

FINDING YIELD IN AN UNLIKELY SUB-SECTOR

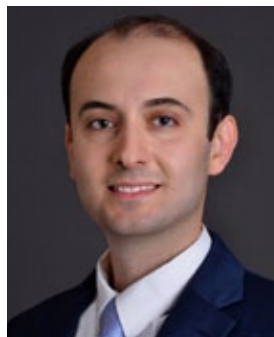
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Overview

Total commercial real estate transaction volume was \$466.8 billion on a 12-month trailing basis in first quarter 2015, according to Real Capital Analytics. While this was short of the peak transaction volume of 2007, new records were set in unit pricing and cap rates for many of the asset classes. These strong trends in transaction activity, record unit pricing, and record low cap rates are expected to continue in 2015, if interest rates do not suddenly increase. One can imagine that in such a competitive environment, it is difficult for institutional investors to find more yield, or more importantly, more yield without taking on a disproportionate share of additional risk. For the purposes of this analysis, we



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wondered whether institutional investors were able to find such a combination in the select-service hotel sector.

Recent Select-Service Portfolio Transactions

We reviewed nine transactions of select-service hotel portfolios for which income information was available since May 2013. The exhibit below presents details for those transactions. Overall cap rates for those transactions ranged from 6.85 percent to 7.96 percent and averaged 7.28 percent. The average cap rate on these transactions was 110 basis points higher than the average required going-in cap rate reported by Situs RERC's institutional investment survey respondents for all property types,

Select Service Hotel Portfolio Transactions

Portfolio Name	Location	Average Year Built	# of Properties	# of Rooms	Sale Price	Sale Date	Price per Room	ADR	Occupancy	RevPAR	NOI Ratio	Cap Rate
Apple REIT Six	18 States	1998	66	7,658	\$1.14B	May-13 ¹	\$149,221	\$115	73%	\$84	31%	6.85% ²
OTO	8 States	2008	16	2,031	\$353.1M	Mar-14	\$173,855	\$122	79%	\$96	34%	7.21%
Concord Hotel	6 States	2005	13	1,650	\$240M	Apr-14	\$145,455	N/A	N/A	N/A	N/A	7.90% ²
Innkeepers	16 States	1929 - 2006	47	6,094	\$958.5M	Jun-14	\$157,286	\$129	76%	\$97	31%	7.51%
Extended Stay	18 States	1992	47	5,908	\$800M	Aug-14	\$135,410	\$121	79%	\$95	31%	7.96%
Courtyard Marriott	15 States	1987	40	5,833	\$656M	Sep-14	\$112,464	\$114	69%	\$78	26%	7.32%
Hyatt Select Service	21 States	1999	38	4,953	\$590M	Nov-14	\$119,120	\$116	75%	\$87	25%	6.92%
Inland Hospitality	21 States	1957 - 2010	48	6,401	\$964M	Nov-14	\$150,601	\$121	74%	\$89	30%	6.96%
Apple Hospitality REIT	11 States	2003	18	1,787	\$206.4M	Feb-15	\$115,501	N/A	N/A	\$66	35%	7.55% ²
Min							\$112,464	\$114	69%	\$66	25%	6.85%
Max							\$173,855	\$129	79%	\$97	35%	7.96%
Weighted Average							\$139,684	\$114	71%	\$88	30%	7.28%

¹This transaction was announced in November 30, 2012.

²Cap rate is based on in-place NOI.

Sources: Various publicly available sources, compiled by Situs RERC, March 2015.

and 50 basis points higher than the average required going-in cap rate reported by Situs RERC's institutional investment survey respondents for hotels in first quarter 2015.

Help from the Debt Markets

In most of these transactions, the buyers have turned to the recovering CMBS market to obtain senior financing. The select-service portfolio transactions which we analyzed were financed from 60 percent to 70 percent through the CMBS market. On top of that, some buyers obtained additional mezzanine financing to bring the total leverage to approximately 80 percent.

The typical CMBS term is 2 to 3 years for a floating rate loan based on a 1-month London Interbank Offered Rate (LIBOR), plus a spread of 200 basis points to 350 basis points. These loans are interest only and usually have two to three 1-year renewal options, for a total term of 5 years. They also require interest rate protection during the extensions as a condition of extending the loan. See the table to the right for additional details.

As noted previously in this report, Situs RERC's institutional investment survey respondents recognize the value present in the lodging market by giving the hotel sector the third highest return versus risk rating and the second highest value versus price rating among other property types (see Exhibit 9 on Page 11).

What is the buyer's strategy?

The main strategy is to improve top line and bottom line figures. Buyers of these portfolios believe in the continued recovery of the hospitality sector, which is also evidenced by PKF's forecast for 2015 (as shown in the exhibit to the right). By creating geographically diverse, scalable portfolios, buyers can maximize value through improving quality of their portfolios and taking advantage of the projected general growth in this sector. Additionally, since select-service hotels have lower fixed costs as a percentage of total costs, growth in recovery periods significantly better net margins for each incremental dollar.

Conclusion

The select-service hotel sector has evolved over the past 5 years into a more accepted institutional property investment, versus a mostly

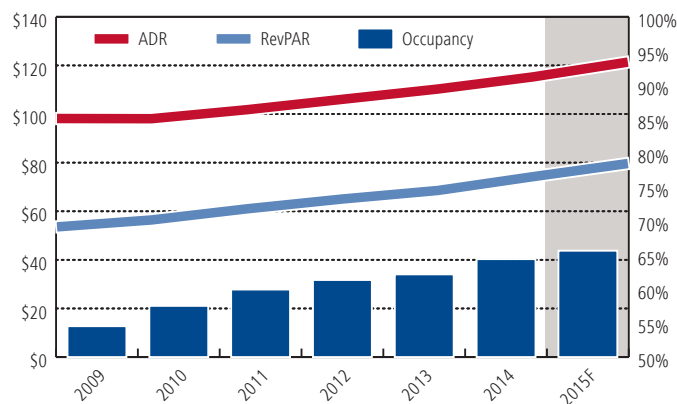
locally-influenced property sector. During this time, it has become a liquid and desired asset type because of the sector's ability to produce cash flow. For the remainder of 2015 and as long as interest rates remain low, returns are expected to be strong. However, given the number of buyers for select-service portfolios and the strong interest in this asset class, investors can expect pricing to become even more competitive, and as a result, total yields will likely tighten further.

Financing Details For Select Service Hotel Portfolio Transactions

Portfolio Name	Financing	Loan Amount	LTV	Interest Rate	Term
OTO	JPM	\$204M	58%	L + 3.50%	I/O, 2 yrs
Innkeepers	JPM	\$635M	66%	L + 2.23%	I/O, 2 yrs
Extended Stay Hotels	JPM	\$570M	71%	L + 2.11%	I/O, 2 yrs
Courtyard Marriott	JPM	\$415M	63%	L + 2.12%	I/O, 2 yrs
Hyatt Select Service	JPM & GS	\$340M	58%	L + 2.45%	I/O, 2 yrs
Inland Hospitality	BofA	\$615M	64%	L + 2.36%	I/O, 2 yrs

Sources: Various publicly-available sources, compiled by Situs RERC, March 2015.

Overall Hotel Trends



Note: Shaded area indicates forecast.

Sources: STR, Inc., PKF Hospitality Research, A CBRE Company March 2015 Hotel Horizons® Forecasts.

