

New Tax Law Invigorates Value-Add Options in Hospitality Sector; Elevated Occupancies Reinforce Revenue Gains

Economy gets a boost from tax reform.

Economic growth surpassed 4 percent in the second quarter, lifted by strengthened consumption and business investment. The new tax law has stimulated the economy by increasing after-tax earnings and pushing consumer and business confidence to near-record levels. This combination has sparked elevated spending and accelerated job creation. Through the first half of 2018, the economy added over 1.3 million jobs, driving unemployment below 4 percent and boosting wage growth to 2.7 percent, its highest level since the onset of the recession. As a result, personal disposable income has grown by 5.4 percent over the last year, dramatically outpacing the 3.5 percent average growth rate over the past 10 years. The combination of low unemployment and more disposable income has translated into particularly strong consumption. Through the summer, core retail sales growth surged to 5.6 percent, well ahead of the 10-year average of 3.1 percent.

Rising inflation and higher interest rates could cool momentum. Accelerated growth brings with it some new challenges. Core inflation has nudged upward to 2.3 percent, raising caution at the Federal Reserve. To rein in inflationary pressure, the Fed has already signaled that it will tighten monetary policy by raising the overnight rate a total of four times in 2018; this will push up short-term interest rates. The challenge for the Fed is that long-term interest rates have been range bound, with the 10-year rate hovering near 3 percent for the last six months. Unless the Fed can push long-term rates up, its monetary tightening policies could invert the yield curve, raising short-term Treasury yields above long-term Treasuries. An inverted yield curve is a commonly perceived sign of an impending recession, raising the risk of a slowing economic outlook.

Tax law a boon to hotel investors.

Increased clarity surrounding the new tax law could spur hotel investment moving forward, particularly as uncertainty pushed some investors to the sidelines last year. Several provisions will also be beneficial to investors, including owners' ability to expense up to \$1 million of depreciable personal property to furnish lodgings. The change will allow owners to deduct the cost of furniture placed into service at their properties rather than depreciating them over several years. The rule also applies to roofs, heating, ventilation and security systems, though deductions phase out after \$2.5 million. This regulation could prompt some investors to consider smaller hotel assets with value-add potential.

Occupancy propels to new heights. The economic tailwinds that have fueled hotel property performance over the course of the growth cycle will continue to bode well for room demand through the remainder of the year. Strong hiring, wage growth and rising confidence levels have boosted personal and business travel, pushing the national occupancy rate to record levels, generating gains in the average daily rate (ADR) and revenue per available room (RevPAR). Occupancy reached a 30-year high in the second quarter of this year to 66.3 percent while both RevPAR and ADR have risen more than 20 percent from their pre-recession peaks set in 2007 and 2008, respectively. Several markets will experience even greater growth, particularly tourist destinations benefiting from elevated summer travel. While low unemployment and stimulative tax rules drive further economic growth and underpin room demand, potential headwinds do exist. Several markets with large development pipelines may face supply pressures and concerns surrounding home-sharing services remain.

Executive Summary

- Consumer and business confidence remain at record levels, supporting economic growth and boding well for all types of commercial real estate properties. Low unemployment and rising wages will benefit hotel properties in particular as increased disposable income drives the creation of travel plans for many consumers.
- Healthy room demand continues to push occupancy to new highs. The rate achieved a 30-year high in June and the trend will continue through the remainder of the year.
- Elevated occupancy continues to support growth in revenue per available room (RevPAR). RevPAR will outpace last year's growth as the sector is supported by strong economic tailwinds.
- Many hotels are evolving to changing consumer preferences to attract travelers away from home-sharing services like Airbnb.
- Investor interest in hospitality properties remains elevated by strong performance trends. Smaller markets are garnering increased interest as their higher first-year returns draw buyer attention.

Tax Reform Brings Significant Changes For Real Estate Investment

Retention of key real estate tax provisions just scratches the surface.

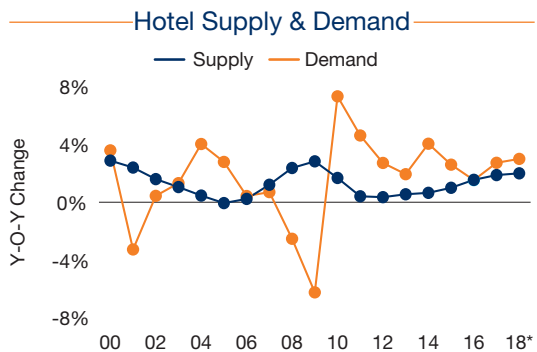
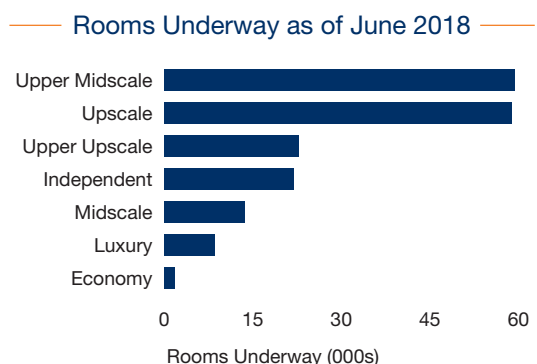
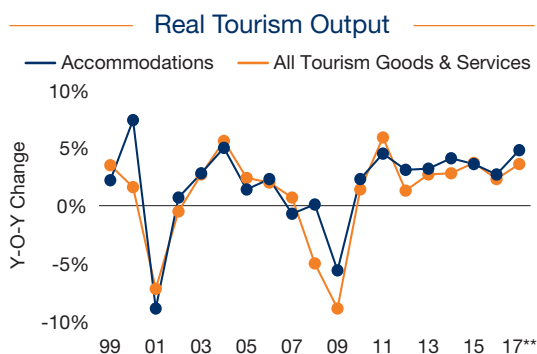
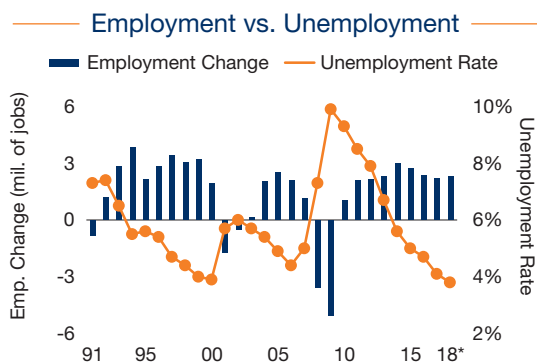
The new tax law kept three of the most important rules for real estate investors: tax deferred exchanges, real estate depreciation and the mortgage interest deduction. Beyond this, the new rules deliver a host of important changes that could reshape investor strategies. Three important changes investors should consult their accountants about include:

- **20 percent pass-through deduction:** For active investors using a pass-through entity such as an LLC, the new 20 percent pass-through deduction will boost after-tax yields. This new deduction has a variety of restrictions based on income and asset base but offers substantive upside for those who qualify.
- **Bonus depreciation:** This temporary provision will phase out after 2023, but it enables investors to immediately expense personal property in real estate assets acquired after Sept. 27, 2017, boosting immediate cash flow. A Cost Segregation Study enables investors to identify the deductible components.
- **Restrictions on business interest deductions:** Companies that have loans on purchased locations they operate from have historically been able to deduct the interest on their real estate. Under the new rules, companies with average annual gross receipts of \$25 million or more face limits on their overall interest deductions. The new rule can make the sale-leaseback of locations more beneficial for companies from a tax standpoint because leases remain a deductible expense.

Traveler Preferences Fuel Hotel Evolution

Supply additions remain elevated this year. While the accelerating economy has boosted occupancy and revenue metrics, rising room demand has boosted hotel construction. Developers have increased supply over the last two years, with more rooms on the way in 2018. By year end, national hotel inventory will have increased by 5.5 percent since 2015, the largest three-year addition since 2010. Elevated supply could begin to soften occupancy in some markets, slowing ADR and RevPAR growth. Los Angeles hotel inventory, for example, has increased by more than 3,500 rooms during the past 12 months ending in the second quarter. Hotel room demand has not kept up with this pace, causing the metro occupancy level to fall 120 basis points during this time to 79.5 percent in June.

Hotels adapt to changing consumer preferences. The rise of popular home-sharing services like Airbnb and HomeAway have created uncertainty for many hotel owners and the industry has begun to adapt to these evolving consumer preferences. While many individuals prefer the local experience that these services provide, they also prefer the product of traditional hotels. As a result, many large companies are creating millennial-centric brands that offer amenities to target this sector. Marriott's Moxy line of hotels utilizes bright colors and unique amenities, like an elevator photo booth, that appeal to these customers. Owners are also finding opportunities in independent hotels, repositioning them around themes to drive interest. In Napa Valley, for example, a hotel redesigned its property around a retro motor lodge theme. Overall, independent hotels continue to have strong occupancy improvement and RevPAR growth, compared with several other chain scales.

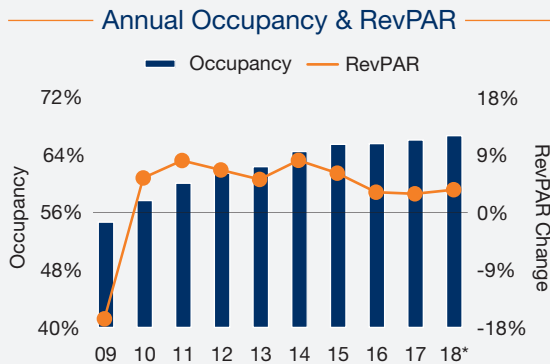


*Forecast

** Seasonally adjusted through 3Q17

Sources: Marcus and Millichap Research Services; STR, Inc.

Accelerating Economy Underpins Strong Hotel Property Outlook



U.S. OCCUPANCY:

60 basis point increase

Economic growth bodes well for travel expectations, drives occupancy improvement.

Strong economic momentum is aiding hotel occupancy improvement. Annual occupancy will climb 60 basis points from 2017 to a forecast 66.6 percent at year end. Several markets will experience even greater growth as consumers broaden their travel plans to popular destinations.

U.S. CONSTRUCTION:

2.0% increase in supply Y-O-Y

Rising supply slows performance gains in some chain scales. Nearly 180,000 rooms are underway as of June. Most of the new construction has been in the upper midscale and upscale segments, which has slowed occupancy and revenue growth compared with other chain scales.

U.S. REVPAR:

2.6% increase Y-O-Y

Revenue metrics post respectable gains.

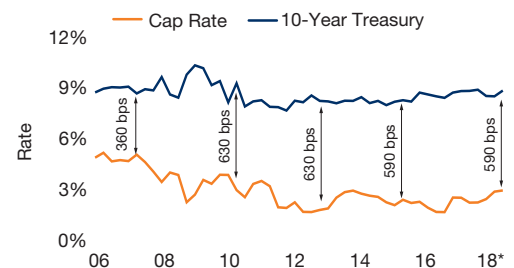
Healthy occupancy improvement is driving growth in the average daily rate and RevPAR. ADR will climb by a forecast 3.6 percent during the year while RevPAR edges up 2.6 percent. ADR and RevPAR are rising at a faster pace than last year, when uncertainty around tax reform and policies slowed growth.

* Forecast
Sources: Marcus & Millichap; STR, Inc.

2018 Investment Outlook

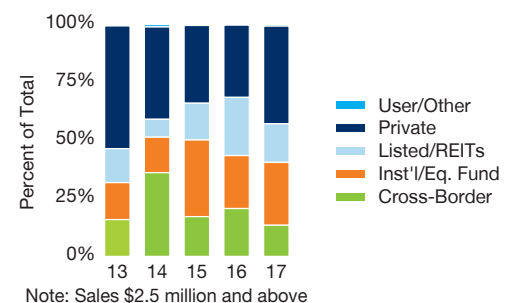
- Smaller markets command buyer attention.** Strong property performance continues to drive investors' appetite for hotels. The number of transactions rose roughly 4 percent during the past 12 months ending in June as trades picked up in many of the nation's smaller markets. In particular, sales increased considerably in the Northwest, Southwest and the Carolinas, escalating more than 20 percent in each region. Vigorous room demand in these areas should sustain buyer interest for hotels in these regions moving forward.
- Private buyers increasingly target hotels.** The share of private investors in the sub-\$10 million price tranche continues to increase steadily. In 2017, more than half of hotel sales involved this segment, which has not occurred since 2013. This year, these investors continue to primarily target limited-service and independent hotels where cap rates in the high-8 to low-10 percent band can be found.
- Evolving traveler expectations could boost demand for independent hotels.** Changing consumer preferences could heighten demand for independent hotels moving forward. Many buyers are finding value-add opportunities in older-independent hotel properties by renovating around themes and expanding amenity packages that are attractive to the experience-oriented traveler. Average first-year returns for independent hotels can be found in the high-8 to low-9 percent band.

Treasury and Cap Rate Trends



* Through 2Q18
Note: Sales \$2.5 million and above

Hotel Buyer Composition



Lenders Pursue Deals as Capital Plentiful; Caution Enforcing Underwriting

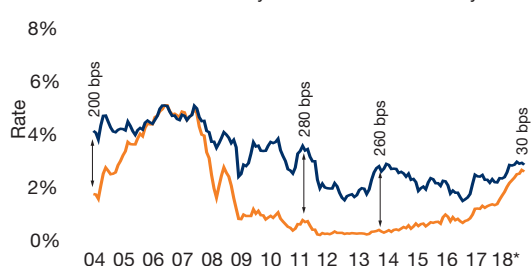
Fed watchful as economic surge raises inflationary pressure.

Strengthened hiring amid exceptionally low unemployment levels has boosted wage growth, placing upward pressure on inflation. Amid that trend coupled with rising trade protectionism and tariffs, the Federal Reserve appears determined to head off inflation risk by continuing its quarterly increases of the overnight rate. These actions are lifting short-term interest rates while the 10-year Treasury rate remains range bound near 3.0 percent. Should the 10-year remain steadfast, Fed tightening could create an inverted yield curve in which short-term rates rise above long-term rates. Although this event has preceded every recession of the past 50 years, many economists suggest such an inversion this year could be an exception to the rule. Because of distortions caused by regulatory changes and quantitative easing, this inversion could be different. Nonetheless, the Fed's stated path does raise recessionary risk levels because it could weigh on confidence levels and restrain spending by consumers and businesses, thus slowing economic growth.

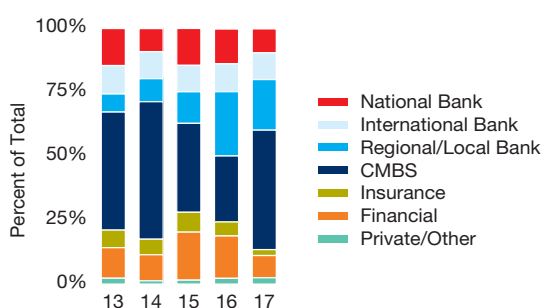
2018 Capital Markets Outlook

- **10-Year Treasury still "sticky" at 3 percent.** After surging at the beginning of the year, the 10-year Treasury has been range bound near 3.0 percent. To create some headroom for its escalation of short-term rates, the Fed has tried to exert upward pressure on long-term interest rates by unwinding its balance sheet. This quantitative tightening has had little influence, particularly as foreign investors have enjoyed a yield premium relative to their native 10-year rates.
- **Potential rapid interest rate escalation a downside risk.** Although capital remains plentiful, lending could tighten quickly for a short period if interest rates rise rapidly. As experienced in late 2016 when the 10-year rose by more than 80 basis points in 60 days, and again at the beginning of 2018 when there was a 60-basis-point surge, market liquidity could tighten if rates jump. Considering this has happened twice in the last two years, borrowers will likely benefit by taking a cautious approach with their lenders and lock in financing quickly.

10-Year Treasury vs. 2-Year Treasury Yield Spread Tightens



Hotel Mortgage Originations by Lender



* As of August 17

National Hospitality Group

Peter Nichols

Vice President, National Director
National Hospitality Group
Tel: (212) 430-5100 | peter.nichols@marcusmillichap.com

Price: \$250

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Sources: Marcus & Millichap Research Services; AHLA; Bureau of Economic Analysis; Bureau of Labor Statistics; CoStar Group, Inc.; Experian; Moody's Analytics; Real Capital Analytics; STR, Inc.; U.S. Census Bureau