WHY 2022 IS THE TIME TO INVEST IN HOTELS

September 15, 2021

ABSTRACT

The hotel industry has become stressed amidst the pandemic. Many assets that produced cash-flow prior to the downturn, are now in early revenue recovery; but still under the pressure of accumulated liabilities. Savvy, investors will recognize 2022 – 2024 as the optimal window to enter the recovery cycle at a time when value is at its peak and cash flow is readily achievable.

This paper explores the untapped potential that could be unleashed to maximize trough to peak gains through the upcoming recovery and growth cycle.

Contents

ABOUT US

Merit Point Capital (”MPC”) is a diversified investment company that serves in the areas of Real Estate Investment & Development, Financial Services, Brokerage, and Business Operations. Our collective of industry leaders covers investment and operational expertise across a broad array of industries.

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Introduction

COVID pandemic economic pressures have severely crippled the hotel industry, and even the industry's most successful owners, developers and operators are searching for relief from the accumulated liabilities resulting from the economic downturn. Opportunistic investors are prepared to invest as cases of special servicing, receivership, foreclosure and note sales peak during the approach to 2022.

This paper overviews the unique attributes of the current market situation and why 2022 – 2024 is the optimal window to invest, and maximize trough to peak gains, through the upcoming growth cycle.

The Case for Hotels

Hotel investment is no longer overlooked and has moved from niche, to mainstream. Hospitality-focused funds have secured over $30 billion for new investment.

With a higher internal rate of return ("IRR") than the MSCI US REIT index over both one- and five-year time horizons preceding the COVID-19 pandemic, the hospitality sector has outperformed both the S&P 500 and the U.S. Aggregate Bond Index since 2000. Hospitality investment achieved higher risk-adjusted returns than the S&P 500 and higher total returns than U.S. Aggregate Bonds. [1]

Over the last thirty years, hotels have:

- Generated a total return of 8.0% per year with a third of the volatility of stocks
- Diversified a portfolio with near-zero correlation to stocks (0.17) and a negative correlation to bonds (-0.05)
- Produced an average annual yield of 7.2%, outperforming both stocks and bonds

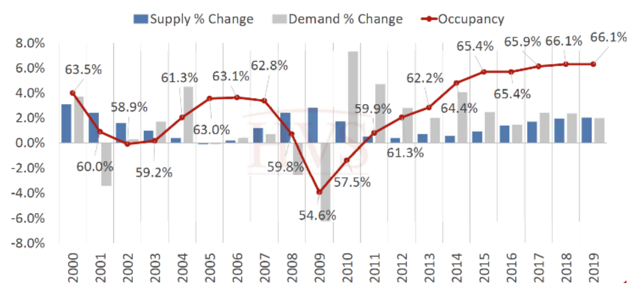
[1] The Global Appeal of Hospitality Real Estate: A Prequin and Pro Invest Report

Industry Resilience

"We remain resolutely bullish on the long-term prospects for hospitality and travel." – Mahmood Kimji, Co-Founder & Managing Principal at Highgate. [2]

The hospitality industry has proven extraordinarily resilient through the course of numerous economic downturns and black swan events. The industry has recovered and set new record highs, even after critics predicted people will never travel the same again (i.e. post-9/11).

US Lodging Trends Through Prior Cycles



Source: STR

Though COVID-19 has presented an unprecedented downturn, and another unique set of circumstances, the hospitality industry will recover. As in the past, this cycle will create the opportunity for strong returns through well-timed and well-executed investment strategies.

The current trend toward working from home and remote offices has resulted in many companies downsizing their leased office space. Those companies will look toward hospitality as a go-to location for collaboration, training, and small meetings.

[2] Skift - Highgate Acquires $4B in Hotels from Colony Capital and Trust Hospitality

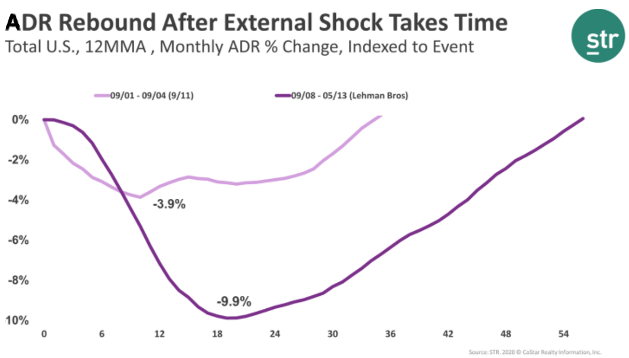
Recovery – Understand the Trends

Trough-to-peak recovery cycle may be prolonged by slow ADR growth; but occupancy will recover sooner as shadow supply (i.e. Airbnb) faces community and political headwinds forcing landlords to pursue a long-term stay strategy, making this sector less competitive to hotels. Hotel chain-scale, group reliance, and leisure mix will be additional recovery factors. Work with someone who understands the nuances of distribution and market segmentation.

Selected Shadow Supply Market Presence					
	Active Units 6/16/21	Shadow Supply % of Hotel Units	*TTM Occ %	*TTM ADR	Q1 20 vs. '21 Y/Y Unit Growth
New York, NY	21,085	24%	48%	$171	-36%
Boston, MA	1,736	3%	53%	$182	-14%
Chicago, IL	5,792	5%	57%	$146	-27%
Dallas, TX	4,340	5%	67%	$128	11%
Denver, CO	4,255	8%	80%	$144	-9%
Los Angeles, CA	10,304	10%	60%	$173	-21%
Miami, FL	9,462	16%	65%	$180	-20%
Nashville, TN	6,533	12%	52%	$227	-14%
New Orleans, LA	6,864	17%	48%	$182	-15%
Orlando, FL	7,323	6%	57%	$174	2%
San Francisco, CA	4,623	11%	58%	$213	-29%
Seattle, WA	4,853	10%	71%	$140	-27%
Washington, D.C.	5,724	6%	53%	$147	-3%

Sources: Deutsche Bank Supply Monitor (4/21); AirDnA (TTM Data as of 6/16/21); hotelAVE*

[3]



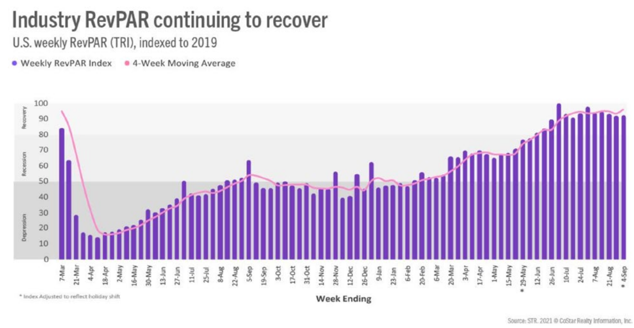
[4]

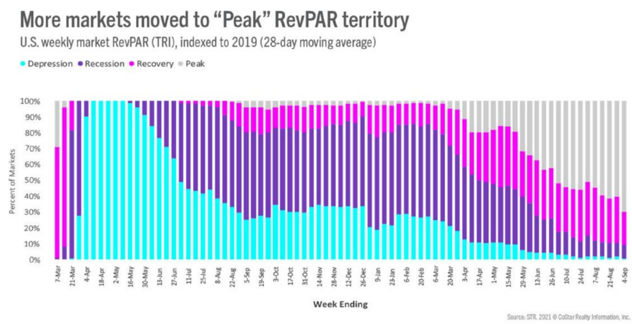
[3] [hotelAVE – Deutsche Bank Supply Monitor; AirDnA]
[4] [STR = US ADR & REVPAR Impact During the Last Two Downturns]

Recovery – Projections

"The paydown in credit card debt, the enormous increase in savings, and the global cabin fever is going to unleash an enormous amount of spending on travel like you've never seen before" he said. "So what does that mean? I think you'll want to invest in hotels." – Jonathan Gray, President & COO of Blackstone. [5]

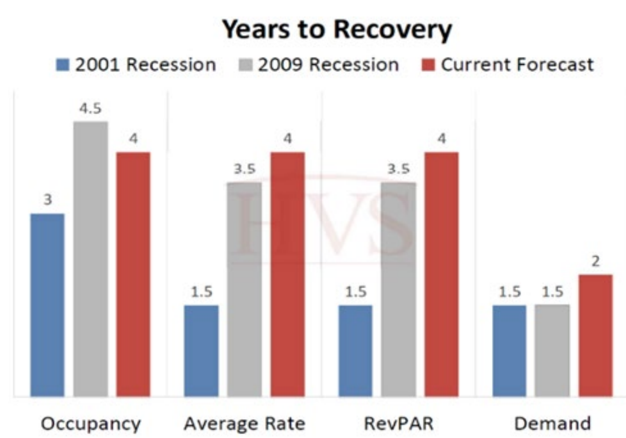
Through August 2021, [half the U.S. outperformed 2019 RevPAR during summer travel surge], [6] according to Smith Travel Research. This surge is bolstered by increased leisure travel demand while corporate offices remain largely unoccupied. Though the post-Labor Day lower demand period will certainly expose current softness of the business travel market.





[7]

History suggests that we can expect TTM demand to recover before rate, which leads to RevPAR recovery. Note that monthly stats show much sharper turns with the first month of rate recovery coming far in advance of the TTM which often includes drastic discounts from the onset of the downturn.



Source: HVS

"Remote work is going to increase traditional corporate travel, because in lieu of going to the office, businesses are going to bring people together for more off-site events. We see opportunities in both travel sectors." – Eric Resnick, Co-Founder of KSL Partners. [8]

Meanwhile, investors tend to look toward future recovery, which explains why the average acquisition discount of just 10.5% [10] is so disconnected from TTM RevPAR and NOI declines:

Investor Surveys						
	Discount Rate		Going-In Cap Rate		Terminal Cap Rate	
	Range	Avg.	Range	Avg.	Range	Avg.
PwC Real Estate						
Luxury/Upper-Upscale	6.5-12.0%	9.5%	4.0-9.5%	7.5%	5.8-10.0%	8.1%
Full-Service	8.8-11.3%	10.1%	6.0-10.0%	8.1%	7.5-10.0%	8.7%
Limited-Service	8.0-12.0%	9.7%	7.0-11.0%	9.2%	8.0-11.0%	9.1%
Select-Service	8.0-12.0%	10.2%	7.0-11.0%	8.5%	7.0-10.0%	8.3%
U.S. Realty Consultants						
Full-Service	9.5-12.0%	10.2%	5.5-10.0%	7.5%	7.0-10.5%	8.0%
Limited-Service	10.0-14.0%	11.0%	6.5-12.0%	8.4%	7.5-12.5%	8.9%
RERC						
All Hotels/Avg.	9.8-11.6%	10.5%	7.5-9.6%	8.5%	8.0-10.1%	9.0%

Sources: RERC Q1 2021, US Realty Consultants Mid 2020, PwC Investor Survey Q1 2021

[5] Morgan Stanley Interviews Jonathan Gray on Disruption: Find the Right Themes March 2021
[6] STR - Half the U.S. outperformed 2019 RevPAR during summer travel surge
[7] STR - US Market Monitor – September 2021
[8] Bisnow – Why Remote Work Will Boost Corporate Travel September 2021
[10] hotelAVE – RERC, US Realty Consultants, PwC Investor Survey

Transaction & Debt Trends

Many owners with CMBS debt are seeking financial alternatives as stimulus plans do little to address their circumstance. Though valuations declined less than many industry experts anticipated, lenders have mitigating risk through lower Loan-to-Value ratios and higher rates as compared to 2019.

Debt models are reducing leverage from historic levels of 65% - 80% LTV, down to 50% - 75% LTV [11]. In many scenarios value is depressed, near or below the existing value of the debt. In other situations, owners were at 80% LTV in 2019, but now only qualify for 50%-60% LTV. Adherence to loan covenants will force many owners to pay down debt at a time when there is no cash flow, bring in priority equity investors, add high cost Mezz debt, or sell. While rates for Mezz debt and Preferred Equity have become increasingly favorable for debt funds, the rates may pressure many owner to sell at a favorable basis for incoming investors. Assets with loans originating from 2017 – 2019 will be most vulnerable.

Financing Trends - Changing Weekly					
	Term	Leverage	Going In Debt Yields	Spread (bps)	Δ vs. Q1 2021
CMBS - Floating Rate	5	50-70%	8.5-11%	L + 225 - 450	-225
CMBS - Fixed Rate	10	50-70%	9-11%	S + 225 - 350	-75
Debt Funds/Mortgage REITs	3/1/1	60-75%	6-11%	L + 400 - 650+	-75
Domestic Banks	3/1/1	50-65%	8-12%	L + 275 - 450	-25
International Banks/Funds	5-10	50-80%	9-12%	L + 300 - 600	0
Life Companies	5	55-65%	10-12%	L + 400 - 600	0
Life Companies	10	55-60%	10-12+%	T + 400 - 500	0
Mezzanine Funds	3/1/1	50-80%	6-10%	L + 700 - 1200+	-100
LIBOR - 30 Day	0.09613	Treasury - 10 YR	1.479	Swap - 10 YR	1.451

Sources: hotelAVE; CBRE; Cushman & Wakefield; Hodges Ward Elliott; PMZ Realty Capital; RobertDouglas; Chatham Financial (6/28/21 at 4:45pm EST)

Organizational leadership must monitor these trends as they develop within each unique market.

[11] hotelAVE – CBRE, Cushman & Wakefield, Hodges Ward Elliott, PMZ Realty Capital, Robert Douglas, Chatham Financial

Savvy Investment Strategy

"Looking forward, we've been doing a lot around the COVID recovery play" he said. "We've invested in a bunch of travel related businesses. We did a US hotel transaction, a Japanese hotel transaction, a UK holiday park business, and a private aviation company. That's an area we're excited about." – Jonathan Gray, President & COO of Blackstone. [12]

When markets turn volatile, novices pull out while experts invest for the long-term. Many companies and individual owners cannot survive the current downturn without losing personal and business assets or incurring onerous debt that will materially decrease or erase the potential for future returns. EIDL and PPP have run their course, and MSLP is a short-term solution for which most hotel owners do not qualify. Many are unable to deal with the new debt equation and some face Chapter 11. Many owners are in a defensive position with mounting liabilities.

Noble's Mit Shah Sees a "generational investment opportunity in hospitality." – CoStar – Noble's Mit Shah Says Best Investments Yet to Come. [13]

There now exists a window of opportunity for investors, with short-term liquidity strength, to pre-empt the private equity acquisition rush by engaging a firm that leverages the strength of industry experts to source viable deals in recovery markets.

One such firm, Merit Point Capital, seeks to use its deep industry knowledge to lead capital deployment for the purpose of buying, fixing and selling domestic U.S. lodging sector companies and portfolios. The current window can enable maximum trough-to-peak gains during the market recovery following the COVID economic crisis.

Organizational leadership is intensely focused on generating capital appreciation by leveraging longstanding industry relationships to bring deals, at a competitive basis, to grow and expand our reach. Investor returns will be delivered through superior asset management and operational expertise as we advise toward proper asset repositioning, right-sizing operational expense, and potential conversion/re-branding of qualifying assets to mitigate risk and drive yield.

[12] Bloomberg – Gray Says Blackstone Favors Travel April 2021
[13] CoStar - Noble's Mit Shah Sees a "generational investment opportunity in hospitality" – August 2021

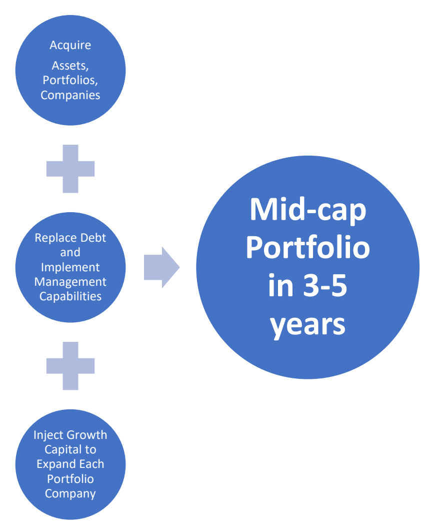
Our Investment Approach at MPC

Our Approach at Merit Point Capital:

1. IDENTIFY & ACQUIRE mismanaged, under-marketed and under-valued assets which were cash-flowing prior to the pandemic, and located in submarkets with growing demand
2. CREATE VALUE through implementation of operational execution plans, reposition and/or rebrand, while driving ADR/rent growth, improving operational efficiencies, and forcing asset appreciation
3. MANAGE by engaging professional management and implementing active asset manage to ensure achievement of operational and financial metrics
4. EXIT timing to maximize investor returns

Our Strategy is to invest in circumstances that align with one or more of these key themes:

- Off-market majority buyout (LBO) / Debt Replacement / Recapitalization resulting from COVID distress, retiring owner or partner, sale of family-owned company, or corporate divestiture
- Identify Opportunistic, Value-Add, and/or Under-Managed assets or management companies which present return on investment capital when married to our core competencies
- Acquire historically cash-flowing assets at a significant discount to replacement cost
- Reposition assets within the first 18 months, to attract occupancy and improve rate premium during the post-COVID recovery period
- Seek markets with growing demand, high barriers to entry, premium location, and assets with unique value proposition that are anticipated to recover more quickly post-COVID
- Diversify portfolio with some core and core-plus assets with less volatile performance history
- Generally hold for a period of 4-7 years; however, may dispose after a shorter or longer holding period if in the investor's best interest



Our Current Target Assets

Targets may include companies, portfolios, emerging brands, hotel management or JV investment in hotels (or notes to control hotels). Investments will range from midscale, limited service & extended stay, to upper-upscale (non-union) full-service hotels located primarily within the domestic US.

Examples of Companies/Portfolios presently under negotiation:

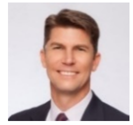
- Off-Market Company 1
  - 11 hotels, $200M valuation (pre-COVID), $134M debt (70% is CMBS due within 1 year)
  - Under lender pressure and wants to eliminate CMBS
- Off-Market Company 2
  - 12 hotels, $204M valuation (pre-COVID), $84M debt
  - Pipeline – 5 to 10 upscale, boutique, select service hotels in A+ urban locations
  - Owner/developer wants to exit current assets and fund pipeline
- Off-Market Note Purchase
  - 1 Southeast Senior Living Asset in a submarket running 90% occupancy
  - $9M note
  - Status is in Pre-opening
- Other – we are in early stages of discussions to acquire a hotel management company, senior living management company, and hotel note sale with up-branding conversion opportunity

Our Value Creation Strategy

Merit Point Capital will implement the following value creation strategies:

- Execute management & procurement strategies, install retailing programs enabled by digital transformation, and implement operational productivity and efficiency processes
- Negotiate principal reduction and replace the debt
- Prune non-cash flowing assets from portfolios
- Release capital for acquisition & growth
- Implement property improvement plans (PIP) of new and existing assets through construction, FF&E, rebranding, occasional adaptive re-use, and energy efficiencies

About Us



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In the wake of global pandemic, we are opportunistic buyers, seeking to invest in companies and real estate assets that have produced free cash flow in the period immediately preceding the crisis or are strategically positioned to deliver extraordinary growth in response to the crisis.

Our active investment approach seeks to unlock value through balance sheet restructuring, operational improvements, and strategic management. We typically invest and partner with companies where the existing management is committed and capable to grow the business organically, while also adding synergistic value through Merit Point Capital’s business verticals.

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