TR Mandigo & Company

Over 40 Years of Hospitality Experience
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Presentation to MAI Chicago

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We're going to keep crying wolf until somebody listens. That's the lesson of that story, right? Last year we anticipated a fairly dramatic decrease in occupancy coupled with rate growth when what we got was a mild drop in occupancy and flat rates. So we're wrong, right? Well, we wouldn't be consultants if we couldn't explain that fairly major difference away. We'll do it in four letters. C-U-B-S. Their win bolstered September through November to extremely high levels, but drove rates up over $10 compared to the previous year. Before that, rates for Chicago were down against every month in 2015 except for June. The Cubs saved us. But even with that, we were still down. And finally after three years of worrying about oversupply, other groups are catching on.

If we keep saying that the market is headed for a downturn, we'll be right eventually.

Again, it boils down to simple supply and demand. At this point, we've got more hotels downtown than at any point prior to the great depression (not the recession), when hotels had over 1000 rooms averaged under 200 square foot a room and didn't have attached bathrooms. Most of those hotels have been torn down or remodeled. Now, we have a ton of smaller hotels, 83% of which are upscale or greater. What's more, every single hotel project built in the last decade has been in the already crowded upper-upscale or luxury markets.

While a few luxury hotels have pushed rates somewhat higher, as in the case of the Langham, rates overall have stagnated. Because of a $30 drop in the recession, rates grew by over 5% for a few years as they struggled to hit $190 again. After they hit 190, rates increased at around the historic average (of 3.5%,) while this year, they stayed flat. Again, while this doesn't show a market in decline, it is indicative of oversupply, as new hotels typically command a higher rate than other properties, but generally lift market rates up, even as they may depress occupancies.

Simply put, there are too many hotels in the same category being built, to the point that newness isn't a sufficient differentiator to bolster rates. Chicago also has a large suburban secondary market, which is easily accessible by both public and private transportation, and so is limited in the amount that hotels, even luxury properties can charge.

While Chicago continues to cannibalize the metro region, resulting in lower suburban occupancies and dramatically less displaced demand from the surrounding markets, those markets typically operate at or around $100 a night, and so are a major limiting factor for any but the highest end hotel, because, realistically for the guest, a central location and a hip vibe is not going to be worth more than $100 a night.

Aside from the Cubs, 2016 was a down year due to q1 weather patterns being unfavorable compared to 2015, which had the highest November occupancy since 2009. In fact, 2017 had a better winter than last year, but early indicators are that the spring and summer months are likely to be down.

The convention season in 2016 was weak compared to 2015, while convention center focused construction continues at a rapid pace. It is unknown what effect this will have on the convention market. While there will be 4 more major events this year compared to last, resulting in an anticipated 6.4% increase in attendance (about back to the norm), the addition of new hotel rooms, including the mammoth 1,200 room Marriot Marquis, may do little more than draw convention guests to that neighborhood and away from other areas. At best, the increase in rooms will mean a drop in suburban overflow.

Charitably, the loss of the longtime head of Chicago's tourism arm and the closure of overseas offices is likely to hurt international travel, as is the negative press generated by continued violence in the city, and perceived overly harsh immigration policies. These may not be felt immediately, but will take time to repair, and will certainly not help Chicago's ability to attract international tourism. We should continue to draw regionally, but with 75% of our visitors coming from the surrounding Midwest, that was never a problem.

Now for some good news (maybe). The disruptors are done disrupting. They came up against the wall of reality that there are actually rules to the game they were playing, and while they got away for years with legally grey tactics, they've been litigated into something if not respectable, than at least predictable. AirBNB continues to consist primarily of investor operators despite their insistence to the contrary, and operate in an unknown but not insignificant number of residences that essentially strictly forbid them, but these are things the company can pass off onto their operators and claim indemnity. For a number of years the strategy was to see what they could get away with and try to get favorable laws in place. That's pretty much done. Moreover, they've expanded about as much as they can in major markets. How do we know? Their global head of hospitality stepped down, and now they're expanding from "hospitality" to "travel", which means they're going to sell "experiences", which puts them in direct competition with Groupon and the other players in that market. They represent an average of around 4,000 rooms in the city, but during Lollapalooza, according to their own representatives, they had around 10,000 rooms. Meaning, they represent a shadow market of up to ¼ of the total rooms in the city. Surprisingly, this doesn't necessarily directly hurt the downtown. Where it is felt most vividly is in actual B&B rentals, and again, in the suburbs.

The OTCs are still a massive roadblock for the hotel industry, because the industry itself still doesn't understand technology. Expedia received massive backlash for their accelerator program, whereby giving Expedia between 1-20% higher commission, they would move a hotel's page ranking higher. Since that industry is so heavily consolidated, there's little to be done about it.
What has changed is several European laws which have taken the pressure off of hotels to have rate parity with the websites, meaning that the hotels can now offer cheaper rates for their own properties than they offer online. It is amazing frankly that it has taken this long, and it is still not the case for the US. Europe as a whole sees around 25% more bookings from OTA sources than we do, so the hit is expected to result in around a 25 decrease according to ehotelier.

Brands, meanwhile, have been attempting to strengthen their online presence and it's about as successful as it appears. Hotels are trying to get around this by offering incentives for direct booking, but the real story is that the industry as a whole is focused on a new trend.

While the last several years have seen buzzwords such as boutique and lifestyle thrown about, this year, the word is "soft brands". Really it's a continuation of the previous concepts, combined with a concept that's been around since even before the inception of its most iconic example: Best Western.

Essentially a soft brand is a member of an organization that relies less on its brand identity and more on their unique characteristics. As a membership organization, rather than a franchise group, it's up to the specific hotels themselves to operate as they desire within the brand specification. To be fair, that's something that's been lost over time with the drive toward standardization and the cookie cutter midscale franchise boom of the 1990's, but the idea itself is older than dirt. When Conrad Hilton went around buying up grand hotels, those were essentially soft brands. Nowadays, to get in on the action, the big players, Marriott with their Autograph, Choice with its Ascend and Hilton with its Curio and new Tapestry collections, are competing with leading hotels of the world and other smaller affiliate groups to build one or two off hotels with interesting names in major markets as a way of both increasing their market share and essentially seeing what sticks. Ironically some of the original lifestyle hotels, like 21C have expanded into other markets while big brand backed properties, such as the Wit, remain a local institution. This has the effect of creating a sense of place and a unique experience, rather than sameness. At this point, we expect hotels to be consistent, safe, and comfortable with a baseline of standard amenities, which were all reasons that franchises proliferated in the 70's and 80's. It's also a move enabled, perhaps ironically, by the existence of OTCs, where a guest can see what they're getting ahead of time, so they don't need to just look in a directory and pick a name brand they recognize.

A more sarcastic way of looking at it is that perhaps we're getting tired of the old American cliché of going to Europe and eating at McDonalds.   It also serves to combat AirBnB in that it creates a hotel that is an experience now in itself, rather than a place to crash.

In addition to Chicago we also try to examine the surrounding areas to look at regional and sub-regional trends. Just as in the city itself, 2016 was down compared to 2015, while rates were up across the board.

The best performing market outside of the CBD continues to be O'Hare, though it was down slightly from the previous year. In actual numbers, demand was down by a mere 3,000 nights, though 200 new rooms added to the market meant that supply outpaced demand by around 20 to 1. Flight caps and the like are all now things of the past, and passenger volume at O'Hare increased by 1 million last year. However, this didn't translate into additional room stays indicating that as the airport increases its passenger volume, much of it is still pass through or regional traffic.

This market is heavily biased toward airline traffic and lives or dies with the success of O'Hare, with a secondary market of conventions and business meetings. Still, it seems that the new normal for the market is around 4% of total passenger volume, compared to its previous 3.5%.

The long term outlook for this market in our projections is for a slight decrease in occupancy, with continued moderate rate growth. It is difficult to suggest the market is in decline, because it is a strong performer, but early 2017 numbers suggest it will be down slightly again compared to last year.

Overall the suburbs have been about even or down slightly thus far compared to last year, while rate growth has been very modest, at around 1%. There were a number of openings last year, with 4 hotels in the north, 3 hotels in the northwest, 1 at O'Hare, 2 in the south, 1 in Lake county, and 9 in the CBD.

Almost directly in line with those numbers are the drops in occupancy percentage, meaning that so far in the year, there isn't more demand to fill the increased number of rooms. That's not the whole story because the first quarter is always an off season, so there's not really any extra demand coming in anyway. We expect that during the busy season, demand will grow, but in some areas like the north, it may be that the increased demand may not be greater than the increased supply, resulting in a drop in occupancy.

Chicago still sees the lion's share of new growth, but there were more construction projects completed outside of the CBD (11 regional projects vs. 9 downtown) though including areas in the city outside the CBD there were 11 Chicago projects vs 11 outside.

That's a marked change from the initial post-recession period, but represents projects that were started several years ago, and completed last year, rather than an immediate new interest in the suburbs.

CHICAGO HOTEL TRANSACTIONS

Over the last year, there have been four notable hotel transactions in Chicago, which show the market is developing something of a split personality. The PUBLIC sold in July for $60 M, or around $210,000 a room, about what it cost initially, while the Hotel Allegro sold in November for $86.7 M, or about $180,000 a room, which was less than the total investment in the property by its previous owner, and substantially under the $225k/room asking price. That said, the Hotel Lincoln sold in February for $70 M, far more than the $45 M it was valued at in 2014. In realistic terms, that gives a range on the average price per room for a upscale hotel property downtown at between $170-$225k, depending on age, location, and performance metrics.

The other side of that coin is the big luxury transactions, typified by the flipping of the Waldorf for over $600k a room, which was the biggest deal in the Chicago market until Oxford Capital sold the stillincomplete London House hotel for $315 M to a German investment firm. That transaction represents nearly $700k per room for the 452 room structure, and is structured as a 25 year lease.   What is more is that Oxford still retains ownership of the first two floors of the building. Although the structure itself is a Chicago Icon on prime real estate, it is unusual to say the least. the pre-opening nature and exorbitant price per room is extremely unusual for the city, and in our opinion, indicative of an investment group eager to get into a market they've identified as hot, at any price. To be blunt, this project is unlikely to make a decent return on investment. It is a jewel in a crown.

NEW DEVELOPMENT

Lodging Econometrics forecasts an additional 4341 rooms will be added to the city in the future, while our own list indicates a potential of over 10,000 rooms. The complete list we have is unlikely to see fruition, but many of the properties are firm or under construction, including most notably the 1,200 rooms at McCormick place in the Marriott Marquis, the 466 in the nearby triplex, another 500 room hotel planned in the area, the 150 room Ace and 119 room Nobu hotels joining the SoHo House, the EMC squared 195 room Autograph by Marriott hotel by Scott Greenberg, a 210 room Cambria Suites on top of the Oriental theater, a 180 room Viceroy Hotel at the old Cedar Hotel site, a 158 room Moxy hotel, a 223 room Canopy by Hilton in the JW Marriott building, the 50 room Midtown Athletic Club, the 175 room Sheraton at Wrigley Field, and the 250 room First Hospitality project ON Navy Pier. That's not including several other neighborhood and suburban projects or projects in early speculation.