

FUNDAMENTALS FALTER AS SECTOR ENDURES RECESSION

The recession continues to exert a tight grip on the hospitality sector, pushing down occupancy and forcing more property owners to cut daily rates to boost demand. Conditions are expected to remain weak over the remainder of 2009 as persistent job losses discourage leisure travel and cost-conscious businesses cut trips. Year to date, occupancy has slipped to the low-53 percent range, while the average daily rate (ADR) has slid to under \$100, and revenue per available room (RevPAR) has declined by double digits. Room supply will continue to be an issue, although perhaps to a lesser degree than envisioned several months ago, before the onset of the most severe phase of the credit crisis and recession. Indeed, since the third quarter of last year, construction financing has become less available, and projects have been removed from the pipeline. Currently, 159,000 rooms are under construction, including more than 75,000 rooms affiliated with national full-service brands. Overall, there is growing sentiment among hotel analysts and national brands that the industry is passing through the worst phase of the downturn, and conditions may start to stabilize soon.

Tight capital markets and the deterioration of operating fundamentals have restrained investment activity, with transaction velocity decreasing more than 40 percent over the past 12 months. Prices also have fallen during the period, reflecting the effects of diminished room revenue on values and sales of nationally branded full-service assets, many of which have been impacted by the decline in business travel. Meanwhile, additional distress is likely to emerge in the quarters ahead, as signaled by the recent bankruptcy filing of Extended Stay Hotels. Also, the delinquency rate on loans backed by hotel properties has risen to the low-2 percent range and is expected to tick up further as falling revenues pressure property owners. Lodging property delinquency reached a high of 8.4 percent in early 2003, a level that could be attained again in the next several quarters as cash flows continue to decrease. Properties most at risk consist of those purchased in 2006 and 2007.

QUICK FACTS

	Year to Date	One Year Ago
Occupancy	53.3%	60.0%
Demand Growth	-8.3%	0.0%
Supply Growth	3.2%	2.3%
Average Daily Rate	\$99.10	\$108.27
Annual Change	-8.5%	4.5%
RevPAR	\$52.78	\$64.91
Annual Change	-18.7%	2.2%
Revenue Growth	-16.1%	4.5%

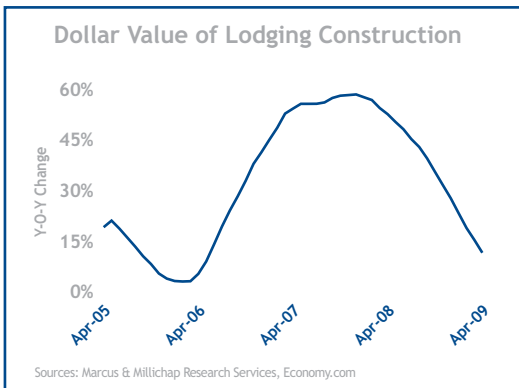
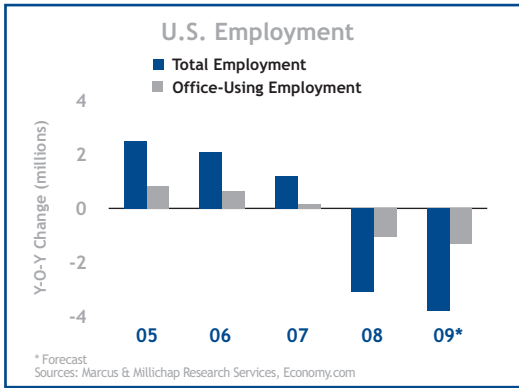
- ◆ **Sector hit hard by ongoing job losses.** All lodging metrics have turned downward thus far in 2009. If the effects of the recession abate by the end of the year, as many economists expect, key measures of performance could stabilize, with a modest rebound possible in 2010 as pent-up lodging demand is relieved.
- ◆ **Capital markets still under strain.** Despite some recent thawing in the capital markets, financing for the acquisition of hotel properties remains difficult to obtain. The conduits, a major source of capital, are still out of action. Many lenders are limiting their exposure to hotel properties, concentrating instead on monitoring the performance of existing loans in their portfolios. Delinquencies and the frequency of loan workouts are likely to rise in the quarters ahead.
- ◆ **Room revenue declines substantially.** Reflecting a sharp downturn in demand and increased use of rate discounting, room revenue was approximately \$100.7 billion over the past 12 months, the lowest trailing 12-month level in more than two years.



ECONOMY AND MARKET CONDITIONS

The steep decline in total and office-using employment continues to weigh on the hospitality sector. Thus far in 2009, 2.9 million jobs have been lost, and 8 million cuts are projected this year, including 1.3 million positions in office-using sectors. Employment losses erode hotel room demand as consumers reduce spending on many items, such as discretionary purchases like travel and vacations. Also, businesses slash travel budgets in addition to reducing head counts.

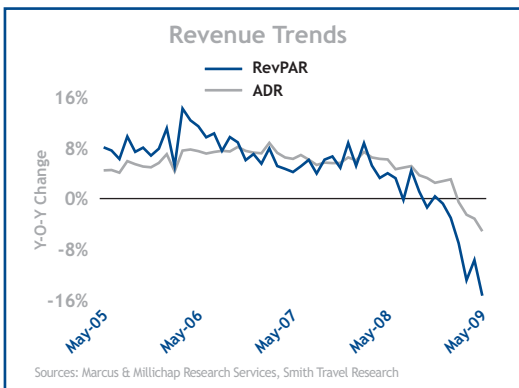
Since the start of the recession, 6 million jobs have been eliminated. Hotel room demand has declined in 19 of the ensuing 29 months, including the last 10 months. Office-using employment, meanwhile, has fallen by 900,000 positions year to date and is down by nearly 2 million workers during the recession. The drop in office-using employment has adversely affected occupancy during the Tuesday through Thursday period. So far this year, occupancy has averaged about 55 percent on these days, compared with 64 percent in the corresponding time frame in 2008. Among the nation's 25 largest markets, 12 have recorded declines in demand greater than 10 percent. The worst-performing markets – Detroit, Atlanta and Chicago – are primarily business destinations and have posted drops in demand ranging from 12.5 percent to 14.7 percent.



Lingering Recession Erodes Room Demand

Year to date, national occupancy of 53.3 percent is 670 basis points less than the occupancy rate recorded over the corresponding period in 2008. The decline is attributable to an 8.3 percent reduction in room demand and a 3.2 percent increase in supply. In practical terms, the drop in room demand translates into about 175,000 fewer occupied rooms each night thus far in 2009. On only three days year to date has daily occupancy exceeded occupancy recorded on the corresponding day last year.

While the demand side continues to weaken, new hotels are coming online at a brisk pace. About 100,000 rooms have been put into service so far this year, compared with approximately 110,000 rooms during the same period in 2008. Although any additions to supply in a period of diminished demand are unwelcome, a turning point may have been reached. With the downturn in hospitality fundamentals, plus limited construction capital, the pipeline of under way and planned projects has contracted about 22 percent from one year ago to 520,000 rooms. Another indicator of building activity, the dollar value of lodging construction put in place, continues to shrink, rising only 11.5 percent over the most recent 12-month stretch, following a 53 percent spike in the preceding year.



Profitability Falls Steeply

Recent additions to room supply have been spread over diminished revenues. So far this year, RevPAR is \$52.78, a decrease of 18.7 percent from one year ago, as revenue from room rentals has plunged 16.1 percent. RevPAR has declined in each of the past nine months and, thus far in 2009, on each day of the week. Year to date, average RevPAR decreases have ranged from a 14.3 percent drop on Saturdays to a 21.8 percent fall on Tuesdays. Ongoing job cuts and reduced travel budgets will continue to strain room revenue during the workweek.

The ADR has decreased 8.1 percent year to date to \$99.66. The ability of property owners to set rates has deteriorated rapidly, as the ADR was up 2.6 percent year over year as recently as the end of 2008. The monthly ADR has declined each month since last September, the onset of the most severe phase of the current recession and credit crisis. Pressure upon owners to slash rates to bolster occupancy and maintain cash flows will remain intense through the rest of the year, especially for owners who purchased assets at the top of the market in 2006 and 2007.

INDUSTRY SEGMENT PROFILE: LARGE MARKETS

The deterioration in hotel property performance has been pervasive, affecting each of the nation's 25 largest markets. RevPAR in the country is down 18.7 percent year to date, and only 10 of the top 25 markets have outperformed the nation, led by a 6.2 percent drop in Washington, D.C. The performance in that market thus far in 2009 is attributable solely to a strong showing in January, when RevPAR was up 28.9 percent due to an increase in room revenue related to the presidential inauguration. RevPAR in Washington, D.C., has decreased each month since January. At the opposite end of the spectrum, a decline in international and business travel has contributed to a 32 percent year-to-date decline in RevPAR in New York City. Meanwhile, Phoenix has suffered from a downturn in airline-generated leisure travel, pushing down RevPAR 28.6 percent this year.

Besides the decline in RevPAR in each of the largest markets, RevPAR in all other markets has fallen 16.8 percent thus far in 2009. At the state level, only North Dakota has posted an increase in RevPAR this year, as the state has not been significantly affected by the economic downturn. California and Florida, though, have each registered a drop in RevPAR in excess of 20 percent. The decline in Florida may be especially pronounced, as its peak travel season from February through April typically sustains property owners through the slow summer and hurricane season.

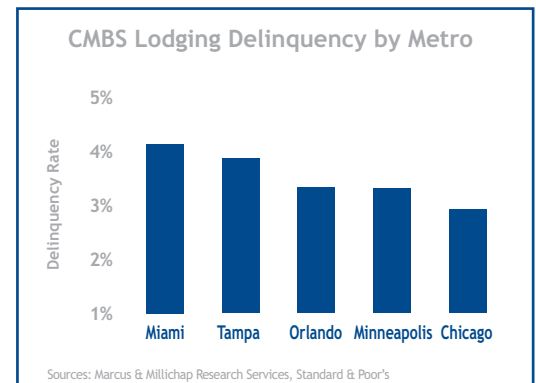
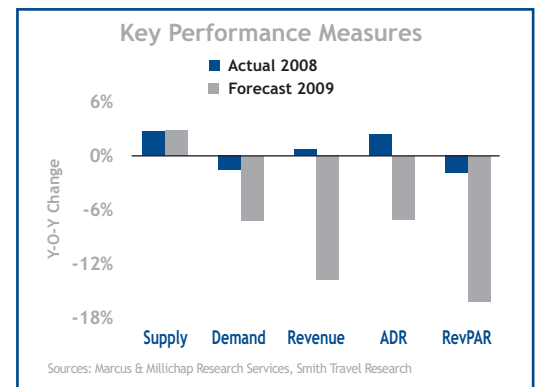
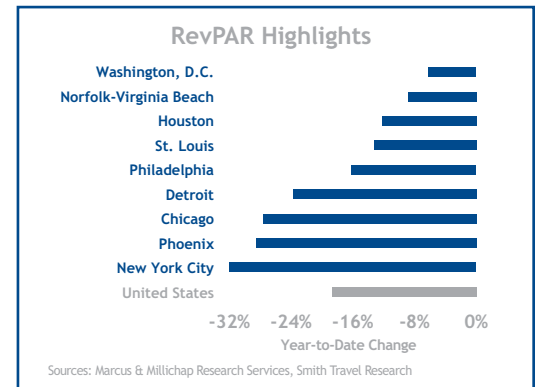
Current Forecast Projects Further Weakness

The intensity and magnitude of the current downturn in lodging fundamentals continue to surprise, and the near term will remain very challenging. This year, occupancy is forecast to fall 590 basis points to 54.5 percent, based on a 7.2 percent drop in room demand and a 2.6 percent increase in the number of available rooms. The current forecast assumes a slight moderation of year-to-date demand trends during the peak summer period, when about 30 percent of annual room demand is typically generated. Also, the increase in the number of available rooms reflects the completion of 130,000 new rooms, slightly more than the number added in 2008. Wider use of rate discounting will continue over the remainder of the year as property owners attempt to bolster occupancy. As a result, room revenues are expected to fall 13.8 percent to a level last attained at year-end 2005. The nationwide ADR is forecast to drop 7.1 percent to \$99.00, while the combination of more available rooms and reduced revenue will push down RevPAR 16.2 percent to \$54.07. Looking ahead, room demand will recover slightly in 2010 as pent-up demand is relieved by a modest resumption in business travel and consumers taking vacations again.

Investment Activity Eases as Fundamentals Falter

Investment activity continues to be hindered by difficulties in financing acquisitions and the decline in operating fundamentals. During the most recent 12-month span, transaction velocity fell 42 percent, while the median price of properties sold declined 18 percent to \$53,300 per room. Less than 40 percent of deals made in that time occurred over the last six months, a period of considerable stress in the credit markets, as lenders curtailed activity. Conduits, for example, were active through a considerable portion of 2008, but the sharp downturn in the economy has since stymied the commercial mortgage-backed securities market.

Distress continues to build for lodging loans in CMBS pools. According to a recent report, the delinquency rate on these loans was 2 percent in the first quarter, compared with a recent low of 0.3 percent in December 2007. Of the nation's top 25 markets, six had delinquency rates greater than the national rate, ranging from 2.2 percent in Phoenix to 4.1 percent in Miami. In fact, the three markets with the highest delinquency rate are in Florida, a state that has been hit hard by the downturn in air travel.



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CAPITAL MARKETS

By WILLIAM E. HUGHES, SENIOR VICE PRESIDENT, MARCUS & MILLICHAP CAPITAL CORPORATION

- ◆ Through the first half of the year, acquisition capital has remained very tight. Conduits have been on the sidelines, and commercial banks have been concerned about the performance of existing loans in their hospitality property portfolios. Indeed, defaults and lodging delinquencies are likely to rise in the months ahead, especially on assets purchased during the peak of the market two to three years ago.
- ◆ The Term Asset-Backed Loan Facility (TALF) was expanded recently to include highly rated CMBS. Modifications to risk-assessment methodologies could reduce the share of legacy CMBS that qualify for TALF; however, the inclusion of newly issued CMBS to TALF has led some lenders to consider originating new commercial mortgages for securitization.
- ◆ Loans on hospitality properties issued by commercial banks are often underwritten at an LTV ranging from 60 percent to 65 percent, with all-in rates from 7 percent to 8 percent. Terms range from three years to five years, and amortization schedules are 25 years.
- ◆ The yield on the 10-year U.S. Treasury has climbed to a range from 3.6 percent to 3.9 percent. Inflation fears have spiked recently, as investors are concerned about the potential effects of the easy monetary policy and increased government spending on the economic stimulus and new programs.

HOTEL PROPERTY INDEX

The index of the largest hospitality markets in the country, excluding Las Vegas, measures the changes in room supply, room demand, ADR and RevPAR so far this year. A market with an index score greater than 100 improved from the year before, while a score of less than 100 signifies a decline. In the most recent index calculation, none of the top 25 markets registered an improvement in performance. While markets such as San Francisco, Orange County and Orlando have recorded only modest increases in room supply, their performance has been impacted nonetheless by significant declines in room demand. Markets with only slight changes in demand, including Washington, D.C., have been affected by considerable supply growth.

Market	Index Value*	Occupancy Rate	ADR	RevPAR
Washington, D.C.	95.6	64.9%	155.74	101.09
Norfolk-Virginia Beach	94.5	49.1%	75.81	37.23
Houston	91.2	60.8%	97.50	59.25
St. Louis	90.8	50.9%	81.68	41.59
Oahu Island	90.3	71.5%	151.77	108.48
Philadelphia	90.0	58.5%	112.18	65.57
Nashville	88.2	53.2%	91.32	48.60
Tampa	87.9	58.4%	112.58	65.70
Denver	87.7	53.3%	94.99	50.63
United States	87.7	53.3%	99.10	52.78
San Francisco	87.0	64.3%	131.98	84.87
New Orleans	86.9	60.5%	121.36	73.44
Orange County	86.9	61.5%	111.81	68.78
Orlando	86.8	64.3%	103.75	66.74

* Values for year-to-date 2009

Sources: Marcus & Millichap Research Services, Smith Travel Research