A TRAVEL, HOSPITALITY & LEISURE SERIES

Staying Power – Reinventing Lodging Real Estate Investment Trusts (REITs)

Ever since their creation via the Real Estate Investment Trust Act of 1960, REITs have provided investors with a tax-advantaged mechanism to invest in large-scale, income-producing real estate assets.

Over the past 50 years, though, the Lodging REITs have underperformed, on average, against other REIT categories as well as the S&P 500. To compete for scarce capital in an environment characterized by high interest rates and uncertainty, Lodging REITs must be better at real estate operations, driving pipeline growth and optimizing the performance of their investment portfolio.

In this piece, we will explore the opportunities for Lodging REITs, including associated external REIT managers (where applicable), to disrupt traditional business models to better weather an unpredictable economic climate, drive higher returns and become more attractive to investors. As optimized investors and growth enablers, Lodging REITs can improve returns and drive performance in key metrics such as funds from operations (FFO), earnings before interest, taxes, depreciation, and amortization (EBITDA) and net asset value across their portfolio.

Understanding the Lodging REIT Challenge

REITs as an asset class have a history of robust performance. Over a 50-year period from 1972 to 2021, most REITs outperformed the 10.8 percent annualized returns of the S&P 500.[1]

Lodging/Resort REITs as a subcategory, however, returned 9.3 percent over the same period. While only slightly lagging the S&P 500, it falls significantly behind other REIT subgroups (e.g., 15.8 percent for Industrials, 14.4 percent for Residential, 12.1 percent for Retail). The last two years have been particularly challenging with Lodging/Resort REITs. They returned negative 15.3 percent on average in 2022 and are essentially flat so far in 2023.[2]

Lodging REITs have a series of unique challenges they must manage to effectively balance resiliency in operations while also positioning for growth moving forward:

Cost of Capital – Given the capital-intensive nature of the business, REITs are particularly sensitive to changes in interest rates. In today's climate of higher interest rates, REITs must be extremely selective in how they allocate new capital and evaluate existing investments.

Real Estate Trends – The pandemic triggered a shift from high-cost and dense urban markets to lower-cost and smaller markets. While that shift is starting to equalize a bit, many traditionally strong markets are slow to recover, with new markets seeking to fill the void. REITs must stay one step ahead of the trends and enter and exit markets quickly to achieve the highest possible net asset value and thereby maximize profits and minimize losses.

Limited Internal Capabilities – REITs historically have been asset-heavy, people-light businesses with internal staff primarily focused on acquisition, portfolio management and financial planning and analysis. As REITs look to find ways to grow FFO and EBITDA, they need to make sure they have the right internal and consultative skills available to proactively manage the growth of the portfolio, drive efficiencies and achieve economies of scale.

Operating Parameters – REITs are required to operate within a set of established parameters, i.e., 75 percent of the company's assets must be invested in real estate, 75 percent of gross income must come from the interest on mortgages, sales of real estate or rents received and 90 percent of the REIT's taxable income must be paid out to shareholders as dividends. Any strategies a REIT develops to drive resilience and growth must be executed within these legal requirements.

Uncovering Opportunities for REIT Reinvention

How Can A&M Help REITs Find Opportunities to Generate More Value?

While challenges certainly exist for REITs, significant opportunities to increase net income and improve EBITDA also exist. Capitalizing on these opportunities generates value for everyone in the REIT ecosystem from investors, lodging brands, management companies and the REITs themselves. To accomplish this, REITs need to assume two key roles: REITs as an "optimized investor" and as a "growth enabler."

REITs as Optimized Investors

This is the role most familiar and comfortable to REITs – strategically acquiring and divesting holdings to maximize FFO and EBITDA. In our experience, however, certain capabilities can strengthen a REIT's ability to operate as an optimized investor, driving efficiency and margin.

Data Driven Growth (Organic and Inorganic)

REITs must continuously evaluate their portfolio performance and quickly decide how and when to acquire, divest, renovate, or reposition assets as well as how to address non-performing loans within the portfolio. While experience plays a key role in this process, leveraging advanced analytics and artificial intelligence to rapidly identify and evaluate acquisition targets and the potential profitability and/or viability of transactions enables REITs to act fast and stay one step ahead of the market and their competitors.

Margin Optimization

REITs should play a more active role in influencing day-to-day operations of their holdings. Working with their ecosystem partners, including hospitality brands and management companies, REITs can improve efficiency of operations and leverage economies of scale across their portfolios including in key cost areas like labor, taxes, insurance, renovations, and others.

Compliance Management

Environmental, sustainability and governance (ESG) comes center stage as REITs balance profitability with consumer and investor perception of them as good corporate citizens. REITs play a key role in ensuring their portfolio navigates changing ESG and regulatory related requirements and ensuring compliance with all applicable laws and regulations. REITs should also look for opportunities to unlock potential tax credits and other relevant incentives to help strengthen ESG capabilities and help self-fund related investments.

REITs as Growth Enablers

REITs must also better understand and mature their potential to be a platform for growth for their underlying assets. This requires having both the requisite internal capabilities to serve in a more consultative role as well as having an "activist investor" mindset when it comes to the operations of their holdings.

Leveraging Data as a Differentiator –

Typically, REITs focus on the aggregation and consolidation of data to support financial reporting. While often highly manual and focused on developing retrospective financial and operational reporting, REITs could enhance these processes with advanced analytics and AI to enable more predictive analytics, allow for greater automation of consolidation and reporting and free up their limited number of personnel to focus on more strategic analysis of the portfolio and identification of areas for improvement.

Being a Strategic Advisor –

In addition to the value derived from data-driven insights at the overall portfolio level, REITs can leverage investments in these analytic capabilities to provide unique, data-driven insights across areas such as pricing, RevPAR and ancillary services (food and beverage, wellness, etc.) to their ecosystem partners and the operations teams running the REIT's assets. Instead of being a passive investor, the REIT could provide a unique service to their operators and ecosystem partners and use these insight platforms as a competitive advantage and differentiator, potentially helping drive additional excitement in the market and securing greater outside capital investment.

Enabling Economies of Scale to Facilitate Growth –

There are several ways REITs can support the growth and profitability of their holdings by leveraging economies of scale to provide value added services. This could be as simple as offering centralized procurement services to secure preferential pricing from vendors for common items (e.g., linens, toiletries, food and beverage, etc.) on behalf of their holdings and share in the savings; or, on a more comprehensive level, could include offering front-, mid- or back-office capabilities as a shared service (e.g., accounting, marketing, human resources (HR), information technology (IT), etc.) to allow field operations personnel to focus on growing their respective businesses and providing a differentiated customer experience.

How Can A&M Help REITs Initiate Their Reinvention Journey?

In our work with REITs, we follow five practical steps to jump start reinvention journeys:

Market and Portfolio Opportunity Analysis – A&M helps REITs perform a comprehensive analysis of their existing portfolio against current consumer, guest, travel, geographic and market trends to identify and capitalize on strengths, provide a plan to close gaps and seize associated opportunities to create a more balanced and diversified portfolio.

Strategy and Investment Plan Development and Execution – In conjunction with the Market Opportunity Analysis step, A&M helps REITs develop and execute their reinvention strategy and associated capital and investment plan to build the requisite capabilities needed to function as optimized investors and growth enablers. The strategy and any associated initiatives and investments should be firmly anchored in building a diversified portfolio with financial strength and predictable dividends while enhancing the ability to rapidly adjust course to navigate changing economic conditions.

Capability and Workforce Analysis – We help REITs evaluate existing personnel to understand the breadth and depth of skills available in-house to support and sustain the reinvention. Where skill gaps exist, we help REIT leadership develop plans to reskill existing employees, hire additional talent and/or implement sourcing arrangements or other partnerships to secure the requisite talent (on an interim or permanent basis).

Operating Model and Organization Redesign – We help organizations break down traditional silos to deliver aligned, effective teams that can operate in agile, cross-functional capacities. Our work helps REITs establish operating models and organizations that work towards achieving common goals with measurable results including FFO, EBITDA and net asset value. This also includes ensuring effective change management and communication programs are in place to actively engage key stakeholders (i.e., employees, ecosystem partners, investors, regulators).

Technology Modernization – Key to building the requisite capabilities needed to enable the reinvention is a modern technology architecture with the speed, scalability and flexibility needed to effectively enable analytics, automation, and innovation capabilities. A&M helps REIT leadership determine where to build, buy or partner to strengthen the organization's technology capabilities and overall enterprise architecture.

Start Here: Reinvent Your REIT Strategy and Navigate Your Path Forward

Warren Buffett said, "In the business world, the rearview mirror is always clearer than the windshield."[3] Over the past 50 years, REITs have had a clear history of successful results and demonstrated value to their investors. While it is easy to look back, the most successful REITs will be those that embrace change and innovation rather than clinging to what has always worked in the past.

To stay relevant in a competitive and challenging marketplace, Lodging REITs need to define, articulate, and implement a clear strategy and program to better navigate changing market, customer, and economic dynamics to drive performance across the metrics that matter most to investors. Those who are successful will be best positioned to achieve profitable growth and deliver higher dividend yields to secure additional investment capital.

Sources:

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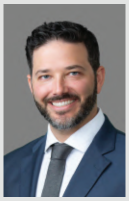
KEY CONTACT:



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