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Over 40 Years of Hospitality Experience
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Presentation to MAI Chicago

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I've heard it said that there are three presentations for every event, the one you planned to give-which is great; the one you actually give; and the one you worth through in your mind after the event-which would have been the greatest one ever. Well, we'll see if we can do that one for the actual.

First, year end, 2015. We had a banner year with an occupancy level of 76% and an ADR (Average Daily Rate) of $209.03. The RevPAR (Revenue per Available Room) which measures a combination of occupancy and ADR to give efficiency of generating revenue or equivalent to comparable total rooms revenue for a property, $158.84. Just for the record, we had forecast the RevPAR at $159.12. We missed by $0.28 or 00.17%-not bad!! Now, before you get all excited about the strong 2015 performance, remember that the ADR in 2008 was $207 and we just got back to that level this year-a span of 7 year to recover the 25% drop in ADR when the financial crisis hit in 2008-2009. We've left a lot on the table during those 7 years and it is reflected in a lot of deferred maintenance, bankruptcies and property transactions over the period.

Memories are also short, so when the market was on the upswing in 2011-2013, developers got excited about the prospects, and interpreted the recovery as significant trends in new demand. That resulted in an increase in supply from 36,800 rooms in 2013 to the current level (year end 2015) 0f 39,090 rooms. These included several notable properties such as the Loews, the CAA, and the Godfrey among others.

Well, the development trend continues. There are 3,400 rooms under construction for 2016, followed by nearly 6,200 for 2017.

We have been saying for years that 2016 was going to be a bad year and the industry is finally coming to terms with that. It's not going to be a major catastrophe like 2009, barring some sort of force majeure, but this year should see occupancies and RevPAR drops for the first time since 2008. In fact, we started out the year with a dismal 11.6% drop in occupancy and a 19.5% decline in RevPAR for January of this year. Granted, that was partially weather related-the snow on the east coast, and is a comparison with a particularly strong January 2015 but it is a harbinger of what is to come.

There are a number of reasons for the conservative outlook, but it essentially boils down to simple supply and demand. Even without the major recessions of the 2000's, the hotel industry runs in cycles. We've looked at data going back to 1960, and have seen 7 distinct recession and recovery periods, with an average length of around 8 years. The longest cycle lasted from 1990-2001, but would have begun anyway even without 9-11-we basically fell off the cliff in the spring of that year and 9-11 merely exacerbated the pain. Looking back, although 2000 was a very strong year, it was buoyed by millennial events, while there was a clear downward trend evident from 1997 through 1999.

While that's a rather historical example, the point remains that Chicago has been a market that skirts around a 70% occupancy when viewed through the very long historical lens on average, so the notion that we can and should expect a new average of around 75% as seen since 2012 is faulty, though hardly unprecedented. It is that view of a "typical 75% occupancy" which has been a leading predictor of every recession that has occurred in the market for as far back as we have data. The reason for this is that it heralds a construction boom. From early 1990's additions were made to the market, adding the in vogue property type of the day to the downtown area: limited service: upscale properties; boutique hotels; and the current trend, lifestyle and luxury properties. New development tends to occur in clusters and phases, and as we have mentioned every year in recent years, that boom is particularly strong this time. We certainly don't have the power to tell people to stop building, and even given Chicago's high room tax, new hotels should theoretically be profitable during all but the lowest of the recessionary periods, but it is an undeniable fact that these new properties increases room supply without creating 100% additional new demand, which necessarily results in lower occupancies. This generally isn't a major problem for the health of the industry until a catastrophic event triggers a decline and causes a larger number of properties to compete for their share of a smaller pie, often resulting in a price war and race to establish the new bottom. An often neglected secondary effect is that the room growth results in less displaced demand from downtown area that historically benefits the surrounding suburban markets. Without this level of new construction, we may not have expected a year over year decrease, although there are a number of factors that make 2016 a relatively weak year regardless.

The convention season this year is terrible, despite the fact that last year's attendance (2015) was up by 4%, because we bid for the Olympics in 2008. Many conventions booked far enough in advance that the largest of these we traditionally were in competition for, chose other locations rather than compete with a potentially crammed city. Now we have neither the conventions nor the Olympics. Unfortunately, we do not have a list of events which chose not to go to Chicago because of an event which didn't happen, but significantly fewer conventions were booked this year.

McPier is in the hole by millions with its construction projects, which according to a major story in last Sunday's Tribune, appear to be considered as a major demand driver only by the agency itself. In addition, Choose Chicago's loss of Don Welsh leaves the agency crippled and adrift, and unable to capitalize on the earlier successes of the revamped tourism programs put in place during the recovery that delivered over 50 million visitors to Chicago in 2015. Those foreign offices, targeted international ad campaigns, and even regional events are now pretty much dead, and though foreign tourism is likely to be down this year anyway, it will make it difficult to reboot in the near future.

The tourism budget getting gutted will have a small negative impact this year, but will have a much more pronounced long term negative effect on the city of Chicago. If you care at all about making

money, tell the politicians to stop playing around with people's livelihoods. While it's not as ethically wrong as withholding money from social services or schools, Tourism is a major part of the Chicago economy, which is the engine of Illinois.

Air BnB

AirBNB continues to be essentially irrelevant for the city of Chicago's hotel marketplace although it represents a shadow market of up to ¼ of the total rooms in the city. AirBnB is more active during peak periods, and has a fluctuating inventory. It is generally cheaper than hotel rooms, though whole-unit rentals are similarly priced. Unsurprisingly, it is having an effect on actual Bed and Breakfasts, though since there isn't a centralized database of occupancy or rate for such operations, it's harder to give an exact number. The proposed solution from the mayor is for hosts to register their rooms and pay taxes (equivalent to a 2% surcharge), and purchase insurance. That's dramatically less than hotel tax and is a prime example of the general attitude of disruption-economy operations of taking an existing established business practice, and attempting to avoid all the regulations that are associated with it.

They also have been implicated as a cause of increased rent for apartment rental rates. This is more of an issue in other areas such as New York, where the company dumped 1,500 listings in New York City before disclosing statistics showing that it was made up of mostly single units rented out by individuals. Even after that purge, nearly 40% of its income was shown to be from multiple property owners, leading to charges that it is a shadow market of essentially illegal hotels, and creating inflation in rental prices. They are going to have to contend with a number of lawsuits in the future and they are spending a great deal of their operating capital on legal teams and lobbyists of the last year, such as their amazingly tone deaf campaign in their hometown telling the government what they should do with the taxes they finally agreed to pay. The other aspect is that the company itself is a product of Silicon Valley investors. Its ridiculously sky high valuation of $25 Billion is based on an expected return of OVER 25:1 on investments. These are based on unachievable long term growth numbers; with the grey market they operate in essentially overtaking the established one. Basically, like a lot of Silicon Valley startups, that number looks good on paper so the early investors can get a good return and leave someone else holding the ball when the tech bubble pops. The total amount of money they've raised is still under $1 Billion, which has been used in three basic places. 1) rapid expansion 2) PR, advertising and fighting regulation, and 3) paying back early investors. It is not known if it is currently profitable, though it's unlikely, as it's been in a rapid growth phase and is attempting to achieve critical mass, whatever that means. This year is likely to see the beginning fall of at least one of the major unicorns whose trademark "Disruption" strategy is essentially crowd-sourcing the risk while keeping the reward, and of course conveniently ignoring the existing regulations of the marketplace. Uber, for example, operates in several countries where it is actually illegal, and encourages their operators to request passengers to sit up front so they look like buddies, rather than clients. One doesn't have to stretch their imagination to imagine similar scenarios for AirBnB. However the chips fall, there will be a number of lawsuits in the year or two to come.

OTAs

Consolidation of the OTCs is essentially complete. Now that Expedia has gobbled up everything in existence basically, phase 2 is when the knives come out. Their accelerator program is nothing more than pay-per click nonsense and another way to extort rank and list space on their page. While it's true

that hotel companies have managed to claw back some of the more absurd rates charged for listing, the accelerator program is a clear attempt to regain some of the ground they lost during the recovery, when hotels finally began to learn to manage inventory more effectively. Essentially, by giving Expedia between 1-20% higher commission, they will agree to move a hotel's page ranking higher. Supposedly it's transparent because you can see the exact number of places you would move by paying higher practically it's a way of trying to create pressure and competition among susceptible hotels, to hopefully trigger a race to the bottom. Obviously, lower prices are better for their consumers, but harmful to the industry as a whole. Unfortunately, for all the savvy that revenue managers and brands have gained in learning to use OTCs as an additional channel for distribution, it's about a decade too late to stop the latest pay-to-play scheme they've set up. So far, while better apps have been somewhat successful, brand websites and industry designed alternatives have been half-cocked and poorly thought out, generally looking like something a generation or so behind the latest designs.

Suburbs

In addition to Chicago we also try to examine the surrounding areas to look at regional and sub-regional trends. Overall, 2015 was a decent year for most markets, with most areas seeing better results than any point in the last 15 years.

O'Hare

The best performing market outside of the CBD is O'Hare, and it has been for most of the historic period. It recovered from a long recession after 9-11 due to the nature of that attack, and really recovered only from 2005-2007. Flight caps, construction, and the 2008 recession dropped the occupancy in the area to a new low in 2009 of 56%. It recovered fairly quickly even as 6 hotels opened or renovated through 2011. Although the hotel market is down by around a half a point from its high in 2014, it is poised to outperform the downtown in terms of occupancy though about $80 lower in rate, as it isn't seeing anywhere near the new development activity as downtown, and should continue to benefit from its location on the CTA.

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. We examined the relationship between total passenger volume and hotel demand, and discovered that while it seems to average at around 3.8 during the historic period, it has been at or well above 4% of all travel, even as the number of passengers at O'Hare has increased by nearly 10 million since the opening of the new runway. Some of this is due to the removal of several old properties during the same period, though demand and occupancies have remained high and consistent with the opening and renovation of new upscale properties. From our research we have found that the casino remains a non-factor in generation of room demand. It is likely that demand in the area did not increase because of an additional 154 new rooms in 2015, though it is also possible that, like Chicago's downtown itself, guests may seek other properties nearby, though not as convenient, when high occupancies cause sufficient increases in rates. The nearby Northwest and DuPage markets, run at least $20 lower per night.

The long term outlook for this market in our projections is for a slight decrease in occupancy, with continued moderate rate growth, as we expect that Rosemont and the city of Chicago will attempt to attract and build hotels in the next five years. Possible sites include the Rosemont entertainment

complex, the new rental car complex, and possibly the international terminal area. Because the area is relatively strong and relatively close to downtown, it is possible other developers may join suit.

DuPage

The western DuPage market has been struggling for the historic period, where in 2000 and earlier it was achieving occupancies at or near the 70% range. The double recessions, increased competition from downtown and lack of overflow days where citywide events would drive guests to the suburbs took their toll on the market, dropping the area down to the mid 50's, and bottoming out at 50% in 2009. While it recovered more slowly than the O'Hare market, it saw it best year in 2015 with occupancies at 65.5% and rates at around $100. There are several concerns in this market, like many regional submarkets, including corporate reorganization, municipally financed hotel construction, and a supply of upscale hotels that tend to verge on the older side, though many renovate frequently. Over the historic period, the area saw the number of hotels change from 96 to 109, then down to 101. In the last year or two we saw the Le Meridian open in the former Renaissance, and the Drake Oak Brook open after a long process. In the near term that number will become 105 as Naperville has been aggressively expanding their hotel base.

Generally, there has been an adjustment in the suburban markets as hotels purpose built for a single or only a few corporations have learned to expand their offerings or close, along with learning to deal with the new realities of the market. In general, we think what we're seeing what could be considered the new stable baseline for this and most of the other submarkets. Obviously there is considerable concern in Oak Brook over the possibility of McDonalds moving downtown, but they tend to do something similar every five to ten years or so and last time it resulted in some of their IT moving. If they do more than bluster it would have a huge and significant impact.

Northwest

To see how that might play out, the Northwest Market is a good go-by. It is similar in number of properties and performance to DuPage, though it saw more development during the recession and recovery, and now sees prices around $14 lower, at about $86. That number may be dragged down somewhat by a relatively large concentration of extended stay hotels, though the greater culprit is likely the age of many mid-scale and even some full service hotels. Because of the historic presence of sears, Motorola, and their support businesses, as well as Woodfield Mall, the area was dominated by business-focused properties. This is still true to an extent, but the shift is essentially irreversible. We also expect continued growth in the region with 5 proposed hotels within the projected period, which should drop down occupancy in their initial years of operation until they are fully absorbed into the market. Particularly large properties, such as the Renaissance, took a number of years without contributing significantly to the overall rate performance of the area. The inverse is not also true, as the Sheraton Arlington Heights did not boost occupancies or rates either. A driving factor in the success or failure of hotels in this region is typically location and proximity to both major demand generators and regional highway traffic.

North and South

The North and South regions, while vastly different in terms of demographics, actually have performed similarly post-recession, though the North region is composed of only 33 somewhat large upscale hotels,

and the south contains 109 properties. They both have important industrial and corporate headquarters and are along major interstates with easy access to the surrounding region.

The similarities end there as the south was a blue-collar area and has been successful due to its strong industrial base, new development, and the continued harrowing of numerous old underperforming hotels, combined with a few openings, essentially replacing budget motels with mid-scale. Though the increasing population and booming construction saw a massive slowdown during the recession, we expect a few more properties to be built in this region in the coming years.

The North, meanwhile, represents a mature, upscale market with only a few pockets of poverty. This creates an uneven mix of historic upscale inns and hotels, with a few unbranded or budget motels. Growth in the area is driven by the health of the Pharmaceutical and insurance markets, which, mergers and such aside, are a solid base for hotel business, as well as a secondary base of collegiate and tourist activity in Evanston. There are a few projects being discussed at current, with possibly as many as 5 hotels opening during the projected period. Because there are only 33 hotels in the market, any new properties will create an immediate drop in overall occupancy until they stabilize, though we expect demand to increase year over year. Rates should go up as well, though without the 5 to 8% increases from the previous year as seen during the recovery. Typically, industries renegotiate corporate rates on a cycle, and tend to hold rates as low as possible. Therefore, we have limited our yearly rate growth to under 3%.

Southwest

Lastly, the southwest market continues to underperform, though it did increase by 3 occupancy points between 2014 and 15. Rates remain fairly low, and growth in the area remains limited. Gaming and casino operations have been diluted by successes in Rosemont and in bars statewide. We do not anticipate, nor are aware of any major shifts in the market which might change the performance in the near term, so our expectation is for slow growth, capping out at around 63.5%, the market area high in 2007.

Long story short, the recovery is done. This is the typical, relatively strong market that we will see until the next recession.

Questions?