Equity Research Report

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CONSUMER: Lodging

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Reasons for this report

✓ Deep dive analysis of recent U.S. hotel revenues and profits, a proxy for the Lodging REIT portfolios and within Lodging C-corps an excellent overview of franchisee health/fee generation of institutional hotel owners.

✓ The analysis is also a read-through on C-corp base and incentive management fees (IMFs) and owned/leased margins.

Feb. Hotel P&L Analyzer: 4Q23 owned GOP margins +50 bps y/y. Group rebound + big city leisure drive positive result

In our analysis of ~1,000 U.S. full-service hotels (data source HotStats), 4Q23 hotel Gross Operating Profit (GOP) margins were 35.9%, +50 bps y/y and -10 bps vs. 4Q19. These figures are mixed versus 3Q23 (-130 bps y/y and flat bps vs. 3Q19). We expect 4Q margins y/y to be better for Upper Upscale, Urban, and Group hotels than Luxury, Resort, and midpriced hotels. Group demand led to stronger F&B margins. Big city leisure was also a tailwind.

Our "Bottom Line": For 2024, we view profit margins flattish-to-down y/y still the base case. TBD variables include: fixed costs, organized labor negotiations, and the recovery of U.S. leisure demand.

Please note our data set continues to skew slightly above the average Upper Upscale hotel and to institutionally-owned urban and resort hotels which may add some variance to STR data and individual public company results. ***Please view the PDF version of this note for superior quality of exhibits.***

Major takeaways:

A) 4Q23 profit results: Hotel profit results were quite varied by the type of property but our data set's overall GOP margin growth was driven in particular by improved group demand and better food and beverage margins. We view 4Q23 as somewhat of a read-through for 2024 as Group RevPAR growth is likely to materially exceed Leisure RevPAR.

Exhibit 1: 4Q23 Versus Prior Years Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 4Q23 vs. Prior Years

	4Q23	4Q22	*y/y % change*	4Q19	*4-yr % change*
Occupancy	66.0%	65.4%	*0.9%*	73.7%	*-10.4%*
ADR	$256	$256	*0.0%*	$224	*14.4%*
RevPAR	**$169**	**$168**	***0.8%***	**$165**	***2.3%***
Total RevPAR	**$270**	**$265**	***1.7%***	**$263**	***2.4%***
Room Margin	72.5%	72.6%	*-0.1%*	72.9%	*-0.5%*
F&B Margin	29.4%	28.4%	*3.5%*	29.9%	*-1.7%*
Operating Department Margin	60.5%	59.8%	*1.2%*	59.9%	*1.0%*
GOP Margin	**35.9%**	**35.4%**	***1.4%***	**36.0%**	***-0.3%***
GOP Per Available Room	**$97**	**$94**	***3.2%***	**$95**	***2.1%***
Total Hotel Payroll (% of Total Revenue)	35.3%	35.3%	*0.0%*	35.2%	*0.3%*
Total Hotel Payroll (Per Available Room)	$95	$94	*1.8%*	$93	*2.9%*
Total Hotel Payroll (Per Occupied Room)	$144	$143	*1.0%*	$125	*15.1%*

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

Source: Truist Securities Research; HotStats

For 4Q23, we estimate:

- **Urban higher-rated hotels were relative profit outperformers:** GOP margins y/y flattish to +200 bps driven by strong group demand (leading to higher F&B margins)

SEE PAGE 19 FOR REQUIRED DISCLOSURE INFORMATION

and rebounding leisure to major markets. **These results also provide a tailwind to C-corp incentive management fees (IMFs).**

- **Resort profits were mixed:** Varied but margins flattish to moderately down y/y (group-oriented hotels better than leisure-oriented hotels)
- **Select-service profits were flattish-to-down:** Our HotStats data set indicates GOP margins y/y down 90 bps on -3.9% RevPAR.
- **December: pop of high spend from leisure guests (including F&B and resort fees) supports the strength of higher-income consumer discretionary spend on travel.**

B) <u>2024 Forecasts</u>: The consensus view of flattish y/y Hotel EBITDA margins on roughly 3-5% RevPAR growth continues to make sense to us under the assumption of labor cost growth of 2-6% y/y. Similar to 4Q23, we anticipate a spread of profit results by type of property given vastly different RevPAR growth. Group and some big city urban higher-rated hotels should have the best opportunity for flattish-to-moderately positive y/y margins on 2024 RevPAR growth north of 4%. Hotels with 3-4% RevPAR growth or less (Upscale to Economy hotels) have a greater likelihood of negative y/y margins. **Among the variables for 2024:**

- **(+) Major recovery of U.S. leisure especially this summer could lead to positive surprises on profitability if actualized.** Stronger leisure demand may allow hoteliers to push room rates more sustainably. Profit margins could expand from greater operating efficiencies on higher occupancy with limited incremental staffing needs. Initial summer booking trends may be more evident around April/May.
- **(+) Strong group bookings close to the date of arrival, a continuation of 2023 trends.**
- **(-) Labor strikes and/or protracted organized labor negotiations** impact not just hotel costs and operating efficiencies but also lead to group cancellations and/or lower group attendance. Several major cities have labor negotiations in mid-2024 although most markets may not see the drawn-out negotiations that took place in Los Angeles in 2023.
- **(~) Non-labor costs.** Insurance, utilities, and property taxes (in total ~ 5-11% of normalized total revenues). Insurance cost growth likely in the single-to-low double digit growth range, utilities TBD, and tax expense partly dependent on success of appeals.
- **1H24: Hotel-level margins generally better in 2Q24 vs. 1Q24.** Due to weather/flight cancellations in January and the timing of Easter, we anticipate EBITDA margins y/y to be weaker in 1Q24 versus 2Q24. Lodging REIT guidance may vary widely in 1H24 depending on city-specific (citywide group), leisure market exposure, and renovation impact. Group mix may be a material determinant of whether a portfolio can achieve y/y profit margin growth.
- **We do not think stock investors have fully appreciated the likely 2024 strategy of lower RevPAR growth to support more group demand (a change to the customer segmentation mix) and therefore greater absolute EBITDA even if margins decline y/y.** This nuance does not come up much with investors as there is often greater focus on headline RevPAR growth and headline EBITDA margin change. However, it will be incumbent on the REITS to show the success of this group mix shift in guidance and earnings results.

C) <u>Stock recommendations</u>:

- **We still view Lodging C-corps generally much better positioned than the Lodging REITS in 2024** driven by LSD-MSD hotel revenue growth and more robust management fees from big group hotels (both base and incentive management fees). As discussed in our 2024 Lodging Preview, we see the biggest variable for hotel REIT stock performance coming from valuation multiple expansion (or contraction), driven by investor sentiment around the direction of interest rates. Improved Asia-Pacific performance will also provide tailwinds on global IMFs. The more diversified global growth platforms of the C-corps and lower exposure to the operating leverage of managing/owning U.S. hotels continues to work in the favor of C-corps, especially in an environment of flattish U.S. Hotel EBITDA margins for 2024.
  - **C-corp pipelines/development: remaining challenged in the U.S. for new build hotels due in part to underwhelming profit margins.** We reiterate our views from April 2023 that hotel new unit growth will be led by international regions, conversions, new brand development in "downscale" lower-rated hotels, and inorganic tuck-in brand acquisitions.
- **Among Lodging REITS, we anticipate varied performance by REIT but we anticipate initial 2024 guidance for Hotel EBITDA margins to be conservative and flattish to down y/y as cost growth is expected to exceed revenue growth.** There will be highly varied market-specific group strength/weakness and in some cases material impact from property-specific considerations such as major renovations, the latter being very difficult to model without guidance. **We would be surprised if any REIT has a better 2024 outlook than Ryman's (RHP, Buy, Scholes) Hospitality segment guidance provided at Investor Day. We expect 2024 Lodging REIT EBITDA guidance to be intentionally conservative** with REITS trying to dull Street expectations in the last few months **but we see opportunities for actualized y/y margin growth particularly if summer leisure demand ends up strong, a scenario where we may not have good visibility until at least the Spring.** Fixed costs such as taxes and insurance and non-labor costs such as utilities may have more uncertainty than labor cost growth. We assume hotels with robust in-house/citywide group demand and outside-the-room spend will have the greatest opportunities for y/y margin growth on at least +5% RevPAR growth.
- **For a few specific foci on some consensus quarterly estimates, please see Exhibits 19 and 20 in regards to below:**
  - **C-corps:** Particularly following Hilton (HLT, Hold, Scholes) 4Q23 earnings and given regional RevPAR recovery in Asia-Pacific, we view Marriott's (MAR, Hold, Scholes) incentive management fee consensus possibly light.
  - **REITS:** We anticipate revisions to quarterly assumptions as there are considerable variations in consensus estimates by quarter. However, at this point in the year, we will be more reliant on company guidance due to portfolio-specific considerations that are very difficult to model with precision.

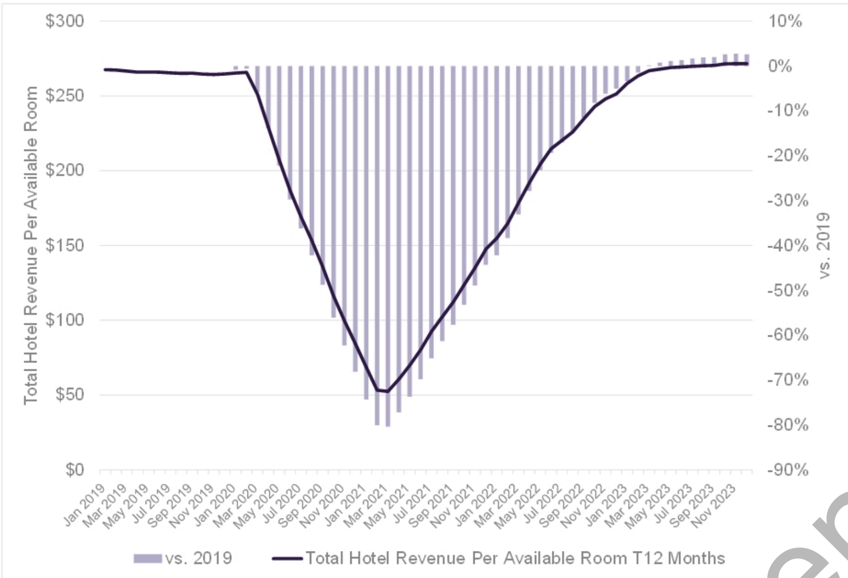
D) <u>Other topics and deeper dive into the P&L</u>:

- **Labor matters: Improving but not improving enough.** Beyond union negotiations this year, we view other cost headwinds to include: the joint employer rule if/when implemented, continued low unemployment, and insufficient progress on work visas/legal immigration reform. Additionally, tight staffing/automation/occupancy deficits challenge property-level employee morale, career advancement opportunities, tipped position compensation, and recruitment.
- **Service/operating matters: Higher room rates would help considerably for the guest stay and for profits.** We view hoteliers' general inability to push ADR harder post-pandemic in a lower occupancy/high inflation period (excluding some leisure markets) may continue to have negative ramifications on owner spend for hotel renovations, staffing levels, and improvements to the guest experience. Absolute profits for some hotels continue to be only around 2019 levels -- and well behind inflationary growth of ~19% since COVID.
- **Margins in 2025-2027:** A slow climb to improving margins, excluding a demand shock, driven by 1) continued low new hotel supply growth and 2) greater operating efficiencies on slowly rising occupancy with limited increases in employee counts and 3) the ability for hoteliers to push room rates even if occupancy levels remain below pre-2020 norms.

A) 4Q23 results:

We start with total revenues or Total RevPAR versus 2019 as a proxy for base management fees for the C-corps and to reflect the important recovery of in-house group demand to full-service hotels. The recovery of group was important for food and beverage (F&B) profits in 4Q23 and drove overall property-level GOP margin gains. Over the course of 2023, total revenues have inched slightly higher than 2019 levels on a trailing 12 month basis, gaining about 100 bps per quarter. As of 4Q23, total revenues were +3% vs. 2019. As group improves, we continue to expect total revenues and therefore base management fees to climb further ahead of 2019 levels.

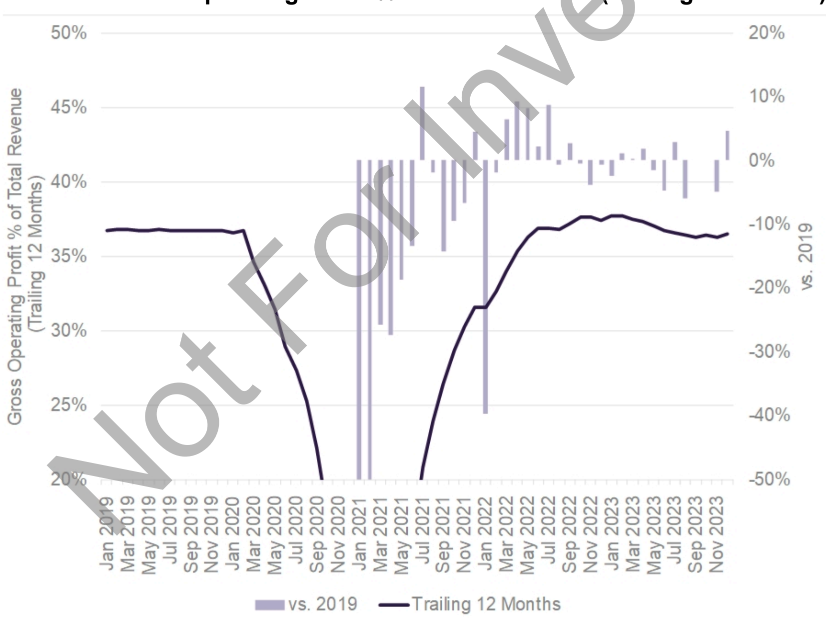
Exhibit 2: Total Hotel Revenue Per Available Room (Trailing 12 Months) and vs. 2019 Recovery



Source: Truist Securities Research, HotStats

GOP margins remain relatively flattish to 2019 levels -- not particularly inspiring trends for Lodging REIT investor sentiment given the post-pandemic messaging of "permanent margin expansion". After some margin degradation in the first eight months of the year, 4Q23 results on a trailing 12 month basis suggest a re-stabilization of margins to about 36% of total revenues or 100 bps lower than 4Q22. Importantly, these results exclude fixed cost headwinds such as rising property real estate taxes and insurance.

Exhibit 3: Gross Operating Profit % of Total Revenue (Trailing 12 Months) and vs. 2019 Recovery

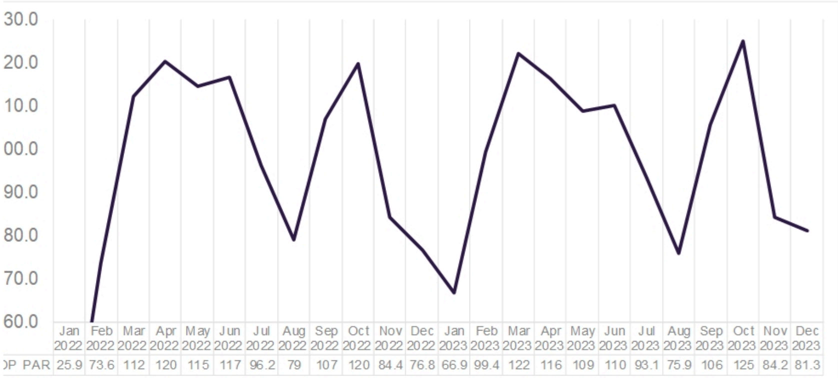


Source: Truist Securities Research, HotStats

On incentive management fees (IMFs), we view the U.S. same store 4Q23 setup more favorably than 3Q23 in terms of y/y change and absolute dollars. IMFs should be a tailwind for C-corps in 4Q23 earnings.

- IMF contribution from Asia-Pacific, which largely flows to C-corp revenues without a profit hurdle and where there has been robust RevPAR recovery (4Q23: +38-46% y/y and +5-8% vs 2019) should be another material tailwind to management fees. **Hilton** (HLT, Hold, Scholes) had IMFs +20% y/y in 4Q23 despite RevPAR for their full-service hotels up roughly 10%. We view part of the IMF tailwind driven by their Asia-Pacific region with RevPAR +42%. These results present a favorable read-through to IMFs for **Marriott** (MAR, Hold, Scholes) and **Hyatt** (H, Buy, Scholes) that report later this week and have even greater exposure to Asia-Pacific.
- Caribbean RevPAR growth in U.S. Dollars continues to moderate (we estimate +10-12% y/y in 4Q23 versus +15-17% in 3Q23) but beyond that we are watchful of the continued relative strength of the Mexican Peso as a headwind to hotel-level profit growth from the region.

Exhibit 4: Gross Operating Profit Per Available Room

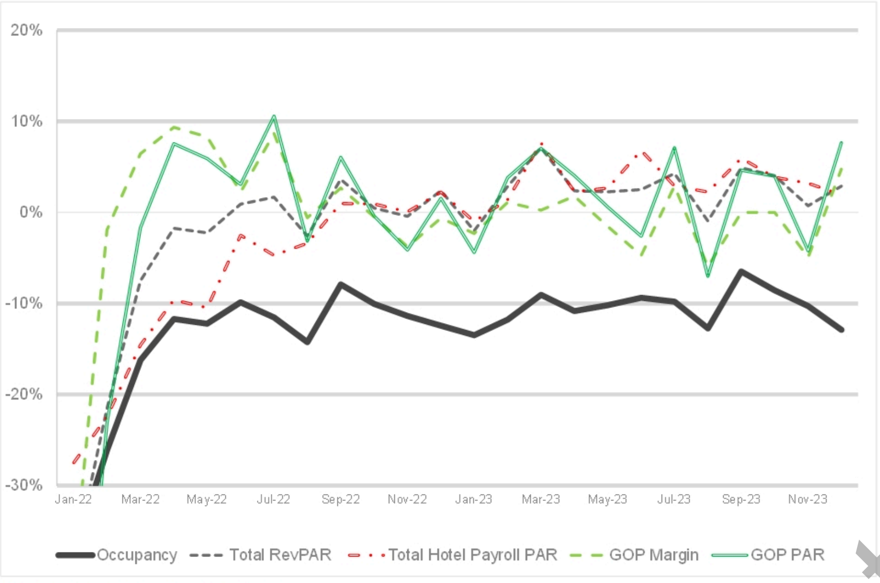


GOP PAR	2019	2022	2023	y/y	vs. 2019
January	70.02	25.89	66.93	159%	-4%
February	95.72	73.58	99.37	35%	4%
March	114.19	112.23	122.21	9%	7%
1Q	**91.72**	**68.82**	**93.75**	**36%**	**2%**
April	111.81	120.23	116.35	-3%	4%
May	108.18	114.53	108.83	-5%	1%
June	113.09	116.54	110.06	-6%	-3%
2Q	**109.78**	**115.01**	**109.72**	**-5%**	**0%**
July	87.00	96.18	93.14	-3%	7%
August	81.56	78.97	75.86	-4%	-7%
September	100.86	106.95	105.61	-1%	5%
3Q	**89.29**	**93.08**	**91.12**	**-2%**	**2%**
October	120.25	119.76	125.05	4%	4%
November	87.99	84.35	84.23	0%	-4%
December	75.65	76.81	81.25	6%	7%
4Q	**94.69**	**93.71**	**96.7**	**3%**	**2%**
4Q vs. 3Q	**6.0%**	**0.7%**	**6.1%**		

Source: Truist Securities Research, HotStats

In the below summary chart, we can see that even though occupancy remains depressed, total RevPAR and profits continue to hover generally in the -5% to +5% range versus 2019. The spike of performance in December 2023 could be partly attributed to very strong urban higher-end travel around New Year's Eve.

Exhibit 5: Occupancy, Total Revenue, Margins, and Labor Costs vs. Same Month 2019

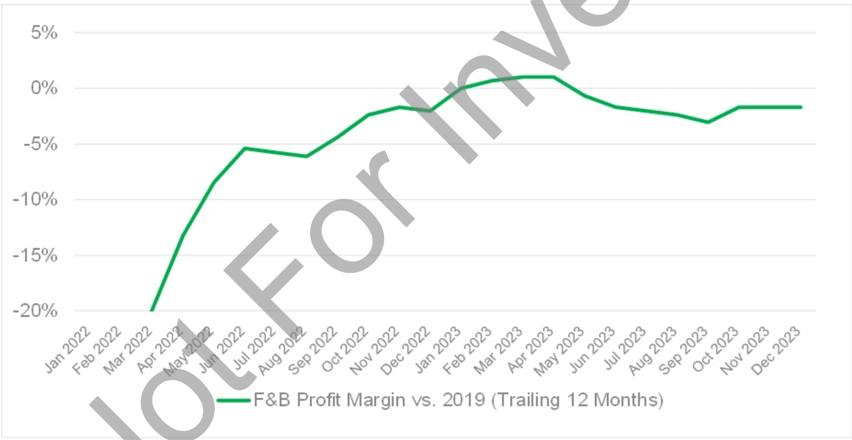


Source: Truist Securities Research, HotStats

Diving into more detail, we can see the impact of outside-the-room revenues to hotel profitability. We start with F&B which represents on average about 30-35% of total revenues for our data set but is a highly labor intensive area of the hotel with lower margins than the guest room. Banquets/catering tend to have stronger margins than restaurants but also requires a lot of staffing (robots have yet to take over serving guests in catered events).

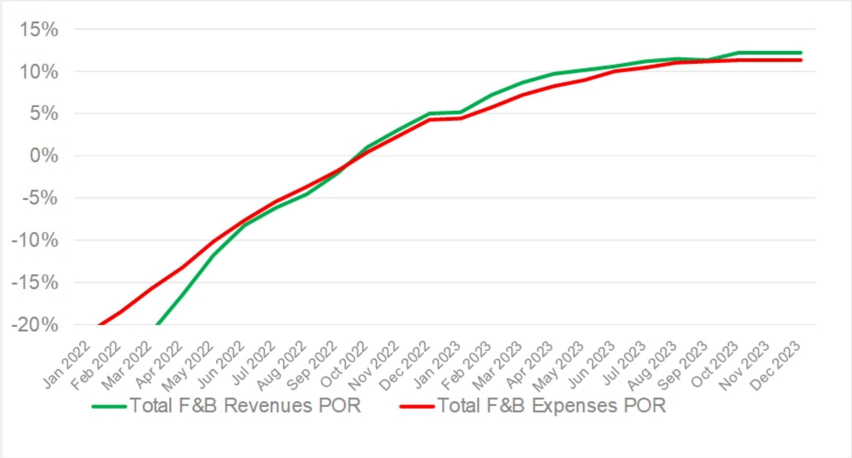
We can see from the below charts that while F&B profit margins versus 2019 have fallen slightly below pre-pandemic levels as hotels have restaffed for higher demand, overall revenue growth is ahead of profit growth, which structurally helps drive better hotel-level margins, as reflected in the summary results in Exhibit 1.

Exhibit 6: F&B Profit Margin vs. 2019 (Trailing 12 Months)



Source: Truist Securities Research, HotStats

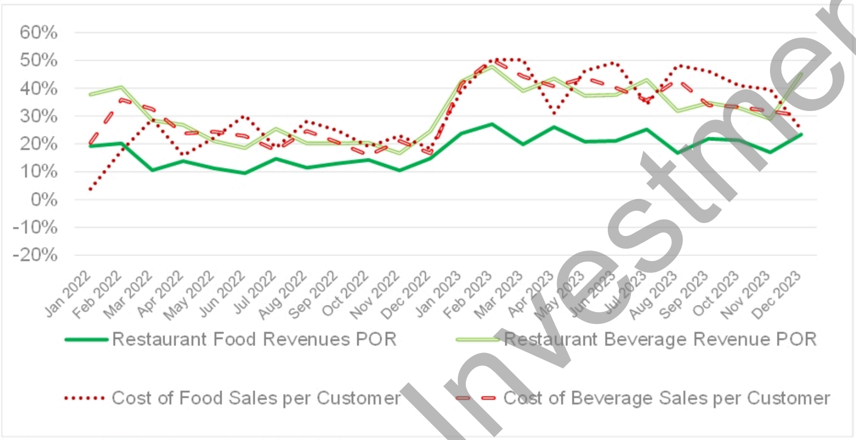
Exhibit 7: F&B Revenues Per Occupied Room (POR) Progressively Higher Versus 2019 and Slightly Ahead of Expense Growth (Trailing 12 Months)



Source: Truist Securities Research, HotStats

We also can see the impact of higher beverage (liquor) spend in December and reduced cost of goods sold food and beverage pressures as additive to the improvement in F&B profitability. That said, due to inflationary cost pressures, higher prices for food and beverage items have not resulted in materially improved profitability.

Exhibit 8: Restaurant Revenue and Expense Trends vs. 2019 Levels: Expense Pressures Starting To Diminish But Without Major Profit Gains

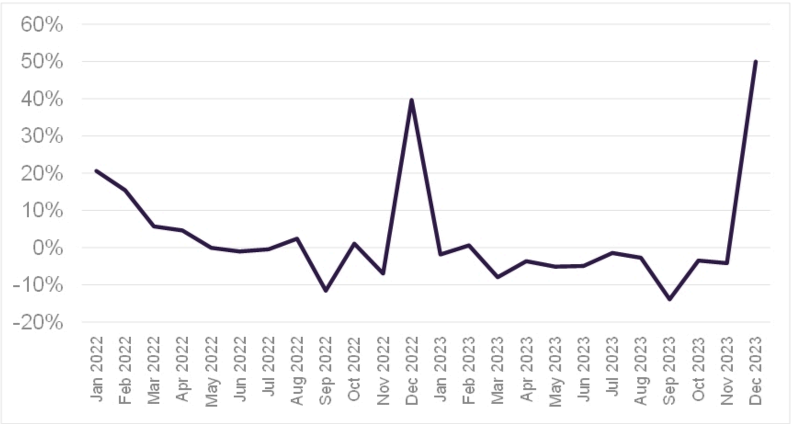


Source: Truist Securities Research, HotStats

We can also see the positive impact of "resort fees" in December where revenues spiked (+7% y/y and +50% versus 2019). We are unsure how much December growth was an anomaly or driven in part by a recovery of big city urban demand around the holidays. November resort fees were +3% y/y but -4% versus 2019.

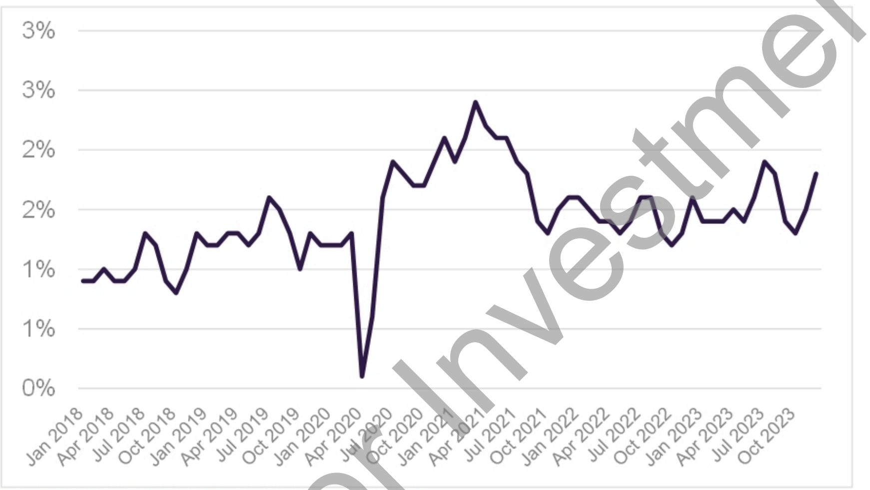
- Despite a lot of media attention and government attention to daily resort/amenity/destination fees, resort fees have maintained at roughly $15-$20 per occupied room in recent years with generally limited growth versus 2019 (WSJ; NBC News).

Exhibit 9: Resort Fees Per Occupied Room (vs. 2019): Not Growing Much, Surprisingly, Although December 2023 Was Very Strong



Source: Truist Securities Research, HotStats

Exhibit 10: Resort Fees (% of Revenues): Moderately Greater Importance to Hotel Revenues Post-Pandemic



Source: Truist Securities Research, HotStats

Shifting to the full-service Lodging REITS: 4Q23 was a better profit quarter than 3Q23 driven by fall corporate and association group demand and some higher-rated urban leisure demand around sporting events and holidays. GOP profit margins were +50 bps y/y in 4Q23 versus -130 bps in 3Q23. Most telling of the importance of group demand in a low RevPAR growth environment was F&B margins +100 bps y/y in 4Q23, a vast improvement compared to 3Q23 of -180 bps. Also unlike in 3Q23, outside the room spend was stronger than room revenues. This result is not surprising given the fall months cater more to higher-paying corporate travelers especially from the fall convention season.

- Importantly, GOP margins do not include fixed costs such as property taxes and insurance. Property insurance is a well-established y/y profit headwind with costs rising 20% to north of 100%. Real estate tax growth will vary; we assume any materially higher assessments will be appealed especially in markets where property sale prices and hotel P&Ls are depressed versus 2019 levels. However, the time from re-assessment to a successful appeal can take years and there may be higher property taxes in the interim period.

Exhibit 11: 4Q23 Versus 3Q23 Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 4Q23 vs. 3Q23

	4Q23	3Q23	*% change*	*Abs, variance*	
Occupancy	66.0%	71.3%	*-7.4%*	-530	*bps*
ADR	$256	$244	*4.9%*	$11.90	
RevPAR	**$169**	**$174**	***-3.0%***	**-$5.17**	
Total RevPAR	**$270**	**$260**	***3.8%***	**$9.91**	
Room Margin	72.5%	72.8%	*-0.4%*	-30	*bps*
F&B Margin	29.4%	23.3%	*26.2%*	610	*bps*
Operating Department Margin	60.5%	60.5%	*0.0%*	0	*bps*
GOP Margin	**35.9%**	**35.2%**	***2.0%***	**70**	*bps*
GOP Per Available Room	**$97**	**$91**	***6.1%***	**$5.58**	
Total Hotel Payroll (% of Total Revenue)	35.3%	35.7%	*-1.1%*	-40	*bps*
Total Hotel Payroll (Per Available Room)	$95	$93	*2.9%*	$2.69	
Total Hotel Payroll (Per Occupied Room)	$144	$130	*11.2%*	$14.57	

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

Source: Truist Securities Research; HotStats

Exhibit 12: 3Q23 Versus Prior Years Hotel Performance (Our Data Set)

Aggregated U.S. Hotel Operating Performance: 3Q23 vs. Prior Years

	3Q23	3Q22	y/y % change	3Q19	4-yr % change
Occupancy	71.3%	69.8%	*2.1%*	79.0%	*-9.7%*
ADR	$244	$245	*-0.3%*	$216	*13.2%*
RevPAR	**$174**	**$171**	***1.9%***	**$170**	***2.2%***
Total RevPAR	**$260**	**$256**	***1.4%***	**$254**	***2.3%***
Room Margin	72.8%	73.4%	*-0.8%*	72.9%	*-0.1%*
F&B Margin	23.3%	25.1%	*-7.2%*	23.2%	*0.4%*
Operating Department Margin	60.5%	61.3%	*-1.3%*	59.9%	*1.0%*
GOP Margin	**35.2%**	**36.5%**	***-3.6%***	**35.2%**	***0.0%***
GOP Per Available Room	**$91**	**$93**	***-2.1%***	**$89**	***2.0%***
Total Hotel Payroll (% of Total Revenue)	35.7%	34.6%	*3.2%*	35.7%	*0.0%*
Total Hotel Payroll (Per Available Room)	$93	$88	*4.9%*	$91	*2.0%*
Total Hotel Payroll (Per Occupied Room)	$130	$126	*2.7%*	$115	*13.1%*

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

Source: Truist Securities Research; HotStats

As we view pre-pandemic comparisons too often focused on one specific year (2019), we are also including in this note full-year comparisons going back to 2018, as far back as we have for same store HotStats data. That said, neither 2018 nor 2019 was a peak profit year for some hotels. We recommend investors review property-specific EBITDA through public filings. What one may find is that some big city urban hotels achieved peak absolute EBITDA in the 2015-2017 range.

Exhibit 13: FY 2023 Versus 2018, 2019, and 2022 (Our Data Set)

Aggregated U.S. Hotel Operating Performance: FY 2023 vs. Prior Years

	FY 2023	FY 2022	y/y % change	FY 2019	4-yr % change	FY 2018	5-yr % change
Occupancy	68.7%	65.4%	*5.0%*	76.7%	*-10.4%*	77.0%	*-10.8%*
ADR	$254	$250	*1.6%*	$222	*14.3%*	$224	*13.4%*
RevPAR	**$174**	**$163**	***6.7%***	**$170**	***2.3%***	**$172**	***1.1%***
Total RevPAR	**$272**	**$251**	***8.0%***	**$265**	***2.6%***	**$269**	***1.0%***
Room Margin	73.0%	73.8%	*-1.1%*	73.3%	*-0.4%*	73.7%	*-0.9%*
F&B Margin	28.9%	28.8%	*0.3%*	29.4%	*-1.7%*	29.7%	*-2.7%*
Operating Department Margin	60.9%	61.7%	*-1.3%*	60.4%	*0.8%*	60.2%	*1.2%*
GOP Margin	**36.5%**	**37.4%**	***-2.4%***	**36.7%**	***-0.5%***	**36.9%**	***-1.1%***
GOP Per Available Room	**$99**	**$94**	***5.3%***	**$97**	***1.8%***	**$99**	***-0.3%***
Total Hotel Payroll (% of Total Revenue)	35.2%	34.0%	*3.5%*	34.9%	*0.9%*	34.7%	*1.4%*
Total Hotel Payroll (Per Available Room)	$95	$85	*11.7%*	$92	*3.3%*	$93	*2.2%*
Total Hotel Payroll (Per Occupied Room)	$139	$131	*6.3%*	$120	*15.3%*	$121	*14.4%*

Note: HotStats sample is somewhat skewed to U.S. full-service hotels although individual hotel results vary widely today by hotel location and customer base.

Source: Truist Securities Research; HotStats

For select-service hotels, GOP margins have not rebounded as quickly as we expected. Logically, we expect select-service margins to eventually improve closer to 2019 levels as individual business travel continues to recover, corporate negotiated room rates and government per diems increase mid to high single digits in 2024, and from limited new hotel supply growth. However, for select-service hotels, RevPAR growth of ~2-4% may be insufficient for material if any profit margin expansion in 2024.

- Please note that while we receive an aggregation of hundreds of U.S. select-service hotels, it is possible that our data is not a clear representation of the performance of the higher-rated select-service and extended-stay hotels in the U.S.

Exhibit 14-15: Gross Operating Profit Margins as a Percentage of Revenues (top exhibit) and vs. 2019 (bottom exhibit)

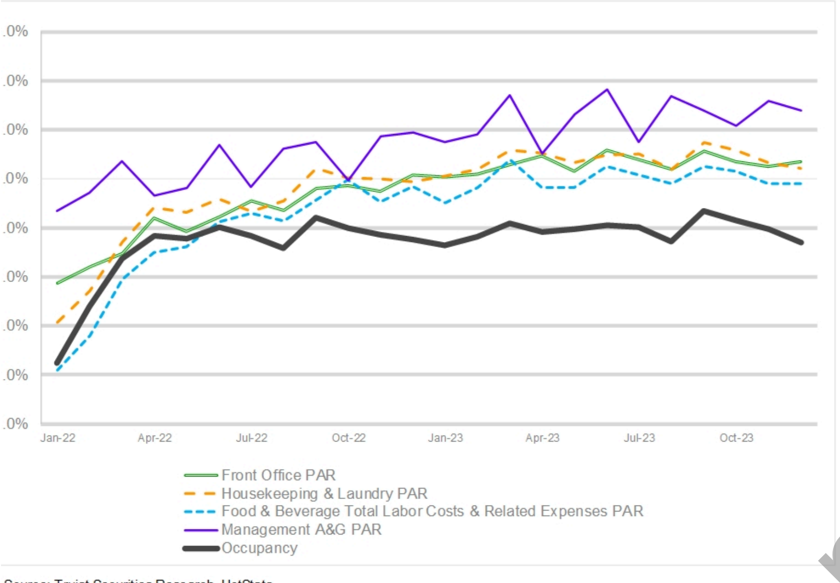
GOP margin seasonality (% of revenue) has largely returned to pre-pandemic norms

Full-service margins still flattish vs 2019. Select-service remains well below 2019 (-6% to -12%)

Note: We have intentionally not presented the deeply negative margins in 2020 for easier visuals.
Source: Truist Securities Research, HotStats

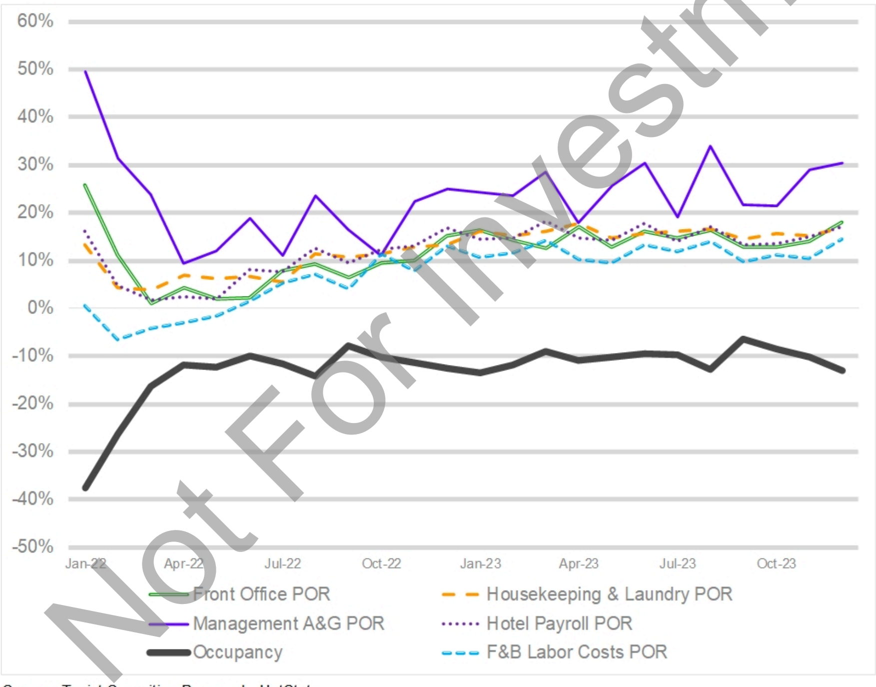
Finally, we conclude this section on trends in labor costs by department. We evaluate trends both per available room (PAR) and per occupied room (POR) although in a more normalized occupancy environment where staffing has mostly returned to a new post-pandemic normal, we view POR as a better proxy of labor costs. As evident in Exhibit 1, hotel ADR in 4Q23 rose 14.4% whereas payroll increased 15.1%. With the exception of property-level management where compensation is 20-30% above 2019 levels (and somewhat above CPI growth), hourly position labor cost growth is in the 10-20% range.

Exhibit 16: Occupancy Compared to Labor Costs by Hotel Department Per Available Room (PAR) vs. Same Month 2019



Source: Truist Securities Research, HotStats

Exhibit 17: Occupancy Compared to Labor Costs by Hotel Department Per Available Room (POR) vs. Same Month 2019



Source: Truist Securities Research, HotStats

B) 2024 Forecasts

As RevPAR (and total revenue) growth provides a proxy for profit growth, we generally view the consensus of 3-5% RevPAR growth leading to flattish y/y Hotel EBITDA margins as a continued reasonable starting place for 2024 profit forecasts.

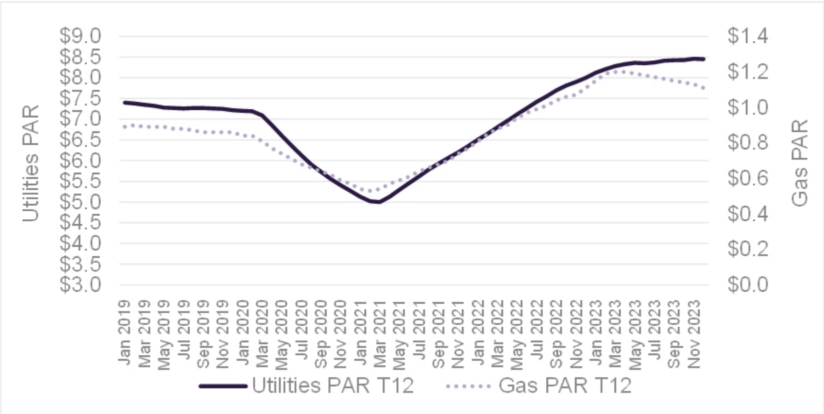
Relative to 2023, better visibility on forward hotel group pace and labor cost growth provides greater confidence for hoteliers to forecast 2024 profits. We may see more Lodging REITS provide full-year 2024 guidance than same time last year. However, there are still uncertainties in hotel budgets for 2024 that may lead public companies to guide conservatively as the impact from the unknown variables may be material to earnings. Below is how we split out the revenue and cost growth for 2024 based on conversations with public and private hotel owners and operators since November 2023.

- **Revenues: If there is profit growth y/y, for now the expectation is large Group demand (e.g. citywide conventions) provides the base and Leisure provides the positive upside risk.**
  - Similar to 4Q23 results, Group demand is likely to be impactful to the degree of hotel-level profit growth, if any, driven by both higher Group RevPAR and outside-the-room spend (restaurants, lounges, banquets/catering, etc.). From discussions at the ALIS Conference in LA in January, there is some cautiousness from hoteliers about how strong in-the-year-for-the-year shorter-term bookings will actualize and if that demand will be as robust as in 2023.
  - Individual corporate revenue growth will likely be driven by rate gains over occupancy gains.
  - Leisure demand is more of the uncertain variable. The questions revolve around the degree of recovery of inbound travel to the U.S. and Americans staying at home this summer in part due to higher costs to travel abroad. Initial summer booking trends may be more evident around April/May.

- **Labor (ex-unions and federal government action on matters such as the joint employer rule): Staffing levels are closer to normalization and as a result the focus is more on wage/benefit increases. Hoteliers continue to expect 2-6% y/y labor cost growth for 2024.** It would take a fairly material increase in occupancy for many hotels to have to add many new positions. We have heard that step-ups for labor are more notable for every five points of occupancy and we do not expect occupancy to grow more than 1-3 points for many hotels.
  - **We view organized labor contract negotiations in 2024 as a variable to cost growth for major union-heavy markets in 2H24 and through the multi-year terms of the next contracts. Due to the timing of negotiations, we view a potential step-up in labor costs especially in 2025.** In general, hoteliers expect LA's contentious negotiations in 2023 to not be repeated in some of the other U.S. markets as part of the issue in LA was lower wages relative to market peers and unrealistic union efforts to house homeless in hotels next to guests (LA Times). We find the theoretical life-safety issues for hotel workers and guests significant enough that we are not surprised this effort was struck from the March 2024 local ballot. However, rolling labor strikes had some impact on citywide conventions in 2023 and it is possible that other cities may have similar situations in 2024. We view that efforts that challenge the group experience do not serve organized hotel workers well in the long-term especially as meeting planners have been more geographically flexible to non-union markets since COVID. That said, there may still be contentious organized labor negotiations in 2024 in select REIT markets.
    - Labor negotiations go beyond wages and benefits; in some markets the labor argument is less about compensation due to already very decent market-appropriate total pay. In some markets, hoteliers anticipate labor efforts to change work rules which can make hotels less operationally efficient and often less profitable.

- **Other hotel costs (variable by hotel/market/owner):**
  - **Real estate taxes (roughly 2-6% of normalized hotel revenues):** Quite variable by hotel. While we have heard of local tax assessors' offices trying to reassess hotels at higher valuations and therefore leading to higher taxes, there is evidence from hotel P&L statements (and this note) that many hotels are not materially more profitable than in 2019 and at lower profit levels relative to inflation. Hotel owners can appeal the higher reassessments but that process can take years to conclude. We are unsure of the impact to hotel owners from a tax relief bill passed by the U.S. House on January 31st.
  - **Insurance (roughly 1% of revenues):** Likely to grow high-single-digits to low-double digits y/y. This 2024 increase follows 2023's increase of 20% to over 100% y/y. We are not sure about Maui hotels due to last year's fires.
  - **Utilities (roughly 2-4% of revenues):** Hoteliers are once again bringing up concerns about utility cost growth, as was the case around the start of the Russia-Ukraine war. However, we do not see gas costs as the driver of utility cost growth as was the case in 2022/2023. We see modest general cost growth at the moment driven by other utility expenses.

Exhibit 18: Utilities Costs Per Available Room – Overall Costs Growing In Late 2023 But Not Driven By Gas



Source: Truist Securities Research, HotStats

For 1Q24 forecasts, we are increasingly more cautious on margin expectations in part from challenging weather and flight cancellations. REIT markets were particularly impacted from heavy rains in California, deeply cold conditions in the Midwest, and heavy snow in the U.S. South. Already 1Q24 was going to have a somewhat harder comp due to the timing of Easter and negative impact to March group (2Q24 would have the easier comp).

C) Other stock considerations

As discussed above, we see better fundamentals for revenue growth in 2024 than profit growth. This dynamic is superior for C-corps that generate more of their fees from top-line results than for public and private hotel owners. We view improved group results will benefit base and incentive management fees for the global C-corps although Owned & Leased EBITDA from U.S. hotels is likely to be more portfolio-specific and harder to model without guidance. For example, several of Hyatt's hotels are large group hotels that may have stronger property-specific results in 2024.

- **On C-corps quarterly consensus estimates, we view Marriott IMFs potentially under-modeled for 4Q23 and possibly 2024 that could contribute to an earnings beat,** especially given HLT's IMF result for 4Q23 (+20% y/y versus MAR's +3% consensus estimate, although there is one low estimate) and MAR's greater exposure to rebounding Asia-Pacific markets.

Exhibit 19: Lodging C-corp Consensus Incentive Management Fees (y/y change). Please note that 4Q23 is actual for HLT; all other time periods are estimates)

	4Q23	1Q24	2Q24	3Q24	4Q24	FY 2024
Hilton (HLT)	20%	9%	10%	11%	9%	10%
Marriott (MAR)	3%	7%	7%	14%	9%	9%

Source: Truist Securities Research, FactSet, Company filings

Development/pipelines: While the good news is that RevPAR growth will be a tailwind for C-corp fees, profit trends in this note suggest continued challenges for the development of many new-build hotels in the U.S. Quite simply, full-service and higher-rated select-service hotel profits when accounting for inflation are well behind 2019 levels. Beyond the P&L are higher costs for hotel construction and higher interest rates. For now, we expect C-corp development focus to continue to be centered on the following:

1. International development
2. Conversions
3. New brand development especially in downscale lower-rated chain scales (a continuation of trends from 2022-2023)
4. Inorganic tuck-in brand acquisitions to shore up weaker organic net unit growth

For the REITS, we provide a summary below of consensus Hotel EBITDA margin estimates for 4Q23 and through 2024. While it is difficult to model the quarters with precision this early in the year, we anticipate some revisions to modeling approaches if/when companies provide quarterly guidance assumptions starting with 4Q23 earnings.

Exhibit 20: Lodging REIT Consensus Hotel EBITDA Margins (bps y/y change)

	4Q23	1Q24	2Q24	3Q24	4Q24	FY 2024
DiamondRock (DRH)	-380	-85	-36	-406	37	-17
Host (HST)	-96	-27	-22	-356	21	-93
Park (PK)	*not provided by ConsensusMetrix*					
Pebblebrook (PEB)	77	-37	137	54	162	91
RLJ (RLJ)	-105	-70	-114	-267	53	-55
Sunstone (SHO)	-238	2	-120	-43	99	-229

Source: Truist Securities Research, Consensus Metrix

<u>Other topics and deeper dive into the P&L:</u>

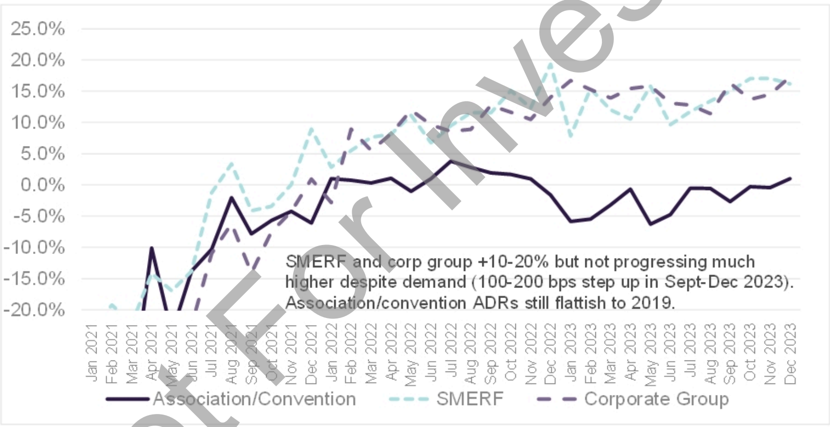
Labor matters: Improving but not improving enough. One recent study of hotel staffing levels comes from the survey work of the American Hotel & Lodging Association (AHLA) where surveyed hotel members noted in January that staffing shortages were moderating (Business Travel News). AHLA pointed to the slow improvement driven by "record-high average wages and better benefits and upward mobility than ever before". Of the survey respondents, 67% noted staffing shortages at their hotels with 12% severely understaffed. The staffing shortages count is lower than the 82% figure in May 2023. The January survey noted that housekeeping was the most critical need of hoteliers.

- **We generally find the greatest issues relating to staffing shortages driven by low unemployment and insufficient progress on work visas/legal immigration reform.** While the Department of Homeland Security announced in November 2023 of an additional 65K temporary nonagricultural worker visas for FY 2024, AHLA noted that there are more than 70K open hotel jobs.
- While higher unemployment would likely alleviate some of the issues facing worker shortages, one continued outstanding item for the service industry is legal immigration reform. This matter is particularly germane to hourly workers in low-wage roles, including some hotel positions. We do not anticipate major changes to immigration reform prior to the 2024 election.
- **Other challenges facing staffing relate to the "bottom line" of workers:** reduced tipping in part from lower occupancy levels, greater automation efforts by hoteliers, and in some cases still very tight opportunities for career advancement at the property-level (we read about this frequently in hospitality worker social media pages).
- An additional headwind to 2024 is the potential "joint employer" rule from the National Labor Relations Board (NLRB) that we discussed last year and would impact franchisors and franchisees by what AHLA calls "classifying franchisors as a joint employer of a franchisee's staff, even if the franchisor has no direct control over workplace rules and conditions." This rule is expected to take effect on February 26th although there are efforts to repeal the NLRB ruling (Reuters).

Service/operating matters and room rates: While perhaps not a popular argument, we believe that there may have been an artificial room rate integrity issue post-pandemic even though room rates generally were not intentionally and materially lowered (demand was not going to be generally induced during the peak of COVID by lower room rates). As one example, the corporate negotiated room rate was held constant after the pandemic even in a higher-inflationary environment. While hotel occupancy is getting closer to pre-pandemic norms, room rate movement in recent months appears discouraging for hotel profit growth, for hotels to have more capital to renovate hotels, and for additional expenses that support the guest experience such as increased staffing. As ADR movement has a much greater flow to profits than occupancy, particularly in a higher inflationary environment, we are not particularly impressed at some of the room rate movement in recent months.

We would think that with stronger group fundamentals that Group ADR would grow more meaningfully as of late, even in a suboptimal occupancy environment. We do not see clear evidence that group ADR rose much in 4Q23 relative to earlier in the year in any subsegment.

Exhibit 21: Subsegment Group ADR: % Recovery vs. 2019 Levels



Source: Truist Securities Research, HotStats

On the transient side, we also question the progress on leisure room rates given a continued decline of retail ADR through 2023. While there has been less "champagne spending" and more travel outside the U.S., we also question if leisure room rates will be challenged to grow materially in 2024 given the readjustments in 2023. For corporate negotiated room rates, we continue to see flattish trends to 2019 despite material cost inflation.

Exhibit 22: Subsegment Transient ADR: % Recovery vs. 2019 Levels

Source: Truist Securities Research, HotStats

We close with some thoughts on 2025-2027 margins. We place this section at the end of the note as many factors can materially impact margins that are unknowable today. However, we think about ways that margins can grow in 2024 and beyond.

- Demand/supply fundamentals provide the easiest rationale for margin expansion as basic economics. In a low supply growth environment and keeping all other variables constant, we anticipate a slow recovery of occupancy per year will aid operating efficiencies and provide hoteliers more confidence to push room rates.

The bigger question is how quickly does a demand/supply re-balance manifest towards profit growth. We created a scenario case to dive into these matters. Taking 4Q23's occupancy deficit versus 2019 (full-year 2023 was similar) and applying the demand and supply growth STR forecasts for 2024 as a constant for future years, we can estimate that it would take until 2027 for U.S. occupancy levels to reach 2019 levels. Obviously this is a rudimentary math approach; it is likely that demand and supply trends will not be directionally constant through 2027.

For a more narrow analysis, we focus on Upper Upscale hotels given a greater occupancy deficit and where improved occupancy trends have a material impact to global C-corp and REIT earnings. We applied a sensitivity analysis to see how long it would take for occupancy levels to return to 2019 based on 100-350 bps of annual occupancy improvement (for reference STR forecasts ~2.5% occupancy growth in 2024 and 2025). Even in a more robust recovery scenario, we do not see occupancy levels returning to pre-pandemic levels until at least 2026. Occupancy levels may not need to get back to 2019 levels to see hoteliers have confidence in pushing room rates or to see profit-driven operating efficiencies, but we view a 0-5% occupancy deficit a better prospect than 8-10%. **As such, based on demand-supply fundamentals alone, we remain less confident of the ability for Upper Upscale hoteliers to drive more substantive profit margin growth until at least 2025.**

Exhibit 23: Scenario Case of Hotel Occupancy Deficit By Year

	4Q23 Occupancy Deficit to 2019	2024 Demand Growth (STR forecast)	2024 Supply Growth (STR forecast)	2024 Occupancy Deficit to 2019	Bps change y/y
U.S.	-4.1%	1.8%	0.8%	-3.1%	100
Luxury	-10.1%				
Upper Upscale	-8.3%				
Upscale	-4.7%				
Upper Midscale	-1.8%				
Midscale	-2.0%				
Economy	-2.1%				
If U.S. y/y occupancy deficit is reduced by 100 bps per year:					
2025 occupancy deficit	-2.1%				
2026 occupancy deficit	-1.1%				
2027 occupancy deficit	-0.1%				
If Upper Upscale occupancy deficit is reduced by xx bps per year:					
	100 bps	150 bps	200 bps	250 bps	350 bps
2024 occupancy deficit	-9.1%	-8.6%	-8.1%	-7.6%	-6.6%
2025 occupancy deficit	-8.1%	-7.1%	-6.1%	-5.1%	-3.1%
2026 occupancy deficit	-7.1%	-5.6%	-4.1%	-2.6%	0.4%
2027 occupancy deficit	-6.1%	-4.1%	-2.1%	-0.1%	
2028 occupancy deficit	-5.1%	-2.6%	-0.1%		
2029 occupancy deficit	-4.1%	-1.1%			

Source: STR, Truist Securities Research

Companies Mentioned in This Note

DiamondRock Hospitality Company (DRH, $9.23, Hold, C. Patrick Scholes)
Hyatt Hotels Corporation (H, $130.48, Buy, C. Patrick Scholes)
Hilton Worldwide Holdings Inc. (HLT, $192.16, Hold, C. Patrick Scholes)
Host Hotels & Resorts, Inc. (HST, $19.58, Hold, C. Patrick Scholes)
Marriott International, Inc. (MAR, $247.02, Hold, C. Patrick Scholes)
Pebblebrook Hotel Trust (PEB, $15.74, Hold, Gregory Miller)
Park Hotels & Resorts Inc. (PK, $15.19, Buy, C. Patrick Scholes)
Ryman Hospitality Properties, Inc. (RHP, $114.56, Buy, C. Patrick Scholes)
RLJ Lodging Trust (RLJ, $11.68, Buy, Gregory Miller)
Sunstone Hotel Investors, Inc. (SHO, $10.75, Hold, C. Patrick Scholes)

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