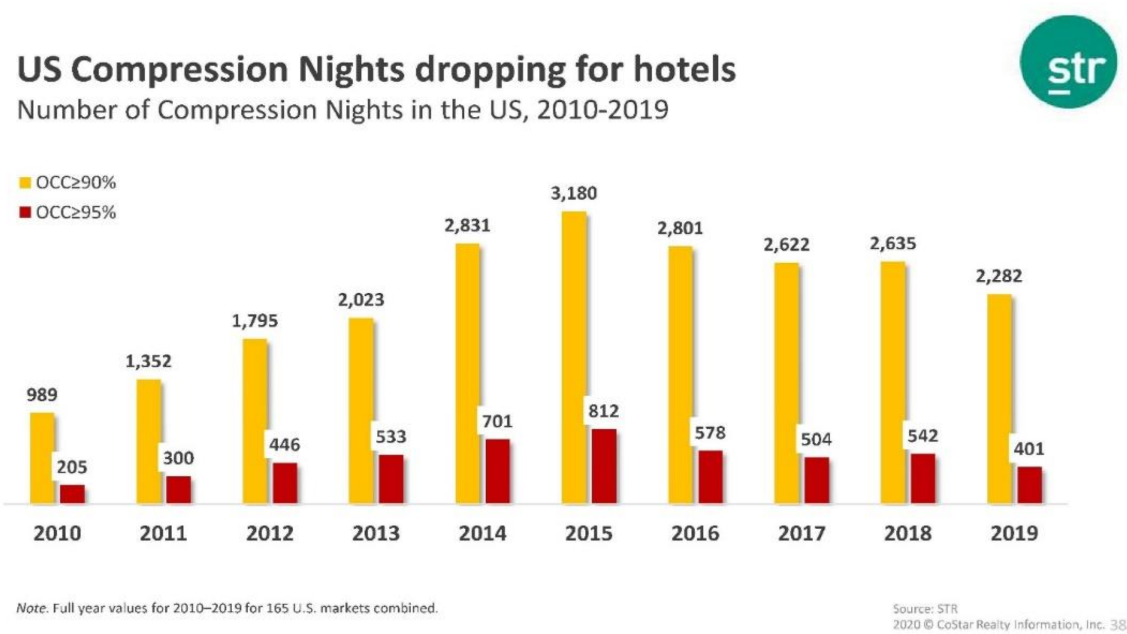
- It is unclear how aggressive hotel owners, associations, and the labor unions will be in reducing Airbnb's impact in the major markets; there have been some success stories and likely more to come.
- Many of the alternative accommodation providers are facing significant challenges in this operating environment and have laid off or furloughed substantial amounts of staff in order to reduce their cash burn rate.

Cruise Lines

Cruise operators are currently under a no-sail order from the CDC. Even when lifted, cruise lines will not use all of their inventory of ships and will experience significant concern with bookings especially from the older and more vulnerable population. All-inclusive and drive-to resorts will benefit from the slowdown in cruise operations.

Room Night Compression

Over the past decade, room night compression has declined significantly. Compression is generally described as the number of room nights with more than 95% occupancy. Compression is essential in order to yield substantially higher ADR.



Room night compression is likely to suffer in the short term but will likely increase in several years when the industry fully rebounds, with less new supply and many large hotels converted to other uses. This will also be significantly impacted should Airbnb and other alternative accommodation providers fail, or pivot away from short-term transient business.

If you would like to discuss hotel/supply dynamics and how they relate to your current or contemplated hotel debt or equity investments, I can be reached at jonathan@jfcap.com or at (917) 238-6917.

Stay Safe!

Jonathan Falik