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Contents

Encouraging trends revive interest in industrial assets

By Susan Smith

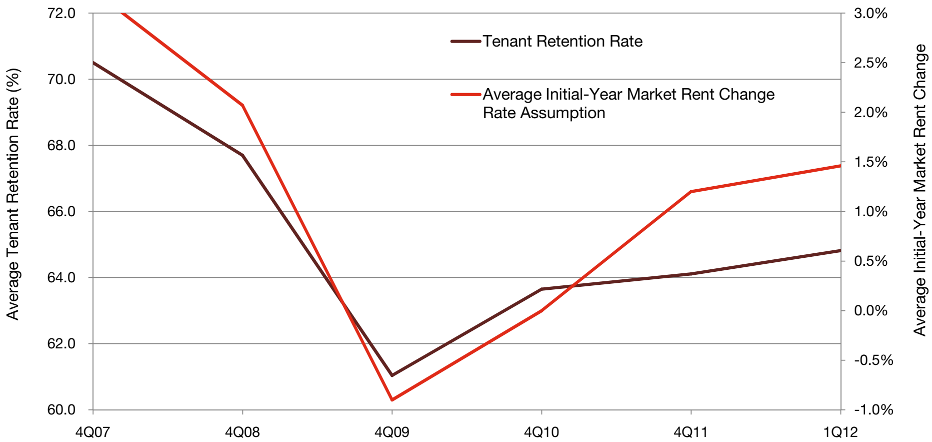
While many investors remain focused on how to capitalize on the burgeoning apartment sector, a growing number of buyers are revisiting the rebounding industrial sector as it continues to demonstrate positive signs of recovery. "Warehouse demand is rapidly picking up, especially in coastal markets with international port access," notes an investor participant of the *PwC Real Estate Investor Survey*. In fact, industrial absorption levels have been impressive even though US economic growth has been weak.

In 2011, leasing demand for industrial real estate grew significantly, allowing this sector to reabsorb all of the space vacated during the recent recession. Moreover, nearly all US industrial markets reported positive absorption trends in 2011 with big-box warehouse activity outperforming the sector as a whole. Many surveyed investors feel that leasing demand for distribution space will remain strong in the coming months despite short-term concerns about economic woes in Europe and the sluggish US economy.

Investors' upbeat outlook for warehouse space is tied to the healing US labor market, which will lead to greater consumer spending and the consumption of more goods. "For us, the underlying positive trends, while sluggish, outweigh the negative ones for this sector going forward," states a surveyed investor. When combined with the limited amount of new supply added to this sector over the past few years, a main reason for acquiring industrial assets now is the potential for rent growth. Overall, rent growth assumptions for the Survey's national warehouse market have increased nearly 235 basis points over the past two years (see Chart 1).

The bullishness expressed by warehouse investors with regard to rent growth potential comes as more warehouse tenants are staying put. As shown in Chart 1, the average tenant retention rate for the Survey's national warehouse market has rebounded over the past two years, rising from 61.0% at year-end 2009 to 64.8% at the start of 2012. In 2009, when underlying fundamentals were much softer, the tenant retention rate plummeted as many warehouse tenants either downsized or relocated due to "better deals." As tenant retention approaches its five-year average (65.4%), the number of surveyed warehouse investors using rent spikes in their cash flow analyses has jumped from 25.0% in the first quarter of 2010 to 60.0% in the first quarter of 2012.

Chart 1– Tenant Retention and Rent Growth Expectations National Warehouse Market



Source: Pwc Real Estate Investor Survey

While the desire to acquire warehouse assets at this point in the cycle is not unusual for many investors, the current investing environment is far from "normal." So, while investors are intently monitoring an array of factors, including the US economy and its impact on this sector's fundamentals, they are also closely watching developers. Even though additions to supply have been constrained, a shortage of quality bulk warehouse space is spurring speculative construction and build-to-suit activity in various markets. As owners of industrial assets know, too much new supply could easily undermine the recovery of the entire sector, as well as many of its top-performing markets.

Overall cap rate trends

In the first quarter of 2012, the average overall capitalization (cap) rate, the initial return anticipated on an acquisition and a reflection of an investment's anticipated ownership risk, decreased in 18 Survey markets, increased in seven of them, and held steady in six. Over the past year, the number of markets posting quarterly declines has fallen while the number reporting either increasing rates or no change has increased. These trends suggest that investors see much of the commercial real estate industry stabilizing. Over the next six months, most Survey participants expect overall cap rates to hold steady in all Survey markets.

Sector overview

Office

Even though the positive US employment reports may take some time to benefit the underlying fundamentals of the national CBD office market, the numbers have instantly brightened the viewpoints of many investors in the office sector. Evidence of an improved outlook is reflected in this Survey market's initial-year market rent change rate assumption, which reported a 300-basis-point increase in its low end of the range in the first quarter of 2012. In addition, the average of this key cash flow assumption increased for the sixth consecutive quarter, reaching 2.19% in the first quarter of 2012.

In the national suburban office market, overall vacancy was lower at the end 2011 than at the start of the year. However, several individual areas continue to contend with oversupply issues. "This office market segment is still weak, but it is stabilizing," comments a Survey investor. In fact, individual vacancy rates declined in 25 of the 37 suburban office areas tracked by Cushman & Wakefield during 2011. In 2010, only 18 individual suburban office markets reported annual declines in vacancy rates.

As the national suburban office market shows signs of improvement, certain Survey investors are becoming more aggressive with their market rent growth rate assumptions. In addition, a growing number of these investors are using rent spikes.

Retail

The national regional mall market is starting 2012 off on a pleasant note, reporting a 20-basis-point decline in its vacancy rate in the fourth quarter of 2011, as per Reis. The decline to 9.2% marks the first downward shift in the past fourth quarters and comes after the retail sector's "decent" holiday sales report, as well as positive year-over-year same-store sales growth for many retailers.

In the first quarter of 2012, movements in this Survey market's key indicators suggest that investors are optimistic that market conditions will continue to improve during the year. As the retail sector continues to strengthen and recover, many regional mall owners are looking to acquire strong-performing assets. Unfortunately, one Survey investor notes that "very few quality malls will be coming to market in the foreseeable future" as most owners are looking to dispose of less-productive malls. Such offerings are not likely to be met with much enthusiasm from buyers given the retail sector's slow-moving recovery.

Despite ending 2011 with a stagnant US vacancy rate, the national strip shopping center market could be poised for a rebound in 2012 due to a lack of new supply and steady improvement in the US economy. Leading this property sector's rebound will likely be the grocery-anchored asset class, where occupancy on a national basis is reportedly outpacing other retail property categories. As a result, investment demand is expect to heat-up for centers anchored by dominant supermarket names.

In the national power center market, dark big-box anchor stores remain a concern for both existing and perspective owners. While some landlords have been successful at retenanting empty big-box spaces, they are filling spaces with nonretail uses, such as medical office space. Investors looking to acquire power centers assets report that prices range from 70.0% to 120.0% of replacement cost and average 96.7%. For potential buyers, tenancy, location, and quality are key investment criteria.

Industrial

With tenant demand for warehouse space on the rise, some investor participants report less of a need to provide free rent, as well as a decline in the amount of the free rent awarded. A year ago, certain landlords were providing as much as 12 months of free rent on a ten-year warehouse lease. In the first quarter of 2012, the high end of the range stands at nine months.

Of particular interest to warehouse buyers are properties located in hot-bed energy and high-tech markets, like Austin and San Jose-Silicon Valley, where job gains, leasing demand, and rental growth are expected to lead the country.

In the national flex/R&D market, the recovery remains very mixed with tech-driven cities, such as San Jose, Silicon Valley, and Seattle, seeing the bulk of leasing demand and declining vacancy rates. For investors looking to acquire flex/R&D assets, most Survey participants believe that market conditions favor buyers while the remainder believes that conditions are neutral - - equally favoring buyers and sellers. In terms of pricing, investors report that prices range from 60.0% to 100.0% of replacement cost and average 83.5% of cost.

Apartment

Investors are flocking to the national apartment market in search of both core and value-added assets due to strengthening demand and controlled new supply. As this sector continues to heat up, investor sentiment has shifted dramatically over the past two years. Then, 87.5% of Survey investors believed market conditions favored buyers. Now, 77.8% believe apartment market fundamentals favor sellers, who are eager to capitalize on a sector where rents are rising.

The Mid-Atlantic, Pacific, and Southeast apartment regions each reveal signs associated with the recovery phase of the market cycle including positive market rent growth. In the first quarter of 2012, the Pacific region posted the highest initial-year market rent change rate average of the three regions, followed by the Mid-Atlantic and Southeast regions. Despite these increases in this key indicator, a few investors note that upcoming cuts in the federal budget could result in diminished job growth locally and a reduction in demand for apartments in the Mid-Atlantic region.

Roughly 83.0% of Survey investors view current market conditions in the Pacific region as favoring sellers whereas the other two Survey regions exhibit a more equal division between favoring buyers, sellers, or neither party in the current investment environment. For investors looking to acquire apartment assets, the Survey indicates that prices range from 60.0% to 125.0% of replacement cost among the three regions. The average sale price is the lowest for the Southeast region at 94.2% of replacement cost, followed by the Mid-Atlantic and Pacific regions with an average price of 102.0% of replacement cost.

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More information on the PwC Real Estate Investor Survey™ can be found at www.pwc.com/us/realestatesurvey or by calling 1-800-654-3387.

Investment property entities

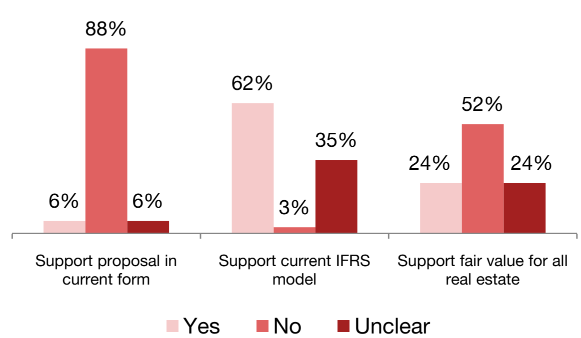
By Lou DeFalco

In October 2011, the FASB issued an exposure draft related to investment property entities ("IPE"). The proposal would fundamentally change financial reporting for many owners of and investors in rental real estate. It could impact not only traditional real estate investors (including both public real estate investment trusts (REITs) and private real estate funds) but also non-traditional real estate and integral equipment owners, such as owners of power plants, cell towers, and pipelines. In February 2012, the FASB heard from constituents on this project. In short, the proposal was not well received. Although intended to better align US GAAP with IFRS and reduce diversity in accounting for investment property, most respondents believe the proposal will not accomplish these goals in its current form. Before analyzing the responses and how they might impact the future outlook for the proposal, let's start with some history and interaction between this proposal and other emerging standards.

History of the project

The impetus for the proposed IPE standard was twofold: (1) to better align US GAAP with IFRS as part of the FASB and IASB's joint lease accounting project, and (2) to narrow the diversity in practice related to accounting and reporting by certain real estate entities. Under the lease accounting project as originally exposed in 2010, entities that report under IAS 40, Investment Property, and elect to measure all of their investment property at fair value would have had a scope exception from

Comment letter trends for investment property entities



applying the proposed lessor accounting model. That reflected the IASB's view that fair value is more informative and represents a preferred model for accounting for these types of investments, including their related leases. Earlier in its lease project, the FASB agreed to a similar scope exemption for real estate lessors measuring investment property at fair value. However, without the proposed IPE standard, there would be no US standard allowing most entities to measure investment properties at fair value and no basis for excluding investment properties from proposed lessor accounting. To address this dichotomy, the FASB added the investment property entities project to its agenda.

The proposed standard also represents an attempt to narrow diversity in practice by certain real estate fund entities. Significant diversity exists in many areas including, income recognition, consolidation, and presentation and disclosure because there is no authoritative guidance to support the different methods used by real estate investment funds to report fair value. In recent years, different ways to address this diversity were explored. For example, in 2007 the AICPA undertook a project to amend the definition of an investment company and determine when a parent or equity method investor should retain the specialized accounting to account for an interest in an investment company. That project resulted in the issuance of SOP 07-1. However, a number of implementation issues arose with the SOP and the FASB deferred it indefinitely. On other occasions, both the AICPA and the EITF tried unsuccessfully to tackle this diversity. The current project on IPEs and a simultaneous project on investment companies are now considered the solutions to address that diversity in practice by real estate investment funds.

Interaction with other emerging standards

The proposed leasing standard

As the FASB and IASB continued to debate the lessor accounting model, a surprise tentative decision was reached in October, 2011 to expand the lessor accounting scope exemption to all investment properties, irrespective of whether such properties are recorded at fair value or historical cost. This tentative decision caused many to question the need for an IPE standard. Public REITs and other similar entities would only tend to favor fair value reporting for their investment properties if it was the only way to avoid applying the proposed lessor accounting model. This is because many would argue that measuring investment properties at fair value is less complex (and provides better information to financial statement users) than applying the lessor "receivable and residual" approach under the lease accounting proposal. Nevertheless, quarterly reporting of fair values for all investment properties would still be a significant undertaking and likely not supported by such entities if not necessary in order to receive a scope exception from the proposed leasing model.

Interaction with proposed investment company and consolidation standards

An entity that is not registered under the Investment Companies Act of 1940 would first evaluate whether it is an investment property entity. If not, it would then assess whether it meets the definition of an investment company. Many aspects of the two definitions overlap, but there are some differences. In addition, the combination of the proposed changes in consolidation, investment property entities, and investment companies could affect many real estate funds. Today, these entities often apply fair value accounting, but substantial diversity exists in the application of that accounting. The combination of the three proposals could lead to more consistent financial reporting, although it may result in substantial changes for some entities.

Key aspects of the proposal and specific constituent feedback

Some of the key issues in this proposal arise in the areas of (1) scope; (2) measurement; (3) consolidation principles and (4) presentation and disclosure. For more detailed analysis of the entire proposed standard, refer to Dataline 2011-34: *Investment Property Entities – The good, the bad and the ugly.*

Scope, scope, scope

The FASB spent considerable time developing the definition of an investment property entity to ensure the "right" entities are within scope. However, the analysis is expected to be complex, and may not meet the FASB's original objectives. Certain defined criteria related to an entity's business purpose, activities, and capital structure must be met by an entity to be in the scope of the guidance.

Critical to the analysis is that the entity must have a defined strategy to exit its real estate investment(s). Some believe that qualifying under the guidance may be difficult for entities that do not plan on selling properties in their core markets. This may be particularly challenging for many current property REITs. Often, capital appreciation is realized by investors in REITs through their sale of the stock, rather than by the entity from the sale of individual property investments.

Specific constituent feedback on scope

Many of the responses focused on potential scope problems and attempting to understand whether certain outcomes of applying the scope criteria were intentional or unintended consequences. In particular, the "nature of business" criterion—which requires substantially all of an entity's activities to consist of investing in real estate—attracted a number of comments. Some noted that investments made through non-controlled joint ventures would not be included when measuring whether "substantially all" of the entity's activities consist of investing in real estate. Depending on the size of such investments relative to the entity as a whole, this could be a determinative factor in whether or not an entity qualified as an IPE. Many questioned why that would be the case.

In addition, constituents want some clarity around the requirement for an entity to have a defined exit strategy for its real estate investments. Specifically, what constitutes an exit strategy and how must it be demonstrated? Accordingly, further clarification may be necessary from the FASB to determine how the test for a "defined exit strategy" for the entity would be applied.

Measurement—more changes ahead

The proposal outlines certain measurement requirements, many of which are positive for real estate entities. Consistent with most real estate funds today, lease revenue would be required to be recognized based on the contractual terms of the lease agreements (rather than on a straight-line or other basis) because future rent escalations are already considered in the real estate valuation. However, this decision has the potential to get revisited based on an IASB decision under the joint leasing project to maintain the requirement to record rental revenue on a straight-line basis for investment property recorded at fair value under IAS 40. Based on that decision reached in December of 2011, the FASB may re-explore whether straight-line rental recognition is required for investment property measured at fair value. Another positive measurement change relates to the initial measurement of real estate properties acquired in a business combination. Entities would no longer have to separate and allocate purchase price to lease intangible assets for existing leases.

However, some changes may be more challenging to apply. One example: the proposal allows investors who report their investments at fair value to report those investments at their "net asset value" (NAV) as a practical expedient, as long as investors in such entities transact at the reported NAV. The problem is certain open-end fund structures may not always transact at the reported NAV. Other entities may not transact at all if they are closed-end funds. This could preclude an investor in such an entity from using this practical expedient. Another example includes the measurement requirements under the proposal regarding liabilities. An IPE would measure its financial liabilities (for example, debt) in accordance with other applicable US GAAP, not necessarily fair value.

Specific constituent feedback on measurement

As expected, the measurement provisions described above as more "difficult to apply" were not favored by most respondents. The requirement to transact at NAV is not supported by "investment entities." Why? It may reduce their ability to use the practical expedient, even if NAV approximates fair value. Most respondents believe an NAV practical expedient is appropriate if the reported NAV is a valid approximation of fair value, as contained in the current literature. They do not believe an incremental requirement for an entity to transact at the reported NAV is necessary. Many "investment entities" disagree strongly with the requirements to measure financial liabilities in accordance with other applicable US GAAP. They cite that a fair value NAV is the most relevant metric for their users. The potential elimination of the option to elect fair value treatment for these liabilities may cause significant concerns for real estate "investment entities." The inability to record such liabilities (particularly property level, non-recourse debt) at fair value would cause large problems in presenting an NAV which was indicative of fair value. This also presents a carry-over impact on an entity's ability to transact at the reported net asset value "NAV" prepared in accordance with US GAAP, and therefore, use of this NAV as a fair value practical expedient.

Consolidation requirements

The proposal would require that an investment property entity consolidate controlling financial interests in: (1) another investment property entity; (2) an investment company; or (3) operating entities providing services to the investment property entity. Other controlling financial interests would be measured at fair value.

Specific constituent feedback on measurement

In general, "operating entities" support these requirements. The story is different for "investment entities," where there are mixed views regarding the proposed consolidation rules. Some would prefer that today's consolidation guidance for investment companies be retained (that is, generally no consolidation and reflecting controlling financial interests at fair value on a net basis). Others, predominantly those who want to present real estate on a gross basis, do support the proposed consolidation rules.

Presentation and disclosure—fair value does not always mean "net" reporting

The FASB has proposed gross presentation and disclosure principles. An investment property entity would present the fair value of investment properties held separately from any associated debt in the balance sheet. In addition, rental revenue from investment properties and related rental operating expenses would be presented on a gross basis. These proposals will represent a significant change for many fair value reporting real estate funds that currently present investments and related activity on a net basis.

Specific constituent feedback on presentation and disclosure

Most "investment entities" seem to favor an option for gross or net presentation to allow flexibility to apply the most appropriate presentation based on the investment strategy. Those preparers would lean toward gross presentation for "core" investments (that is, where income yield from the property is a primary aspect of the investment strategy). For those investments that are more "opportunistic" in nature (that is, capital appreciation is the primary driver of the investment strategy), net presentation might be preferred and is perceived to be more meaningful to the investors in such funds. As for the "operating entities" most seem to favor a gross presentation which is similar to how such entities report results today.

What's next?

The FASB held roundtable discussions in the spring and is expected to begin redeliberating soon. Given the feedback so far, it is unclear how the project may proceed. The FASB's emphasis appears to be on finalizing the proposed investment companies' standard first and potentially incorporating some of the aspects of the IPE proposal into the investment companies standard, specifically for real estate funds. The FASB will also likely revisit the investment property scope exclusion in its proposed leasing standard this summer which could directly impact the fate of the IPE standard. Stay tuned in the coming months as there is certainly more to come on this topic.

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Ownership profile of public lodging REITs

By Aran Ryan and Abhishek Jain

During 2011, public lodging real estate investment trusts ("REITs"), were the most active buyers of hotel real estate, with $7.2 billion of acquisitions representing 37 percent of commercial real estate transaction activity by dollar value, according to Real Capital Analytics[1], a commercial real estate research provider. In 2012, through March, public lodging REITs acquired approximately $551.0 million of hotel real estate. Indeed, public lodging REITs were the largest net acquirers of hotels in both 2010 and 2011, while other investors, including other institutional investors such as private equity firms, were net sellers.

This draws renewed attention to the importance of public REIT ownership in the lodging sector, and raises key questions. While estimates place the REIT ownership share of overall institutionally-owned commercial real estate at 10 to 15 percent on a property value basis[2], specific information on REIT ownership of hotels is less readily available. What share of the lodging asset inventory in the US is currently owned by public lodging REITs? What are the characteristics of the REIT-owned hotel base, how does it differ from the broader US lodging industry, and what are the implications for REIT investors and other market participants?

To address these questions, PwC conducted a hotel-by-hotel analysis of 1,036 hotels owned by public lodging REITs in the US, which we refer to in the remainder of this article simply as REITs (*key terms, analytical steps, and sources are discussed in the Research Background side bar*). Results point to a focus of REIT ownership on upper-tier hotels in top markets, and show ample room for further deployment of capital through this type of ownership structure.

Our discussion of these results follows a three-part structure, beginning with a look at market segmentation: What types of hotels are currently owned by REITs? With this understanding of the prevailing REIT investment blueprint in mind, we examine market penetration by REITs along certain key parameters to address the question: What share of the existing hotel inventory is already owned by REITs? Lastly, we close with comments on implications.

REIT criteria: Location, location, location?

Are there any specific characteristics that public REITs look for in hotels? Are the hotels owned by public REITs "typically" upper-tier or "almost

1 Real Capital Analytics (RCA), (April 2012) *Hotels Trends & Trades* report. Retrieved from www.rcanalytics.com/trendsandtrades.aspx

2 National Association of Real Estate Investment Trusts (NAREIT). (2012, January 4). *2011 REIT Returns are Four Times Those of S&P 500* [Press release]. Retrieved from http://www.reit.com/portals/0/PDF/NAREIT-2011-REIT-Market-Report.pdf

exclusively" upper-tier? Is REIT ownership concentrated in certain markets? Is there a "REIT-type" hotel? In considering these questions, we focused on the following fundamental hotel characteristics:

- Market type (whether the hotel is located in one of the top 25 markets in the US, another metro area, or in a non-metro area);
- Location type (whether the hotel is located in a local area categorized as urban, suburban, airport, resort, or rural);
- Size (hotel room count)
- Brand affiliation (whether the hotel is affiliated with a major brand, or operates as an independent property)
- Market positioning (the hotel's positioning in terms of characteristics such as price and facilities, as measured by Smith Travel Research chain scale segmentation, e.g. luxury, upper upscale, upscale, upper midscale, midscale, economy);

Location emerged as a key criterion in our research. Hotels located in metro areas offer investment characteristics that are often attractive to institutional investors such as REITs. Major markets typically offer a diverse base of demand generators, barriers to the entry of new supply, potentially more favorable attributes for debt financing, and expected depth in the potential pool of future buyers for the hotel asset upon exit.

The combined result of such location benefits is evident in the statistics on REIT ownership in the top 25 metro areas, measured by number of hotel rooms ("top 25 markets"). Based on our research, 67 percent of REIT-owned rooms are located in the top 25 markets. In comparison, only 31 percent of all US hotel rooms are located in these markets.

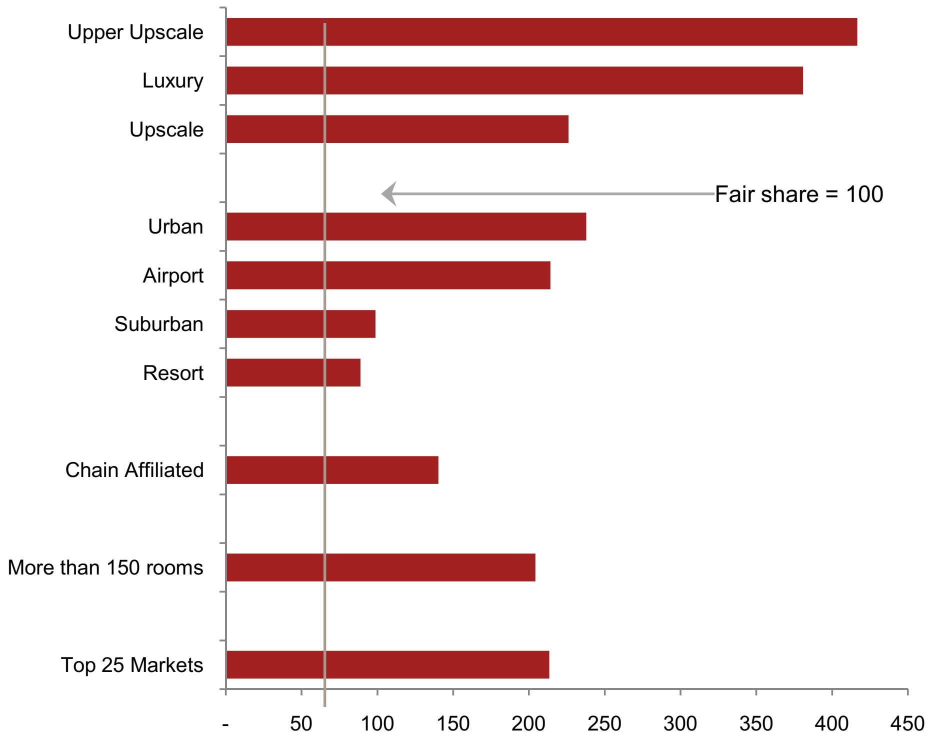
The concentration of REIT ownership is similarly evident when considering the type of hotel location, as 72 percent of the rooms owned by REITs are located in urban and suburban areas (compared to 51 percent for the US overall), with another 14 percent in airport locations (compared to six percent) and 11 percent in resort areas (compared to 12 percent), while only three percent of REIT-owned rooms are located in rural locations (figures reflect rounding), which includes small metros and interstate locations (compared to 30 percent).

These location concentrations are a key characteristic of REIT ownership in the US. However, concentrated ownership in major markets also reflects the focus of REITs on large, brand-affiliated, upper-tier hotels, as such hotels are also most heavily concentrated in urban areas.

As background on these last three characteristics, we observed the following:

- **Size:** Over 75 percent of REIT-owned hotels have more than 150 rooms, compared to 38 percent of all US hotels.
- **Brand affiliation:** Approximately 97 percent of the REIT-owned hotel inventory is affiliated with one of the major lodging chains, compared to 69 percent of all US hotel inventory.
- **Market positioning:** REIT ownership tends to focus on upper-tier hotels, with 55 percent of REIT-owned hotel inventory being classified by Smith Travel Research as being in the luxury or upper upscale chain scale segments, as compared to 13 percent of all US hotel inventory. Another 27 percent of REIT-owned hotels are in the upscale segment, compared to 12 percent for the US overall.

Figure 1: Public REIT Ownership by Hotel Type – Premium to Fair Share



Source: Smith Travel Research and PwC

Note: Premium to fair share is calculated based on the share of a particular type of hotel in REIT portfolios relative to the share of such hotels in the US. For example, the REIT ownership premium to fair share in the Urban hotels category is 238, which is calculated as the share of REIT-owned hotels that are urban hotels (37 percent) divided by the share of all US hotels that are urban (15 percent), multiplied by 100.

The relative concentration of REIT ownership of certain types of hotels is expressed graphically in the chart above.

Recognizing the close connection between location, size, brand affiliation, and market positioning, we performed a regression analysis. The purpose was to gain a better understanding of the independent importance of each characteristic, while holding the other factors constant. The results support the overall picture evident in the concentration percentages. In summary, hotels that are most likely to be owned by REITs are those that are in urban, suburban or airport locations within metro area markets; offer a greater number of guest rooms; and which are affiliated with a luxury, upper upscale, or upscale brand.

Market penetration. What share of hotel inventory is already owned by REITs?

Have REITs achieved similar market penetration in the lodging sector as has been achieved in other commercial real estate sectors? From one perspective, we can consider that REITs own only approximately five percent of the total US hotel inventory. However, given the breadth of US hotel inventory, that statistic is of limited relevance. To more directly address market penetration, we sought to see if it was possible to narrow the focus to a portion of the lodging sector that represents “REIT-type” hotels.

In particular, we considered the hotel characteristics that were common to many REIT-owned hotels in the first part of our analysis. Based on these characteristics, we set out a hypothetical definition of a REIT-type hotel as one that has the following characteristics:

- More than 150 rooms;
- Located in an urban, suburban, resort or airport location; and,
- Affiliated with a lodging brand in the luxury, upper upscale or upscale chains.

Of the 1,036 hotels owned by REITs, 459 fit all three criteria of this hypothetical definition, 312 meet two criteria, and the remaining 265 hotels met one or none of the criteria. This indicates that while there are numerous REIT-owned hotels with a different mix of characteristics, almost half of REIT-owned hotels fit the hypothetical definition of a REIT-type hotel.

Given this finding, we were curious to consider it in context of the broader US lodging sector. Of the hotels that meet this narrow, core, REIT-type classification, what share is already owned by REITs? We analyzed all US hotels, and found approximately 2,755 hotels would qualify to be a REIT-type hotel by this working definition, equivalent to 19 percent of total US room inventory. Of these 2,755 hotels (approximately 911,000 rooms), the REIT inventory of 459 hotels (approximately 163,000 rooms), is equivalent to 18 percent by room count. Within the top 25 markets, REITs own 21 percent of REIT-type hotel rooms. Similarly, REITs own approximately 19, 21 and 12 percent of all REIT-type rooms in the luxury, upper upscale and upscale chain scale segments, respectively. In many of these markets, major lodging C-corps also have substantial holdings.

Overall, these findings indicate that the concentration of hotel ownership within publicly traded REIT structures is broadly similar to the broader REIT ownership of 10 to 15 percent of investment grade commercial real estate, as reported by National Association of Real Estate Investment Trusts (NAREIT).

Implications

We identified three key conclusions from this analysis:

- The aggregate portfolio of REIT-owned hotels is heavily concentrated in the top 25 markets and upper-tier segment of the market (luxury, upper upscale and upscale chain scale segments). Because performance trends in major metro markets, and luxury and upper upscale segments experienced more extreme cyclical peaks and troughs in the most recent economic cycle than the broader US lodging sector, it's important that REIT investors follow not only broader US lodging performance, but also trends within relevant cross-sections.
- REITs own 18 percent of the larger, metro area, upper-tier hotels in the US that met a working definition of REIT-type hotels, and 22 percent of such REIT-type hotels in the top 25 markets. This market penetration, and the fact that only a subset of all US hotels is transacted each year, indicates that there is ample room for REITs to continue to account for a substantial portion of hotel acquisition activity before reaching an unreasonably high market penetration.
- In addition to the acquisition potential within the base of large, upper-tier hotels in major markets, there are other segments of the lodging industry that remain largely untapped by public REITs. REITs own significantly less than their fair share of limited service, as well as independent hotels, which includes properties positioned as upper-tier boutique hotels. REITs own less than one percent of all independent hotel rooms and approximately two percent of upper midscale and midscale hotel rooms in the US. The upper midscale segment has experienced solid supply growth in the last 10 years, in part due to evolving guest preferences. Though such properties have numerous operating and development process differences from hotels typically owned by REITs, there have been recent signs that public REITs are becoming more active in the acquisition of both independent, as well as limited-service hotels. In 2011, public REITs accounted for approximately 32 percent and 37 percent of limited service and independent hotel acquisitions by dollar value, respectively.[3]

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Research background

We analyzed the ownership of the existing inventory of hotel rooms in the US on a hotel-by-hotel basis, based on data provided by Smith Travel Research as of March 2012. In total, the analysis included 52,153 US hotels, with approximately 4.9 million rooms, including 225 hotels with approximately 141,000 rooms in Las Vegas. Our analysis focused on ownership by 17 publicly-traded lodging REITs, and does not include hotels owned by other publicly-traded organizations, including lodging C-corps, and private REITs. Percentages reported in the article are calculated based on room count, unless otherwise specified. Chain scale segments are a method by which branded hotels are grouped based on the actual average room rates of each brand. Independent hotels, regardless of average room rates, are included as a separate chain scale category. The chain scale segments are: luxury, upper upscale, upscale, upper midscale, midscale, economy and independents. Additional information on which brands are included in each of the chain scales can be obtained from Smith Travel Research.[4]

3 Real Capital Analytics (RCA), (April 2012) Limited Service and Boutique Hotels Trends & Trades report. Retrieved from www.rcanalytics.com/trendsandtrades.aspx
4 http://str.com/documents/2011_STR_US%20Chain_Scales.pdf

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