

PUBLIC NOTE

What's Wrong with Hotel REITs?

Peter Lewis

peter@plraresearch.com



In “[What's Wrong with Health Care REITs?](#)” we looked at three basic problems that are (still) not getting enough attention. Hotels are another property type where much of the REIT underperformance is clearly secular or structural, and it can help a lot just to spell things out. This time I'll also discuss some potential solutions at the end, with a few positive examples.

1. CORPORATE TRAVEL HAS RESET

This is taking a while to shake out, but it's pretty clear that the pandemic Zoom effect has taken a permanent bite out of business travel—particularly corporate travel, in the higher chain scales where REIT portfolios are concentrated. It hasn't been nearly as bad as some of the overcaffeinated doomsday predictions during the pandemic, but even 15-20% is a big hit.

Of course, this is somewhat offset by the post-Covid spike in replacement costs, and the sharp drop in new supply. But the REIT portfolios are heavily branded, and the large brand systems are leaning into conversions to make up that unit growth—as well as lower chain scales, where the prototypes are cheaper to build. So the competition within any given loyalty program is still growing, and that brings us to our next point...

2. BRANDS HAVE TOO MUCH LEVERAGE

I used to joke that Marriott invented the modern hotel REIT to be the cheapest part of their capital stack, but it's barely even a joke. After almost three decades, MAR has outperformed their own REIT spinoff by a staggering 1500%, or almost 10% annually:



And Host is one of the BEST-performing hotel REITs over these longer time frames, and many private owners have had worse returns than the REITs. Why does anyone keep signing up for this?

It's a long story, and one that many hotel owners would be happy to tell you. But this friction with the brands is almost never aired publicly, which of course is part of their structural advantage. For most guests and even much of the business world, the hotel sector IS the brands—even as they've become more commoditized, and the internet has made it easier for guests to compare individual properties.

For our purposes here, I'll just give you two high-level answers. One is that brands (and OTAs) have consolidated much faster than the fragmented ownership base, and hotel loyalty programs have become a unique and *very* powerful lever to control the rest of the value chain—arguably even more powerful than airline miles, and with fewer constraints on new supply.

The other is that we've had three straight worst-ever hotel downturns (9/11, GFC, Covid), which would be worse for the owners than the franchisors in any franchised business. This was harder to predict than brand consolidation, and it's more understandable that real estate investors weren't underwriting enough of the downside risk. And maybe it's also more optimistic—just in the morbid sense that the next downturn can't be much worse than Covid without wiping out the industry, and unencumbering some of the real estate.

But some of us thought that might start to happen in 2020, and we were wrong. And the fact is that franchise fees (and other terms) have never changed nearly

enough to reflect the *last* downturn—much less the growing structural costs (like CAT property insurance) that are also borne by owners.

3. TROPHY COLLECTING

From one of my old investor notes:

Are you a fan of simultaneous invention stories, like calculus or the telephone? If so, you'll be amazed by how many times hotel REITs have independently concluded that the ideal REIT portfolio includes fancier, trendier and more "iconic" hotels than the ones they currently own...

That was too harsh, but it gives you an idea of the scale of this problem. It's too harsh because the REITs have at least three coherent reasons for converging on leisure and luxury:

- leisure demand has a better long-term growth outlook than other segments
(even before the Covid effects in point #1)
- wealthier guests will remain less price sensitive
- resorts have less supply risk than other hotel types

I agree with them about the first two, but the third one is tricky, because it's not just about ground-up supply in the local comp set. You also have to consider upmarket redevelopments of existing hotels, as well as competing destinations with lower construction/labor costs, and competing vacation products like cruise lines. As you get into triple-digit rates and more of a jet set customer base, you're competing with even more global options, and more kinds of "irrational" supply.

In comparison to other property types with a "dilute your way to quality" problem in REITland, or a market timing problem with acquisitions, hotels also have a higher capex burden and much more cyclical cash flows. When you combine these factors with point #2, it's a recipe for repeated brand-friendly acquisitions and conversions that fade after the first few years, and are eventually sold at a loss to finance the next trophy investment.

IS THERE A WAY OFF THIS TREADMILL?

Well, there are a few basic things that can help, and many of these ideas trace back to Pebblebrook (PEB) and their predecessor LaSalle. You can lean into independent hotels, soft brands, and third party management with flexible contracts. You can add some discipline to capital allocation by publishing your internal NAV—or by focusing on better KPIs and earnings metrics, like the new team at DiamondRock (DRH). You can buy back your stock at gaping NAV discounts, and we're finally starting to see more of that across the group.

Other apparent solutions are more idiosyncratic, like RHP's strategy of ruling out dispositions entirely ("we do not believe capital recycling through transaction activity creates long-term value") and investing (for a while) in major renovations/expansions over acquisitions. This has worked well in their Gaylord circuit—very large group assets with lower supply risk—but it's hard to replicate elsewhere, or at least harder to scale.

Like any REIT, you always have a shot at marketing your stock to an NAV premium, or riding there on an upcycle/bull market, and using those positive investment spreads to compound your way to more of a premium. The most interesting example in this group was an all-luxury REIT called Strategic Hotels that lasted about a decade in the public markets, and eventually went private at 25c more than their IPO price.

Even if that sounds like a feat worth replicating, it would be much harder at the discounted valuation levels that have now sunk in... well, never say never, in this current meme stock market. But the other problem with trophy collecting (in any property type) is growing private market competition, and the associated negative selection effects; the points in the cycle where the "window opens" for REITs to win these auctions are often the times where the growth/value spread is widest, and the pricing for trophy assets is most inflated.

I'll say this for Strategic: unlike their current imitators, they demonstrated that it's worth a lot to have a genuinely differentiated investment strategy that can get investors' attention, and to be the only clean pure-play vehicle for public exposure to a niche property type or subtype. We've seen some recent examples of that in other REIT sectors, and there are probably more ways to do it in hotels.

But at the group level, hotel REITs are a more sympathetic case than health care, and they will keep bringing you back to the same awkward question: how should we value REITs in a property type where the asset-level returns are simply too low for the stock market? How should we *want* them to allocate capital?

In theory, the old NAV framework could answer this question better than the current earnings/hybrid approaches, or my own framework that I laid out in two other recent public notes. In practical terms, I'm not really sure how to answer it.

But one thing I do still believe in is the importance of lower brand encumbrance, and other ways of creating some healthy distance from the largest brand systems. They are smart companies and great stocks, and every REIT needs a good working relationship with them... but their interests are not well-aligned with REIT shareholders, and their current winning streak won't last forever. If you have to accept lower near-term yields to preserve optionality and control, that's often a better PV on its own terms, and it's also a call option on future brand/loyalty fatigue—or on new tools like AI that could finally disrupt the current system, and connect owners and guests more directly.

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