SECTOR

REIT ▪ United States

U.S. Hospitality Sector Update

The path to recovery

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VALUATION AND ACTION

Reiterate OUTPERFORM on ARA US Hospitality Trust (ARAUS SP) with 12M TP of US$0.67.
We remain optimistic on ARA's portfolio's ability to outperform its peers due to the quality of its assets. Our TP represents an 87% upside (incl. div) to the current price. We expect 2Q20 to bear the brunt of 'peak shutdown', then 2H20 to present a stunted recovery before a full recovery in 2H 2022. Read our 1Q company update for more details.

Defensive portfolio with cost flexibility associated with the select-service and extended-stay sector to keep margins buoyant.
With 85-90% of variable costs, management has been diligent and proactive in implementing cost saving initiatives, saving up to US$143k per month as demand declines.

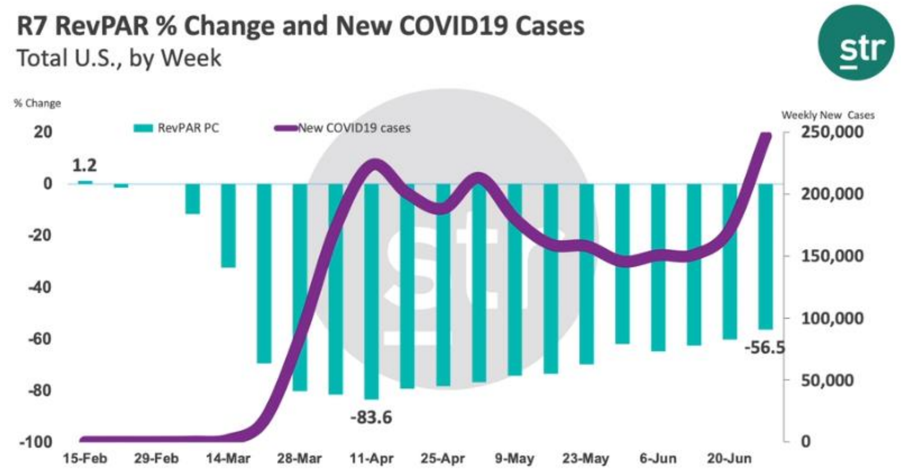
Risks:
Despite loan covenant waivers for the next 12 months, property values may not recover in time.
While demand may improve over the next year, we remain cautious as it may not be sufficient to support a RevPAR growth recovery.

A second wave.
Critics have been quick to warn the US of opening up too quickly, as it may trigger a second wave of infections that will prove to be only more destructive.

The worst is over. Most likely.

RevPAR deterioration hit a coronavirus-low, at *only* -56.5% for the week ending June 27th 2020, as compared to at least -60% in previous weeks. However, a key observation is also that new Covid-19 cases in the US peaked at 250,000 during the same week, especially in several states that were among the first to reopen in early-mid June.

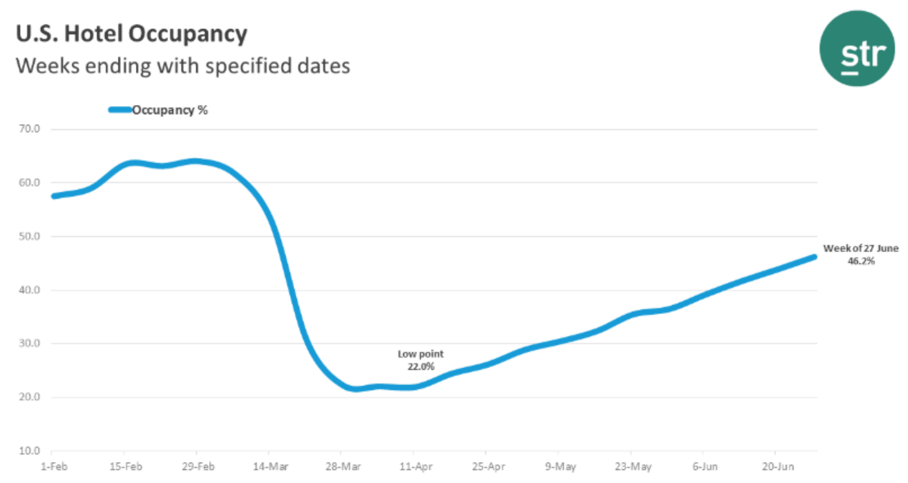
Figure 1: RevPAR % change and new Covid-19 Cases, weeks ending 15 Feb 2020-27 Jun 2020



Source: STR, KGI Research

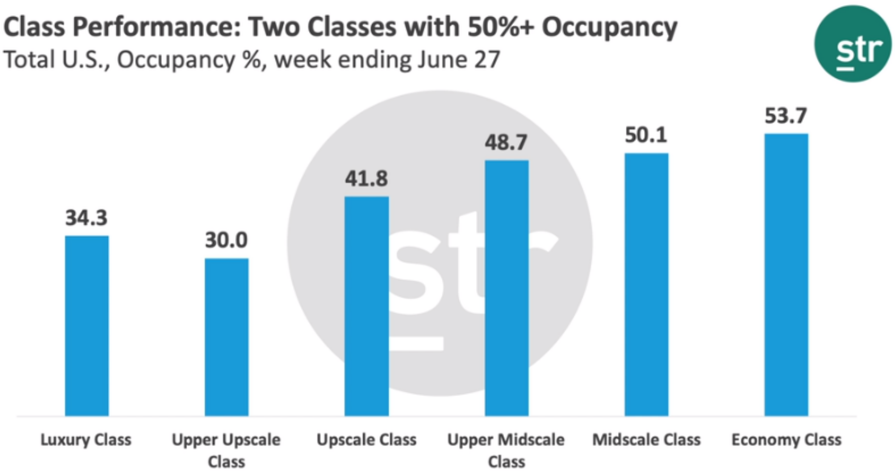
Occupancy also hit a high of 54.1% since April, over the weekend of the 26-27th June, in line with the consistent trend of increasing occupancy across the US, week by week. This was driven mainly by the leisure drive-to demand, as movements are still predominantly road travel rather than air, and a clear preference for destination locations such as beaches and national parks rather than traditional urban destinations.

Figure 2: US hotel occupancy, weeks ending 1 Feb 2020-27 Jun 2020



Source: STR, KGI Research

Figure 3: US hotel occupancy, by class, week ending 27 Jun 2020



Source: STR, KGI Research

While ARA has 3 properties in Virginia, none are in the area of Norfolk/Virginia Beach.

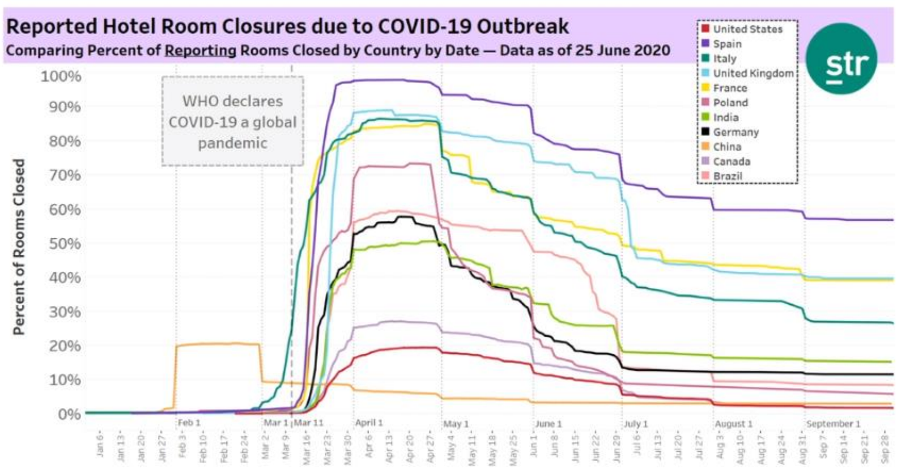
ARA has 2 properties on the edge of Detroit, Michigan – in Livonia and Auburn Hills, and 1 property in Tampa, Florida.

ARA has 1 property in Boston Massachusetts, and no properties in Orlando, Florida.

Specifically, in the week ending June 27th, only Norfolk/Virginia Beach, Virginia reached a 60% occupancy level, along with Detroit, Michigan and Tampa/St. Petersburg, Florida surpassing 50% occupancy levels. Besides Oahu Island, Hawaii, Boston, Massachusetts and Orlando, Florida registered the lowest occupancy levels of 27.5% and 28.9% respectively.

While most hotels are also already open since the easing of restrictions, it is notable that even at the height of closures, the US has never reported more than 20% of hotel room closures.

Figure 4: Reported hotel room closures due to Covid-19 (US data in red)



Source: STR, KGI Research

Where do we go from here?

Given the current environment, we believe that most travellers would continue to prefer to forgo air travel in the near term, and opt only to drive to their intended destinations, even if the destination were not where they had initially wished to spend their vacations. This means that hotels in drive-to locations would be first to benefit from leisure transient demand, and will continue to do so until air travel returns. Hotels may also see much more domestic demand as many are forced delay any and all international travel plans, whether by air or cruise.

This is largely supported by the significant drop in the ratio of air travellers to the total number of rooms sold, from 60% pre-Covid to just under 25% for the week ending June 20th. However, we also believe that those who are flying are more likely to be business travellers who need to be making efficient use of their time, rather than leisure travellers. Consequently, hotels that cater to the needs of the transient business traveller would be next in line to rebound from their April lows.

Figure 5: Weekly ratio of air travelers to hotel room sold, 7 Mar 2020-20 June 2020

Source: STR, US Transportation Security Administration (TSA), KGI Research

With a faltering economy and an enormous amount of uncertainty about how and when the Covid-19 recovery will begin to play out, most travellers would lean towards more economical options. In a normal world, this would mean renting Airbnbs or choosing economy-class or midscale class hotels that would allow for as much savings as possible.

However, in a post-pandemic world where masks and sanitisers are the new true essentials, we should begin to see preferences shifting towards branded, maybe upscale, hotels, due to consumer expectations and perceptions of cleanliness. A survey from the American Hotel & Lodging Association and Morning Consult[1] had also revealed that 43% of 973 adults surveyed planned on saying with family and friends on their next overnight trip, while 39% plan to stay in a hotel and only 9% plan to stay at a short-term rental such as Airbnb or VRBO. Nearly eight in 10 are planning for a trip of four days or less, suggesting long weekend trips will be the first vacation travel to return.

In another survey done by P&G Professional just in May 2020 on the impact of Covid-19 on consumer expectations of future travel and dining expectations, it was already apparent that cleanliness and housekeeping procedures were the most important attributes for hotel guests, surpassing both the price of the room and location of the hotel itself. Specifically, 57% of the 850 frequent travellers surveyed expect more transparency around what hotels are doing to keep guests safe and rooms clean, both in-person and on company websites, while 67% expect to see more thorough and frequent cleaning.

38 of ARA's hotels across the States are Hyatt-branded, with the remaining 3 being Marriott-branded.

As a result, in the last month, we have seen all the top hotel brands worldwide making their declarations, commitments and dedications to ensuring a clean and safe environment in all of their hotels to restore consumer confidence. For example, Hyatt's Global Care & Cleanliness Commitment has included GBAC STAR™ cleanliness and training accreditation processes through the Global Biorisk Advisory Council (GBAC) at all Hyatt hotels. Going one step further, Hyatt has also engaged medical experts to provide counsel on cleanliness guidelines, including:

[1] AHLA & Morning Consult National Tracking Poll #200681: 973 Adults Planning To Travel In 2020, June 2020

- Health & Hygiene: Dr. Daniel Lucey, M.D., M.P.H., Infectious Diseases Professor, Georgetown University Medical Center; Fellow, Infectious Disease Society of America
- Colleague Safety: Dr. Charles Yarborough, M.D., M.P.H., Preventive/ Occupational Medicine Expert; affiliated with Johns Hopkins Department of Medicine and Johns Hopkins School of Public Health
- Food & Beverage Safety: Dr. Elaine Black, Ph.D., Food Science and Microbiology, Ecolab

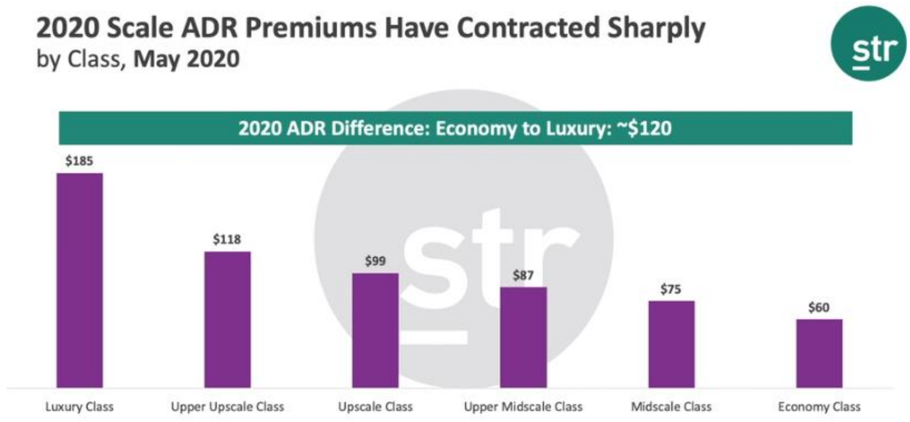
Similarly, from Wyndham Hotels to InterContinental Hotel Group (IHG), many have shouted their cleaning and sanitation programs from their hotel rooftops, and with strong, long-standing histories of being best-in-class, brands are hoping that consumers will continue to place greater levels of trust in them and thus patronize their hotels, despite a slightly higher price tag.

Enter: Select-service and extended-stay branded hotels

Not only do the select-service and extended-stay segments offer higher gross margins for businesses, but they are now also the hotel guests' first choice as a fine balance between trustworthy cleanliness and sanitisation, and relatively lower prices to the usual full-service branded hotels. We are now also seeing countless hotels pivoting their marketing strategies to connect with locals through both community servitude as well as offering a respite from staying at home with staycation offers, but these will consistently work better with trusted and quality brands who are able to offer a value premium.

Additionally, average daily rate (ADR) premiums on upscale and upper upscale have also come down sharply, with an upscale class room costing just about 30% more than a midscale class room, making the substitution or upgrade much easier for guests.

Figure 6: Average daily rates (ADR) premiums have contracted sharply in 2020



Source: STR, KGI Research

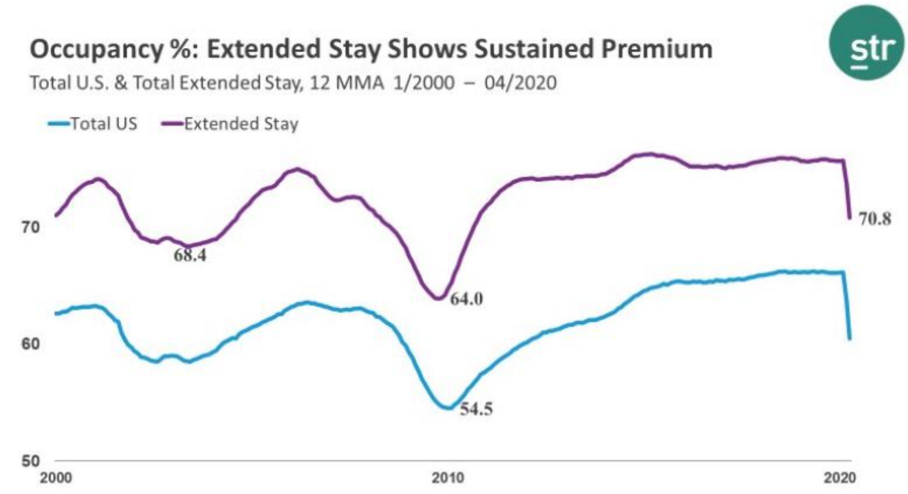
In ARA's select-service hotels, they have moved to a complimentary pre-packaged breakfast box, but as business volumes increase, they plan to offer spreads of individually wrapped or packaged items that do not require common utensils.

Especially in extended-stay hotels that have a more residential feeling for guests, families are able to enjoy time away from home, while still being budget-friendly and spending quality family time with in-room kitchenettes to cook their own meals instead of dining out. Extended-stay hotels have been surprisingly resilient in the current climate, with the apartment-style rooms appealing not only to leisure road travellers and families, but also essential workers such as healthcare, first responders, government or logistics staff who require temporary accommodation in the course of their work.

As a matter of fact, the absolute occupancy of extended-stay hotels have continuously outperformed the U.S. by a fairly wide margin. Even in the prior two downturns, the extended-stay occupancy, on an annualized basis, has never dipped below 64%, almost 10 points above the U.S. performance trough.

ARA has seen higher occupancy rates for their Hyatt House and Residence Inn hotels during the month of May; occupancy levels for the extended stay hotels were on average 5 percentage points higher than Hyatt Place hotels.

Figure 7: Occupancy of extended-stay segments show sustained premium



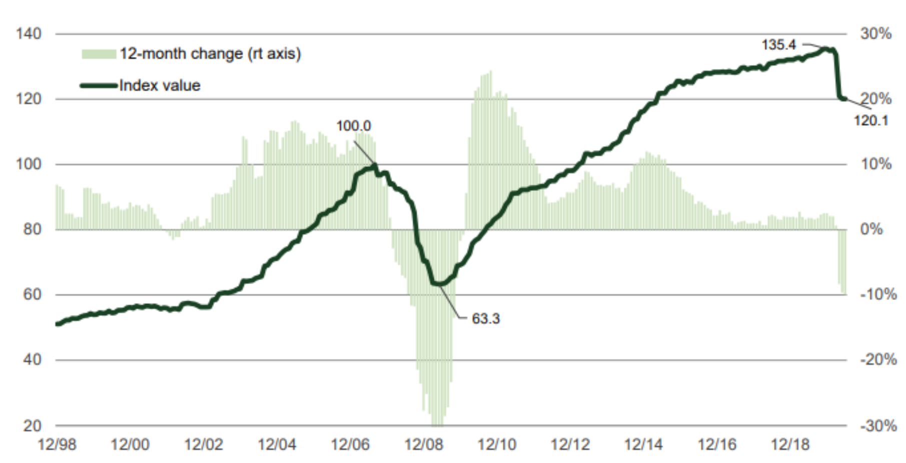
Source: STR, KGI Research

With less dependence on events revenues and less focus on other non-essential services that seem to only be a bane to Covid-19 such as spas, massages and gyms, branded upscale select-service and extended-stay hotels are in the running to be winners in the hospitality sector coming out of the pandemic – both to the business and consumer.

Moving forward

As of June 2020, property prices remained unchanged from May, as per the Green Street Commercial Property Price Index (CPPI), since any price adjustments reflecting the economic slowdown and uncertainty brought on by the pandemic had already been incorporated into the CPPI values previously.

Figure 8: Green Street Commercial Property Price Index (CPPI), updated 7 July 2020



Source: Green Street Advisors, KGI Research

The headline all-property index, in which the lodging sector holds a 7.5% weight, is down approximately 11% from pre-Covid levels, while the lodging sector specifically has been down 25% in the same period.

ARA has a 12-month loan covenant waiver expiring in 1Q21, and has sufficient working capital and liquidity at present to meet its current obligations.

However, we note the risk that if property prices do not recover quickly enough, or should there be any further unprecedented developments with regards to Covid-19 in the US, ARA may have to conduct an equity fund raising exercise at year-end.

Figure 9: Green Street CPPI: Sector-level indexes, updated 7 July 2020

	Index Value	Change in Commercial Property Values		
		Past Month	From Pre Covid	Past 12 Mos
All Property	120.1	0%	-11%	-10%
Core Sector	120.9	0%	-10%	-9%
Apartment	139.6	0%	-10%	-4%
Industrial	158.8	0%	-5%	2%
Mall	77.0	0%	-20%	-33%
Office	107.2	0%	-9%	-7%
Strip Retail	95.5	0%	-15%	-14%
Health Care	132.9	0%	-7%	-6%
Lodging	81.6	0%	-25%	-25%
Manufactured Home Park	232.0	0%	-4%	8%
Net Lease	91.8	0%	-8%	-7%
Self-Storage	176.9	0%	-5%	-1%
Student Housing	133.9	0%	-14%	-12%

Source: Green Street Advisors, KGI Research

All Property: retail (20%), office (17.5%), apartment (15%), health care (15%), industrial (10%), lodging (7.5%), net lease (5%), self-storage (5%), manufactured home park (2.5%), student housing (2.5%).

Core Sector: apartment (25%), industrial (25%), office (25%), and retail (25%). Retail is mall (50%) & strip retail (50%).

Health care: medical office (30%), senior housing operating properties (25%), senior housing net leased (20%), skilled nursing (15%), and life science (10%)

The supply pipeline has come down slightly in May 2020 to 217,300 rooms though, from 220,000 rooms in April 2020, and we expect that we are now seeing the beginning of the downward trajectory that we have seen in the previous crisis, that lasted from 2008-2011.

Figure 10: Occupancy of extended-stay segments show sustained premium

Source: STR, KGI Research

Due to the cyclical nature of the industry, hotel projects are typically planned, approved, and funded during improving and/or peak periods of hotel performance, but begin construction when occupancy and average rates begin to abate or even decline. In the current pandemic, the sharp, never-before-seen decline in hotel operating performance is expected to be challenging for construction financings for new and work-in-progress (WIP) projects. Projects may also be reversed into planning from final planning phases, as hoteliers consider changes in hotel design particularly in food and beverage spaces, public areas etc., and these may result in longer term shifts in construction costs and timelines.

However, in the short term, the eventual dip in overall rooms under development may help allay supply concerns and potentially help markets recover in the current environment, as well as supporting valuations and providing some bolster to balance sheets.

The future of hospitality

ARA is now working to improve the user-friendliness and functionality of its smartphone applications, upgrading their door lock systems to RFID key systems, and getting menus and hotel information digitized.

Everything from communicating with the front desk, ordering services, or streaming content on the hotel television will also require higher internet speed and capacity. In preparation for these trends, they have been investing in upgrading the internet infrastructure in their hotels and have also upgraded all television sets to allow for streaming services.

ARA's revenues and guests are largely domestic-driven, allowing it to recover more quickly and before other hotels in international-demand-driven locations.

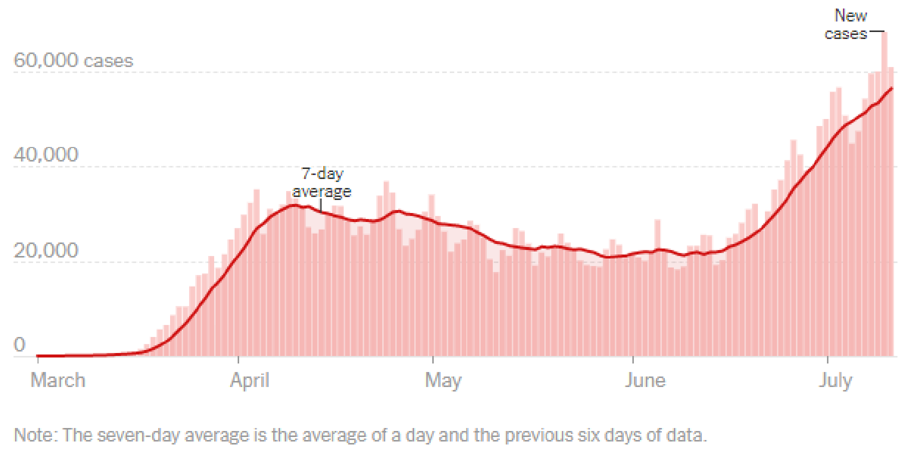
In light of the COVID-19 pandemic, hotels are now forced to re-envision the lodging experience in the era of a 'new normal' as consumer preferences and behaviors shift. One of the biggest challenges hotels will have to first overcome is not only actually ensuring the safety of guests and staff with new safety procedures, but also communicating them clearly and effectively to mend consumer confidence.

Enhancing the guest experience. We expect technology to be at the heart of all future hotel experiences. Guests will undoubtedly start seeking less human-to-human interactions when checking-in and out of hotels – upgrading door locksets for keyless entry and leveraging mobile devices for check-ins will be the first step for most, while room-service and ordering vehicles are also safe ways for guests to get enhanced services at their fingertips, as suggested by Andrea Grigg, managing director at JLL Hotels & Hospitality Group. Enhanced technology, such as voice-activated and mobile technology, will also become a necessity in hotels in the 'new normal'. Additionally, with the concept of experiential travel being increasingly prevalent in recent years, we will now see an even greater emphasis on the guest experience through the design and amenities offered in guest rooms, restaurants and communal spaces.

Recovery might take a while. Ultimately, the recovery of the travel and hospitality sector is highly dependent on how the pandemic evolves over the coming months or even years, across the globe. Air travel and tourism between countries will have to be re-opened – which would call for a full recovery from the pandemic, for the risk of Covid-19 to completely subside. Even with green lanes or specific travel agreements between countries, the volume of travellers and resulting demand will not measure up to what it was before.

What is worrying though is the recent surges in case numbers throughout much of the United States, including in several states that were among the first to reopen.

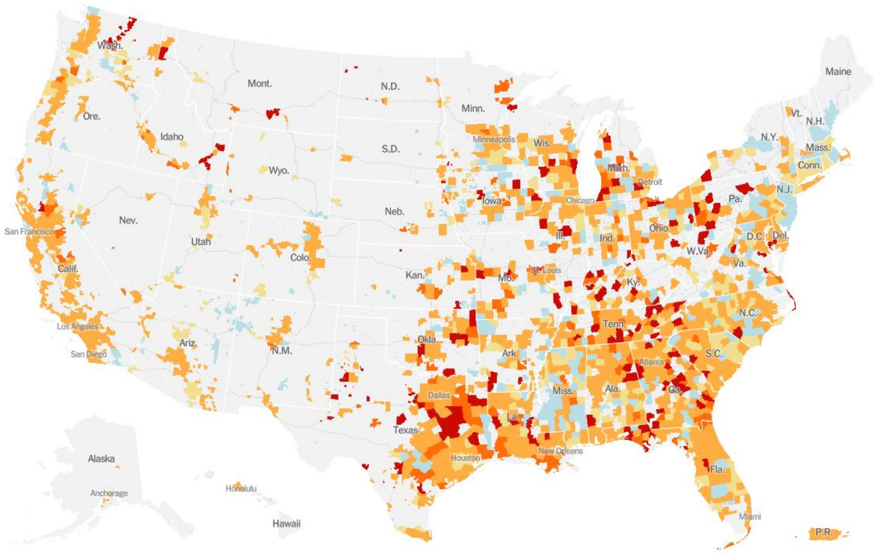
Figure 11: New reported cases by day in the US



Source: The New York Times, KGI Research

According to a Reuters tally, Florida's cases have risen by over 10,000 for three out of first four days of July, including climbing by 10,059 on July 5th, surpassing the highest daily tally reported by any European country during the height of the coronavirus outbreak there. The daily death toll also rose sharply during the 2nd week of July, amid the dramatic surge in confirmed. Texas, Arizona and South Carolina have all seen their death tolls rise by more than 100 percent from mid-June, according to an analysis of state and county health data by The Washington Post. Consequently, we think that there is still an underlying risk of restrictions being re-imposed, potentially harsher and maybe even for longer than before.

Figure 12: Covid-19 in the US: Map of hot spots and case counts, updated July 13th 2020

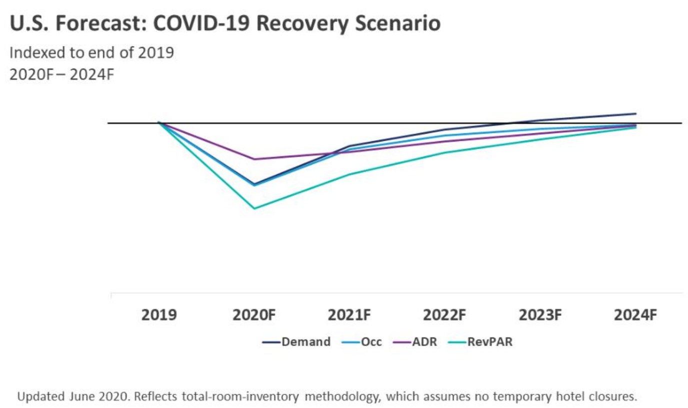


Source: The New York Times, KGI Research

On top of pandemic worries, the hospitality sector's fate is also tied to the US government's fiscal policies, inflation levels, unemployment rates and consumer confidence, all of which are still dependent on the result of the 2020 US elections at year end. The leading candidates for each national party have very different policy expectations that have potentially very significant implications for longer-term economic growth in the US.

However, we note that most experts within the industry expect US hotel demand to return pre-pandemic levels by 2023, with pessimistic forecasts taking 2 years longer. According to Jan Freitag, STR's senior vice-president of lodging insights, STR expects recovery to take at least 11 quarters for the number of room nights sold to rise to 2019 levels, and for occupancy to reach the 20-year historical average (assuming no significant setbacks in its fight against the coronavirus).

Figure 13: US lodging sector recovery scenario forecasts



U.S. Forecast – % Change (June 2020 Update)

Key Performance Indicators (% Change vs. Prior Year)

2019A – 2020F – 2021F

Metric	2019 Actual	2020 Forecast	2021 Forecast
Supply	+2.0%	-4.4%	+5.5%
Supply (Total Room Inventory)*	+2.0%	+1.4%	+1.3%
Demand	+1.9%	-36.2%	+35.4%
Occupancy*	-0.1%	-37.1%	+33.7%
ADR	+0.9%	-21.4%	+5.2%
RevPAR*	+0.8%	-50.6%	+40.6%

*Reflects total-room-inventory methodology, which assumes no temporary hotel closures.

Source: Tourism Economics, STR, Hotel News Now, KGI Research

ARA is a pure play US hospitality REIT with 41 Hyatt and Marriott branded upscale hotels in the select-service and extended-stay segments.

At the end of the day, we prefer the more resilient players in the hospitality sector who will be in a better position to ride out the waves of uncertainty in the coming months as the Covid-19 situation evolves, on top of an unresolved trade war and a highly anticipated presidential election at YE2020:

1. those who are less dependent on international demand and tourism; and
2. branded hotels in the limited-service, select-service, and extended-stay segments, and are between midscale to upscale on the chain scale.

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Rating	Definition
Outperform (OP)	We take a positive view on the stock. The stock is expected to outperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Neutral (N)	We take a neutral view on the stock. The stock is expected to perform in line with the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon.
Underperform (U)	We take a negative view on the stock. The stock is expected to underperform the expected total return of the KGI coverage universe in the related market over a 12-month investment horizon
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