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REAL ESTATE INVESTMENT SERVICES

HOSPITALITY

SUMMER HOSPITALITY MARKET REPORT

HOSPITALITY CRE: 3 UPDATES

1. CPI, INTEREST RATES, & CAP RATES

March 2024 reported a rise in the Consumer Price Index (CPI), indicating persistent inflation, making a June Federal Reserve rate cut unlikely. This development impacts the hotel market directly, potentially extending the decline in hotel values beyond earlier predictions.

THERE WAS SHARED OPTIMISM THAT HOTEL TRANSACTIONS WOULD INCREASE IN Q3 AND Q4 2024 AS EXPERTS ANTICIPATED A 25-BASIS POINT CUT BY JUNE 12TH; HOWEVER, IT NOW APPEARS THERE'S ONLY A 46% CHANCE OF A 25-BASIS POINT CUT BY THE FED IN THE SEPTEMBER 2024 FMC MEETING.

Historical data indicates that property values typically decrease by 10% to 20% in the six (6) months following the first interest rate cut; thus, we forecast commercial real estate property values to continue declining through Q1 and Q2 2025, but likely longer. CoStar Group analytics forecasts a 75 to 125 basis point increase in cap rates for the next 12 months, making it more attractive for buyers than sellers.

2. PROPERTY IMPROVEMENT PLANS (PIPS)

Franchisors are now requiring their franchisees to complete Property Improvement Plans (PIPs) without further delays. This change has been prompted by a significant spike (30% to 40%) in PIP costs due to COVID-19. As a result, many property owners find it financially impractical to complete these costly PIPs.

This situation presents a buying opportunity for investors, as owners may choose to sell their properties rather than bear the high costs of PIP completion. Lee Hunter, chief operating officer at Hunter Hotel Advisors, noted that PIPs now cost between $35,000 to $40,000 per key for a mid-market, select-service hotel. These increasing expenses could heavily influence an investor's decision in the current market context.

Hospitality is the only commercial real estate asset class requiring existing owners to reinvest millions of dollars into the building to maintain the existing NOI in the form of the PIP. Thus, there will be a greater concentration of hotel properties (supply velocity) coming to market relative to multifamily, retail, and industrial properties, so an owner considering a sale of a hospitality property to 1031 exchange into an alternate class in that of retail, multifamily, industrial, etc., must list the hospitality property before market inventory increases as hospitality property pricing will decline greater than alternate asset classes (multifamily, hospitality, industrial, etc.), which again, is due to the greater percentage of existing owners becoming sellers due to unaffordable PIPs and franchisors demanding PIPs becoming completed.

3. SELLER (ASK) VS. BUYER (BID) SPREAD & DECLINING PROPERTY VALUE

In an executive panel, Dustin Fisher of Noble Investment and Mehul Patel of Newcrest Image shared that the hospitality market is experiencing a minimum of 10% spread between the seller's ask and the buyer's bid, and institutional buyers are offering as much as 20% from pricing guidance.

Industry experts expect an increase in Market Inventory (hotel properties for sale) as a result of motivated sellers with PIPs or loans coming due, coupled with the owners who will then list their property following the Fed rate cut projected to occur in September 2024 per the CME Fed Watch Tool. Supporting evidence is the fact that institutional-quality hotels continue to come to sale via auction 'as-is, where-is' terms, meaning that some of the "smartest people in the room" are putting their money on hotel values continuing to decline for the foreseeable future (comparable to Blackstone timing the market by unloading their Motel 6's in 2021 and 2022).

All of the events above will lower hotel pricing due to increased market inventory of hotels for sale (supply), supported by the historical fact that commercial real estate properties continue to decline in value for the six months following the first rate cut.

TO SUMMARIZE, HOSPITALITY PRICING WILL DECLINE THROUGH MAY 2025. THEN, BY Q3 2025, INCREASED TRANSACTION VELOCITY AND BUYER DEMAND OUTWEIGH THE INCREASE IN MARKET INVENTORY SUPPLY, RESULTING IN INCREASED HOTEL VALUES.

CALIFORNIA MARKET

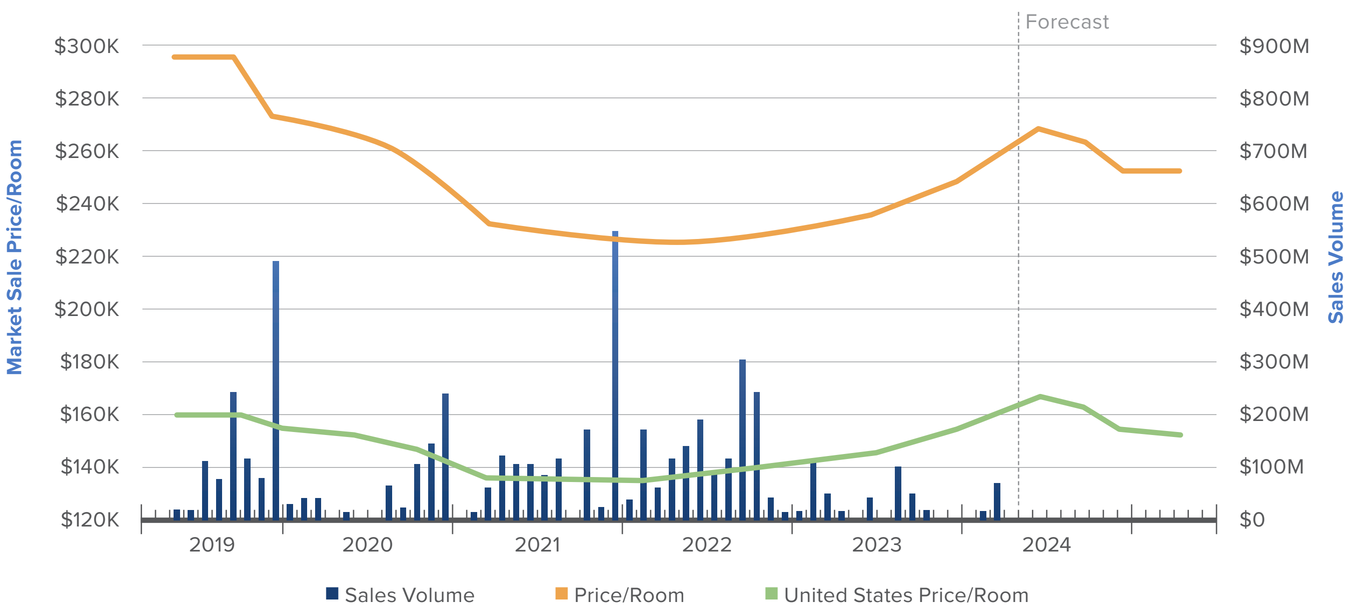
- California hotel transaction volume fell 56.5% in 2023 as many investors claim to be waiting on the sidelines.
- In 2023, Southern California hotel purchase deals had a value of $2.31 billion, down from $5.8 billion in 2022.
- The hotel sector hasn't completely recovered from lockdowns during the 2020 pandemic. Financial headwinds caused some hotels to slide into foreclosure. In other cases, hotel property owners gave the keys to their lenders.

LOS ANGLELES, CA

- Leisure visitors remain the primary travel segment of the market. However, similar to national trends, leisure travel softened as visitors reverted to standard travel patterns, and the market has become more reliant on business-generated travel through conferences, conventions, and corporate travel.
- While hotel topline performance is favorable, **room labor expense has steadily increased in the past few years, potentially impacting profitability**. Hotel worker protection ordinances have taken effect in many Los Angeles counties, raising hourly pay and limiting daily square footage cleaning amounts. Also, union contracts expired in June 2023, resulting in the largest hotel strike in U.S. history.
- In the past 12 months, hotel transaction volume has declined by nearly 75%. Since the "Mansion Tax" took effect in April 2023, only four hotels have traded in the Los Angeles market with price points above $20 million, two of which were tax-exempt.

SALES VOLUME & MARKET SALE PRICE PER ROOM

Source: CoStar Group



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