STONE BRIDGE
INVESTMENT GROUP

January 2022

Do Independent Hotels offer Opportunities?

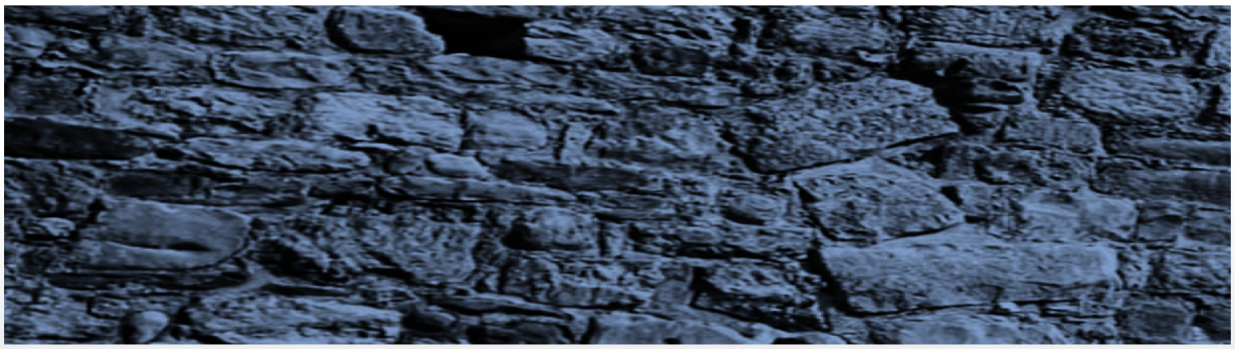
Despite Covid-19, we continue to see attractive investment opportunities in the U.S. Lodging Market for private capital investors represented by prudent and dedicated investment managers. Branded and independent hotel properties have now been thoroughly tested under both peak and trough market conditions. Branding in and by itself is not a pre-cursor for financial success. An independent hotel that has sound hotel programming, carefully chosen location attributes coupled with a properly vetted hotel manager can both adequately shield private capital investors from undue investment risk and produce attractive risk-adjusted returns. Stone Bridge continues to seek out both independent and branded hotel investment opportunities.

With an estimated 55,000+ branded and independent hotels and in excess of 5 million hotel rooms across the U.S., all impacted to various degrees by Covid-19, the domestic lodging industry has grown increasingly competitive and complex to navigate for owners, investors and managers. According to an article published by *Hotel News Now* in 1990, the U.S. lodging market at the time comprised nearly 2/3 independently owned and operated hotels. Three decades later that number stands at less than 40%. Part of the reason for the decline in representation by independents can be traced to financing requirements imposed on ground-up hotel development projects and the introduction of soft-branding alternatives for otherwise independent hotels. As increasingly more passive investment capital has entered the lodging segment, so has the perceived notion that branded hotels offer safer and healthier returns on invested capital over independents.

Leading up to the Covid-impacted market conditions of 2020 and 2021, the U.S. lodging market for independent hotels benefitted from a reasonably favorable outlook. Research performed by the Expedia Group in 2019 indicated that independent hotels across the U.S. benefitted from a near 5% growth in demand for the year prior (2018). The performance was reportedly particularly strong when looking beyond popular, large city destinations in favor of smaller markets. Of course, reductions in travel during 2020 into 2021 caused by Covid-related market conditions did hurt independents as they did branded hotels. The conventional wisdom, however, among a majority of lodging market participants has been that hotel brands offer a safe harbor for owners during difficult market conditions. Thus, the pressing question is: how do independents actually perform in good- and especially bad times relative to their branded peers?

In a recent white paper published by Preferred Hotels & Resorts based on data provided by STR and CoSTAR, the authors address this question. The analysis suggests that U.S. branded hotels under-performed independent hotels during the height of a Covid-induced operating landscape from March 2020 through August 2020. In fact, the report indicates that during this period, branded hotels trailed independents in occupancy by nearly six percentage points. Moreover, during the same period, independents achieved an average-daily-rate (ADR) premium of nearly $20 over branded hotels. The authors go one step further and conclude that "…*independent hotels significantly outperform those affiliated with a franchise brand, both in banner years like 2019 and during times of crisis such as 2009, following the economic crisis and, most recently, in 2020 due to the COVID-19 pandemic".*

Other independent research reach similar conclusions. Lodging-service provider JLL Hotels & Hospitality Research recently examined hotel performance across branded and independent properties. Their research reveals that on a year-to-date May 2021 basis, independent hotels had recovered 76% of their revenue-per-available-room (RevPAR) from Calendar 2019, the undisputed RevPAR watermark year in lodging performance across the U.S. Meanwhile, their branded counterparts had on average recovered 68% of their 2019 RevPAR performance at same point in time. JLL conclude that *"…the average independent has actually outperformed their branded peers during the crisis, though there is a lot of nuance to this conclusion".*



***"Interest in distinctive independent hotels and resorts has grown considerably in recent years, particularly among Millennial travelers. They are attracted by unique architectural design, ambiance and décor, and the more personalized service typically provided by these properties. Investors are more inclined to evaluate these properties favorably than in the past because astute use of online marketing tools and social media can serve as an effective proxy for expensive marketing programs funded by the large franchise organizations"*, says Peter C. Yesawich, Chairman of Yesawich Holding, LLC and co-founder of MMGY Global**

As the overall U.S. lodging sector now exhibits a variety of early post-Covid comeback stories, independent hotels naturally once again receive their fair share of attention. Independent hotels generally have the flexibility to create unique guest experiences through hotel programming. Such programming involves everything from the initial reservation process, to guest-staff interaction and touchpoints, public space and guestroom planning and décor, service amenities and eventually the final post-stay evaluation and follow-up. In the Hospitality Net online article "The Future of Independent Hotels, June 29, 2021", author John Smallwood, CEO of Travel Outlook, argues that "…*Travelers in 2021 no longer want the same travel experiences as their friends and neighbors. They want a unique vacation handcrafted for their trip. Travelers are moving away from large chain resorts and towards individually owned and operated hotels….".* When investing into lodging, we submit that private capital investors should pay attention to the ability of the hotel and its manager to facilitate a quality guest experience that has the propensity to create long lasting personalized memories and thus loyal repeat business amongst its clientele.

Covid-19 has shown us that location attributes of hotels are of outmost importance because they often go hand in hand with demand/product segmentation. We have discussed this topic at length in a prior article called "***Is it the Right Time to Invest in U.S. Hotels?***". For example, hotels substantially reliant on corporate demand and/or convention group business may not have location attributes that allow them to backfill lost corporate and convention room nights with leisure or entertainment demand.

While the industry is on trajectory to rebound from the depths of the pandemic, data suggests it's still missing a key demand component: corporate travelers. While U.S. hotel occupancy returned to near pre-pandemic occupancy by summer 2021, market participants generally agree that recent gains have been driven primarily by vacationers and leisure travel. A July 2021 report by the U.S. Travel Association projects that business travel spending will not reach pre-Covid levels until 2024. Moreover, Chip Rogers, President and CEO of the American Hotel and Lodging Association went on record recently in an NBC news article stating that "…*by the end of the year, we think 2021 is only going to be at about 30 percent of what 2019 was for business travel*." A similar sentiment is offered in the "U.S. Hotels State of the Union" report by CBRE Hotels Research from December 2021, which concludes that group demand across larger U.S. business convention markets still hovers 40% to 60% below 2019 levels. We urge private capital investors to continue to exhibit discipline and pay attention to location attributes and leisure demand when investing into lodging.

"The U.S. Lodging Market is quickly evolving to adapt to emerging consumer preferences across the entire travel industry. Traveler preferences for domestic locations reachable by car continue to dominate, as does the desire for smaller, more private lodging alternatives over crowded mega-style hotels and resorts. The anticipated "return to the office" by the U.S. corporate segment is not materializing as quickly as previously expected, and the outlook for corporate events and conventions remains murky. The near-term outlook for lodging continues to favor markets and specific hotels with a focus on experiential, health & wellness, and entertainment" **says Scott Robinson, Managing Director, Co-Head of Real Estate & Lodging at Oberon Securities**

As communicated by us in the aforementioned prior article, the selection of hotel operator has never been a more important investment consideration than is the case today. According to Phocuswright, a global travel research provider, worldwide hotel gross bookings amounted to in excess of $523 billion in 2019. Online sales represented 42% of this total and online travel agents (OTAs) captured two thirds of online sales. The opportunity to bring an institutional-caliber management platform to a hotel asset historically managed by a smaller, owner-operator may offer substantial value creation potential. Experienced revenue management personnel and systems coupled with dedicated sales & marketing resources (particularly in the online and OTA areas) oftentimes afford the new manager the ability to more aggressively drive and maximize pricing of every single hotel room on a daily basis. We stress the need for continued focus by private capital investors to properly vet the experience and abilities of hotel managers.

"An independent hotel requires 20 or more booking channels to support attractive bottom-line performance. The customer experience starts at time of booking and it is important for hotel managers to carefully organize and continuously evaluate this process. Effective revenue management relies on sophisticated automation and systems, but complex decision-making also requires experienced professionals to ensure daily rooms pricing is targeted to fluctuating guest wants and needs. Experienced third-party hotel managers are able to bring the proper resources, planning and execution to independent hotels that smaller owner-operators may be challenged in providing" says **Kevin Kilkeary, President and CEO of Prospera Hospitality.**

In conclusion, some myths about investing in independent hotels have been proven as incorrect. Recent empirical research simply does not support the simplistic narrative that investing in a brand, in and by itself, ensures improved risk-adjusted returns. We are not suggesting that branded hotels cannot offer attractive economics. In fact, our firm continues to seek out and evaluate attractive branded hotels for acquisition. It is our belief, however, that through intelligent hotel programming of services and amenities, careful site selection and with an experienced hotel manager in place, independent hotels can offer an attractive investment opportunity for private capital investors. In other words, if you are knowledgeable and selective, today continues to be an excellent time to invest in hotels across the United States, including those independent of brands.

About the Author:

Rickard Olander is a Partner with Stone Bridge Investment Group. Stone Bridge was founded in 2012 and invests private equity into lodging and industrial real estate.

www.stonebridgeig.com