HospitalityResearch
QUARTERLY UPDATE
Marcus & Millichap
National Report *Midyear 2014*

Growing Room Demand Outstripping Rise in Supply

With the economy gaining momentum during the second quarter, little appears to stand in the way of the U.S. hotel sector attaining new highs in occupied rooms and room revenue in 2014. At midyear, the demand trend is rather straightforward. Specifically, the expanding economy and strengthening job market will spark additional spending by businesses and consumers, helping to fill more hotel rooms. Group demand is also positioned to increase. What remains less clear, however, is whether new construction will prevent the sector from reaching even loftier heights than are currently anticipated. Supply growth nationwide has been restrained, prompting some reassessment of earlier projections that envisioned many more new rooms coming online by this point of the cycle and highlighting some of the competing forces at work here. For one, the revival of construction lending and the gradual rise in leverage on those loans will support additional deliveries in the quarters ahead. On the opposing side, lenders' selectivity regarding projects and development groups may ultimately limit the number of new rooms placed in service, while the window is narrowing for developers to complete projects and secure long-term financing at the current low interest rates.

Low interest rates, though, are drawing new sources of capital into the hotel sector and are sustaining intense bidding among existing property owners seeking to trade up or expand portfolios. Rising transaction and dollar volume along the lower chain scales illustrate an active group of small investors, while additional deals completed recently at the upper end reveal the presence of large investors. Debt sources remain focused on top brands in primary markets, but competition to expand market share is pushing lenders to follow selective sponsors into secondary and even tertiary markets more frequently than one year ago. Lender discipline remains evident and is helping maintain a close alignment between operating fundamentals and pricing. For their part, sellers and prospective buyers are also adhering to reasonable price expectations, and resistance frequently arises whenever asking prices are not justified by recent performance. Cash flowing assets are preferred by most lenders, leaving funding for transitional assets more challenging to source, especially in deals for less than $15 million.

National Outlook

	2013	2014*
Occupancy	62.2%	63.4%
Demand Growth	2.2%	2.9%
Supply Growth	0.7%	1.0%
Average Daily Rate	$110.34	$115.31
Annual Change	3.9%	4.5%
RevPAR	$68.65	$73.09
Annual Change	5.4%	6.5%
Revenue Growth	6.2%	7.5%

* *Forecast*
Sources: Marcus & Millichap Research Services, Smith Travel Research

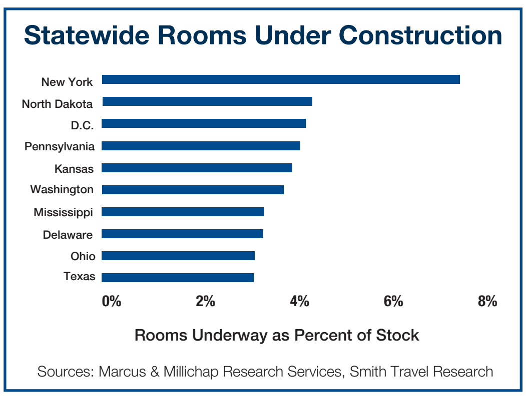
- **Economy Pumps Up Hotels.** An expanding economy will support GDP growth in the 3 percent range in 2014 and U.S. employers will add 2.7 million jobs, a gain of 2.0 percent. Additional business spending on travel and the recovery of vacation benefits by workers finding jobs recently will support strong room demand in 2014.
- **New Brands and Refreshes.** Early this year, Hilton launched its Curio concept that features independent hotels operating under the Hilton banner. Work also proceeds on the introduction of the AC Hotels by Marriott, with initial locations in Miami, Chicago, New Orleans and New York. As for brand tweaks, Red Roof Inn is rolling out its Plus+ concept for the best performing assets in its line, while Hampton Inn pushes its Forever Young Initiative.
- **Seeking Millennials.** The constant introduction of new concepts and re-configuring of existing formulas partly reflect the industry's courting of the millennial generation, or those born from the 1980s to the early 2000s. This age group is expected to account for nearly half of business-flight spending by 2020.

U.S. Employment Trends

*Forecast
Sources: Marcus & Millichap Research Services, BLS, Economy.com

National Economy

Robust job creation in the second quarter beat expectations and effectively extinguished any lingering concerns that the contraction of the U.S. economy in the first three months of 2014 foretold a downturn. Private-sector payrolls have regained all of the positions lost during the recession, while favorable trends in business spending and expansions in manufacturing and service sector activity supported an acceleration of growth from April to June. A faster pace of economic growth will assuredly spur additional travel spending by businesses and consumers, supporting further gains in hotel performance. Core capital goods purchases, a proxy for business spending that tracks new orders for non-defense durable goods, continue to steadily rise in conjunction with the expansion of payrolls. Personal consumption expenditures, or consumer spending, is also tracking a steady rate of growth. The volatile durable-goods component of this measure, a barometer of consumers' outlooks and willingness to make significant financial commitments, has consistent risen for four years, a period also characterized by rising hotel room demand. Buoyed by an improving job market, consumers appear more willing and capable now to spend on travel than at any time since the downturn ended.

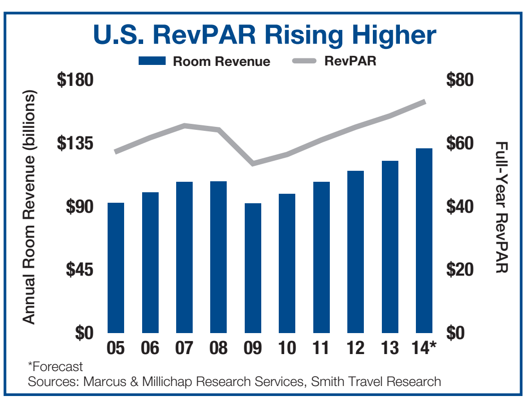


Statewide Rooms Under Construction

Sources: Marcus & Millichap Research Services, Smith Travel Research

Occupancy Trends

The expanding U.S. economy continues to generate new room demand. In the first half of 2014, U.S. room nights jumped 4.1 percent and available rooms increased 0.8 percent to yield a 200-basis-point surge in occupancy to 63.7 percent. Despite the addition of new rooms in many markets, the construction cycle has not quite ramped up to the degree predicted. Developers continue to favor upper midscale and upscale brands due to their name recognition and their relative ease of building. Roughly two-thirds of all rooms underway in the U.S. are in these chain scales and, to date, occupancy here has not suffered. Meanwhile, the potential impact of construction pipelines varies greatly by state. More than 13 percent of rooms under construction nationwide are in New York City, accounting for the large pipeline in that state. The new supply that has come online in New York City has provided travelers with accommodations at previously under-served price points, resulting in a minor rise in occupancy thus far in 2014. In North Dakota, however, room demand has not kept pace with supply growth. Developers, especially those working in the oil-and-gas Williston Basin, continue to face competitive pressures from the completion of permanent housing stock.



U.S. RevPAR Rising Higher

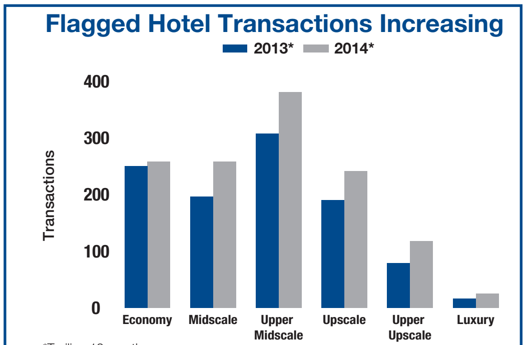
*Forecast
Sources: Marcus & Millichap Research Services, Smith Travel Research

Revenue Trends

Climbing room demand and higher daily rates are driving up revenue measures nationwide. Year to date, the nationwide ADR rose 4.1 percent, slightly more than the rise one year ago, while RevPAR advanced 7.5 percent, topping last year's 5.6 percent gain. ADR is driving a greater share of room revenue and RevPAR growth, and the gain in rate has been achieved primarily through transient room demand. A greater contribution from group room nights would enable hotel operators who can lock up large room blocks to raise rates on a property's remaining inventory, yielding a higher rate of ADR growth overall. While the recovery in group room demand has been tepid, recent developments indicate an upswing is imminent. Forward-looking booking trends and comments by brand executives during last quarter's earnings calls indicate more committed group occupancy over the remainder of 2014 and into 2015. With a greater contribution from group demand, ADR is set to rise this year at the fastest pace since the recession ended and drive up RevPAR for the fifth consecutive year despite somewhat higher supply growth. Year to date, RevPAR in the 25 largest markets has grown 7.8 percent, compared with a 7.3 percent gain in all other places. Among the nation's largest markets, Nashville, Denver, along with Orange County, Los Angeles, San Diego and San Francisco, are tracking double-digit increases thus far in 2014.

Investment Trends

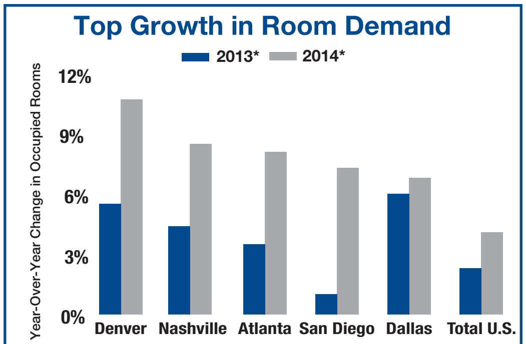
Considerably more hotels sold in the past 12 months than in the preceding year, and higher transaction volume and rising prices yielded a significant gain in dollar volume. Expanded access to debt financing, higher leverage for a broader range of properties, and a massive flow of equity into the sector are sustaining favorable conditions for making deals in 2014. Leverage averaged in the mid-50 percent range in 2010 as hotel performance started to recover but now approaches 70 percent on average in many transactions. Staked with low-cost acquisition debt, keen investor demand drove up transactions involving branded midscale, upper midscale and upscale properties over the past year. Strong room demand and revenue trends will support interest in these assets in primary markets in the months ahead, and increasingly send investors into smaller markets for assets that meet return objectives. Sales of economy hotels over the past 12 months were virtually flat but remain elevated nonetheless, indicating a sizable presence of small investors in many markets. Meanwhile, upper upscale and luxury brands accounted for more than 11 percent of all flagged hotel transactions over the past 12 months, up from slightly more than 9 percent in the preceding year. The higher proportion of deals in the top chain scales illustrates the flow of large, well-capitalized investors in the lodging sector.



*Trailing 12 months
Sources: Marcus & Millichap Research Services, CoStar Group Inc., RCA, Smith Travel Research

Hotel Sector Spotlight: Top 25 Markets

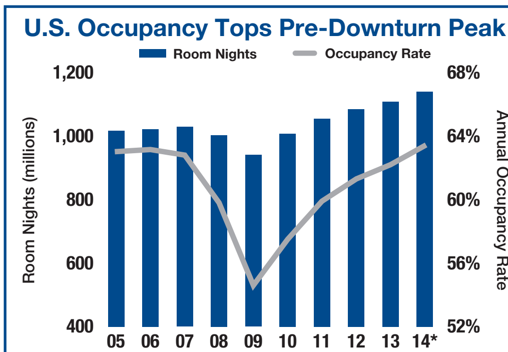
The focus of many investors on assets in top markets remains supported by recent performance, though secondary and tertiary markets continue to merit serious consideration as well based on recent results. So far this year, the presence of deeper and more diverse drivers lifted room demand in the nation's 25 largest hotel markets 4.6 percent, exceeding the 3.9 percent gain recorded in all other places. Only Oahu, Hawaii, among the largest markets posted a nominal drop in occupied rooms, while 13 markets outpaced the rate of increase for the entire group. An extended ski season in the Rockies and strong demand in March stemming from convention attendance drove up room nights in Denver 10.7 percent through the first six months of 2014. Excluding the sizable gain in March, demand still grew an average 9 percent monthly in the market. All operating metrics in Nashville are stellar this year thanks to a vigorous local and state economy, and robust leisure, business and state government demand. The market's substantial 8.5 percent jump in room nights is enabling property owners to leverage demand to assertively raise rates. A late-recovering economy in Atlanta is elevating room demand there, while San Diego and Dallas round out a ranking of the five best performing large markets by room demand thus far in 2014.



*Year to date through June
Sources: Marcus & Millichap Research Services, Smith Travel Research

2014 National Forecast

The U.S. hotel sector will record another year of strong growth in room demand and room revenue. Greater business spending and leisure travel will underpin a 2.9 percent rise in room nights during 2014, topping last year's gain of 2.2 percent. Combined with a 1 percent increase in available rooms, a rate of growth well below the long-term average, nationwide occupancy will climb 120 basis points to 63.4 percent this year to surpass the pre-recession high. ADR will be the principal driver of higher room revenue and higher RevPAR. This year, the national ADR will rise 4.5 percent to $115.31, while RevPAR will advance 6.5 percent to $73.09. Looking out over the near term, room demand will continue to grow at a faster pace than available rooms, leading to additional increases in occupancy and RevPAR beyond this year. Overall, the final half of 2014 looks promising. Peak summer travel season, which runs from June through August, has started strongly, and occupancy during this span is on track to top 71 percent this year after hitting 70 percent in 2013. In addition, a repeat of last year's government shutdown will not occur, providing for very favorable year-over-year comparisons in markets with national parks and in government-reliant markets, including the Washington, D.C., metro.



*Forecast
Sources: Marcus & Millichap Research Services, Smith Travel Research

Marcus & Millichap

NATIONAL HOSPITALITY GROUP

Gregory LaBerge
National Director
National Hospitality Group
Tel: (630) 570-2200
glaberge@marcusmillichap.com

Capital Markets

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

- Conduits continue to compete to secure a greater share of acquisition financing business. For loans starting at $5 million, spreads are roughly 200 basis points above the 10-year U.S. Treasury swaps for top brands in the nation's largest markets. Increasingly, however, CMBS lenders are demonstrating a willingness to write deals in secondary and even tertiary markets for well-located properties and solid sponsorships. Leverage averages in the low-70 percent range, up from a few months ago, but lenders will stretch to 75 percent for the best transactions. Deals are typically underwritten based on trailing 12-month performance, though some lenders are demonstrating greater openness to pro forma transactions in select circumstances.
- National, regional and local banks are also competitive sources of funding for hotel transactions. Leverage is typically around 70 percent for the best transactions, though some lenders will extend to 75 percent LTV for best-in-class assets and top sponsorships. Cash-flowing assets are favored, while loan terms vary from three to seven years at rates generally ranging from 200 to 300 basis points above the corresponding U.S. Treasury swaps. Outside of the conduits and banks, a greater number of mezzanine lenders and private equity sources are active in the financing arena to complete the capital stack.
- The Small Business Administration's 7A and 504 programs remain commonly employed funding options for hotel owners and investors, though their use has dropped as other sources have stepped in. Nonetheless, the SBA programs are a valuable alternative source for loans as high as $15 million, with terms of up to 25 years for the 7A and 20 years in the 504.

Recent Marcus & Millichap Transactions

Hotel Name	State	Rooms
La Quinta portfolio (four properties)	FL, MO, TN	504
Dells Island Resort & Conference Center	WI	228
Royal Celebration Inn	FL	222
Ramada Conference Altoona	PA	216
Grand Orlando Palms	FL	199
Best Inn & Suites	CO	194
Parkside Inn & Suites	FL	188
Stratford Inn Extended Stay	GA	185
Ambassador Hotel & Conference Center	CA	162
Baymont Inn & Suites	FL	162
Clarion Inn and Conference Center	OH	157
Quality Inn Ocala	FL	152
Baymont Inn & Suites	LA	142
Courtyard by Marriott	AR	114
Holiday Inn Webster/Houston	TX	109
Motel 6	CO	94
Ramada Inn West	AZ	89
Holiday Inn Columbus Southeast	OH	81
Motel 6	OR	81
GrandStay Hotel & Suites	WI	80
Hampton Inn Sulphur/Lake Charles	LA	79
Comfort Inn & Suites	UT	78

Marcus & Millichap

Prepared and edited by
Art Gering
Senior Hospitality Analyst
Research Services

For information on additional research materials, contact
John Chang
First Vice President, Research Services
Tel: (602) 687-6700
john.chang@marcusmillichap.com

Price: $150

© Marcus & Millichap 2014
www.MarcusMillichap.com

The information contained in this report was obtained from sources deemed to be reliable. Every effort was made to obtain accurate and complete information; however, no representation, warranty or guarantee, express or implied, may be made as to the accuracy or reliability of the information contained herein. Sources: Marcus & Millichap Research Services, BLS, BOC, CoStar Group Inc., Economy.com, Lodging Econometrics, Real Capital Analytics, Smith Travel Research