

## Stock buybacks by lodging REITs: *Do they work in the down cycle?*

In 2015, lodging REIT stock prices lost more than a quarter of their value after six consecutive years of steady gains. The NAREIT lodging REIT index plummeting -27.3% over the course of the year.<sup>1</sup> At the same time, the private market value of hotel assets continued to climb, leading to steeply discounted company valuations.

Lodging REITs have taken divergent responses to these developments. Strategic Hotels initiated a search for strategic alternatives in the summer and announced a sale to Blackstone in September, at a 13% premium to its pre-offer price. Another REIT recently announced it would distribute the proceeds from an asset sale to shareholders via a special dividend. However, seven other lodging REITs have authorized share repurchases worth just over \$2 billion, a range of 4% to 22% of company stock.<sup>2</sup>

Company	Share repurchases authorized (\$000s)	Estimated Market Cap (1/22/16, 000s)	Approximate % of market cap repurchased
CHSP	\$ 100,000	\$ 1,400,000	7.1%
DRH	\$ 150,000	\$ 1,630,000	9.2%
HT	\$ 200,000	\$ 916,590	21.8%
HST	\$ 1,000,000	\$ 10,380,000	9.6%
RLJ	\$ 400,000	\$ 2,290,000	17.5%
RHP	\$ 100,000	\$ 2,330,000	4.3%
XHR	\$ 100,000	\$ 1,530,000	6.5%

Are share buybacks by lodging REITs a good use of capital at this point in the cycle? Because IRS regulations limit REITs' ability to retain earnings, buybacks tend to be funded by debt or asset sales – and to a limited degree, cash reserves. But lodging REITs play in a more volatile space, and are subject to liquidity challenges during cyclical downturns – to an extent not shared by other REITs.

Using an analysis of stock buybacks during the previous lodging cycle, we argue that lodging REIT shareholders may be better served at this point in the cycle by other strategies, such as special

dividends financed by asset sales or an outright business sale. We argue that in the previous downturn, buybacks were not effective in stabilizing share prices or protecting dividends:

*In the last downturn, modest stock buybacks were wiped out by large share issuances in short order as the end of the upcycle turned quickly into the downcycle.* In 2008, several lodging REITs who were not sold to private equity bought back stock as prices began to decline. However, stock prices continued their descent until the second quarter of 2009. Most lodging REITs were forced to issue large volumes of shares at declining prices to raise cash, wiping out the impact of the 2008 buybacks. On average, REITs issuing buybacks subsequently issued greater volumes of stock.

*In the last downturn, stock buybacks may have accelerated lodging REITs' cash crunch.* To the extent that buybacks were financed by drawing down cash reserves and increasing debt, they pushed REITs into a more precarious position at the worst possible time. Most lodging REITs halted distributions entirely; some also requested permission from the IRS to issue distributions in stock rather than cash.

*Could stock buybacks act as M&A deterrents?* Investors should carefully evaluate the impact of proposed stock buyback plans on the REIT's ability to pursue other strategic alternatives. Would a change in EPS or price/FFO impact executive compensation? Would buybacks be offset by stock issued to executives? Would a leverage-funded buyback discourage potential takeover offers by increasing the cost of an acquisition?

Management teams are appropriately considering how to exploit the gap between high real estate values on the one hand, and depressed share prices on the other. But investors should urge management teams to consider other ways to make this gap work for shareholders. By distributing the proceeds of asset sales to shareholders as special dividends, for example, management teams allow shareholders to choose whether to plough their funds back into the company.

Further, past cycles suggest that lodging REITs take a beating in terms of share prices and dividends for years, suggesting lodging REITs should consider an outright sale of the company. Roughly half of lodging REITs successfully executed business sales at or around the peak of the last cycle, achieving on average a 20% premium for shareholders.

## Is the timing right for share repurchases?

After reaching a cyclical high on or around the end of 2014, lodging REIT shares lost over a quarter of their value, on average, in 2015. Some management teams have begun using capital to repurchase their own shares at these lower prices.

In fact, the price of lodging REIT stocks indicates some skepticism in the market about a rebound in the near term. On average, the lodging up-cycle lasts 7 years.<sup>3</sup> Lodging REIT stock prices have been steadily increasing since Q2 2009. One analyst sees the hotel industry entering the final third of the current cycle.<sup>4</sup>

While industry fundamentals remain decent, analysts and investors see storm clouds on the horizon. U.S. supply growth is picking up, particularly in key markets, approaching the 2% long term average growth level.<sup>5</sup> Interest rates have begun to increase after being frozen at historic lows. Events such as Paris and San Bernadino attacks may impact travel plans and intentions. Indeed, the market strongly punished lodging REITs for missing revenue and EBITDA projections even slightly in the second half of 2015.

A Merrill Lynch analyst told *The Wall Street Journal* in August 2007: “And there’s always the possibility that the bottom of this REIT bear market hasn’t been reached, Mr. Sakwa [Merrill Lynch] said. If the credit panic spreads, stocks could tumble further, making buybacks poor investments.”<sup>6</sup>

## How will REITs finance share repurchases?

REITs typically have less free cash flow than corporations, as they must distribute most of their income to shareholders via dividends. Funds for buybacks can also be raised by selling assets or leveraging up.<sup>7</sup>

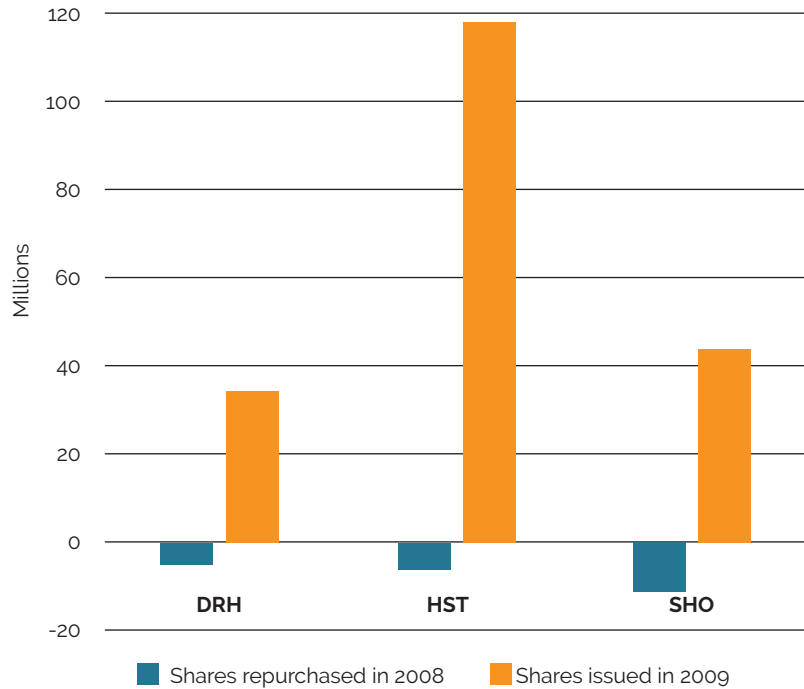
‘Share repurchases may be a plus for REIT net asset values in the short-term, but over time the resultant increase in leverage could impair credit quality,’ according to Fitch Director Reinor Bazarewski. ‘It is important to note that current REIT leverage is above levels seen at the end of 2006, just before share buybacks spiked sharply during the last credit cycle.’<sup>8</sup> As we will see, in 2009, many lodging REITs had to reduce or suspend dividends due to a cash crunch.

Of the seven REITs announcing share repurchase programs in 2015, four have provided information about how these buybacks may be funded. Of these four, three include cash and financing as possible funding sources, while one (Host) announced plans to fund repurchases through asset sales.

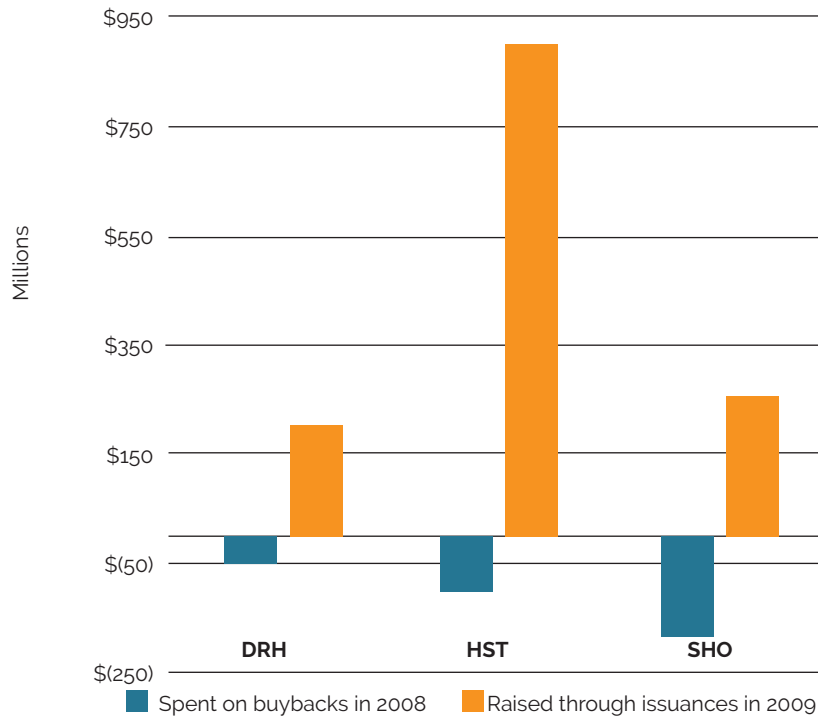
## Lessons from the Past, 1: Buybacks were followed swiftly by share issuances

Diamondrock (DRH), Host (HST) and Sunstone (SHO), three of the four veteran lodging REITs pursuing share repurchase programs in 2008, completed share issuances the very next year that were 3 to 18 times the volume of shares repurchased the previous year.<sup>9</sup>

Volume of stock buybacks and issuances by lodging REITs, 2008-2009 (millions of shares)



Cost of stock buybacks and issuances by lodging REITs, 2008-2009 (\$000)



Moreover, REITs that had executed share buybacks in 2008 increased their share volumes by an average of 26% by the end of 2009, while lodging REITs with no repurchase programs in 2008 increased their share volumes by an average of 13%.

## Lessons from the Past, 2: Buybacks did not save dividends

In the last downturn, lodging REITs not only saw share prices lose upwards of 80% of their value; they also saw dividends dry up, or, in most cases, cease. On average, lodging REITs suspended periodic dividends for an average of 2.7 years.<sup>10</sup>

Company	Per share dividend mid-2008	Per share dividend mid-2009	Dividends stopped	Regular dividends resumed	Years without dividends
AHT	0.13	0	26-Sep-08	27-Mar-11	2.50
BEE	0.24	0	26-Sep-08	12/11/2015	7.21
DRH	0.25	0	3-Sep-08	23-Mar-11	2.55
FCH	0.35	0	10-Oct-08	13-Jan-14	5.26
HPT	0.77	0	16-Jan-09	21-Jan-10	1.01
HST	0.196	0	29-Dec-08	4-Nov-09	0.85
HT	0.72	0.2			0.00
LHO	0.175	0.01			0.00
SHO	0.35	0	17-Dec-08	26-Sep-13	4.78

At the time, the IRS attempted to ease the cash crunch REITs were experiencing by allowing them to issue up to 90% of their dividends in stock.<sup>11</sup> At least three lodging REITs elected to distribute stock in place of dividends pursuant to this ruling during the downturn; all had repurchased stock in 2008.<sup>12</sup> Strategic Hotels was not able to resume paying dividends after the last downturn at all.

## Who benefits?

Critics of stock buybacks note they do not actually create value — by, for instance, repositioning or renovating assets — but instead may be a way to engineer improved performance metrics, at least in the short term. Investors should evaluate:

- How the volume of stock repurchased compares to the volume of stock issued for executive compensation. Is the share buyback a means of moving capital from shareholders to executives?

- Whether share repurchases have an impact on executive compensation. Some shareholders have filed shareholder proposals asking boards to factor out the impact of share repurchases when calculating per-share operating metrics for the purposes of determining executive compensation.

## Alternative to Buybacks: #1 Issue dividends

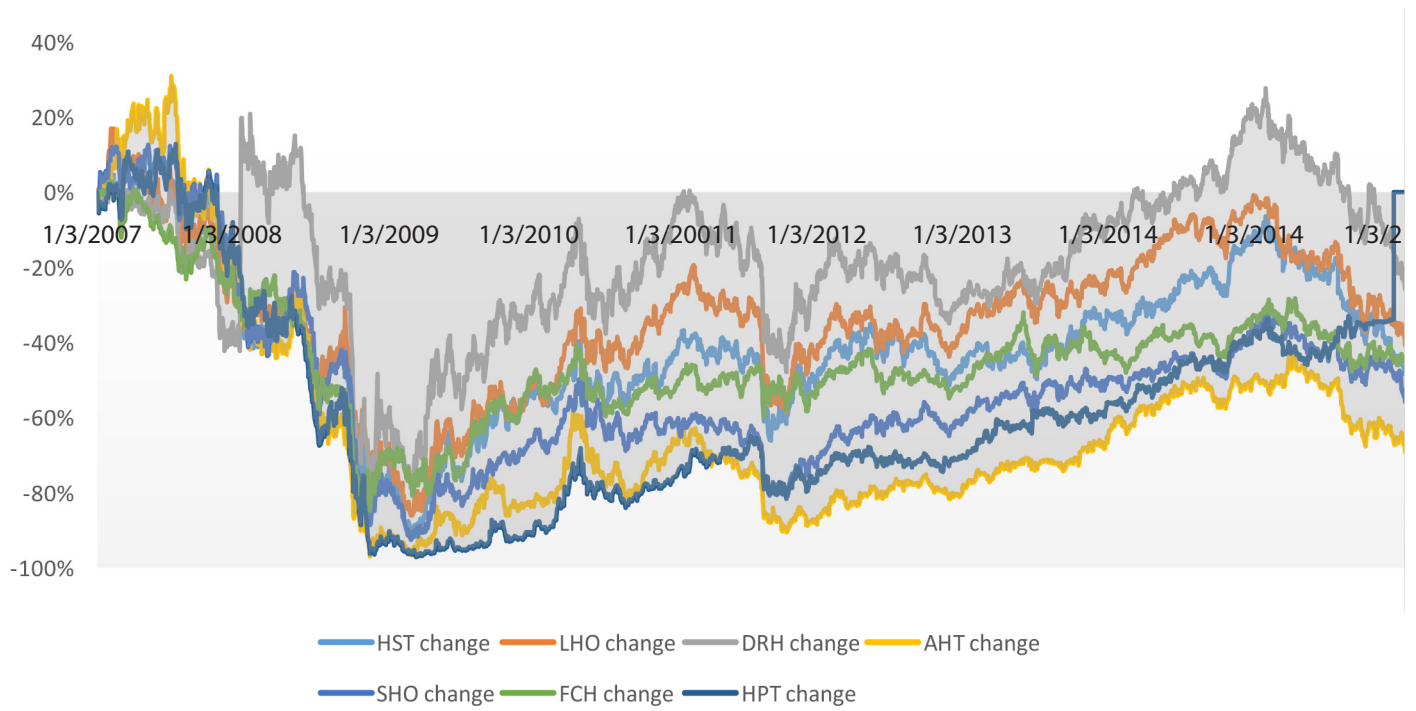
Proceeds from asset sales and excess cash can be distributed to shareholders as dividends, rather than being ploughed back into share repurchases. Special dividends preserve investor choice – if investors have confidence that lodging stocks will recover quickly, they can reinvest these dividends into company stock. But if they are skeptical about the near-term fortunes of lodging stocks – and share prices suggest that many are – they can reinvest elsewhere.

If the three lodging REITs that completed share repurchase programs in 2008 had instead distributed funds of the same value to shareholders, shareholders would have realized between \$0.189 and \$2.88 per share in special distributions.<sup>13</sup>

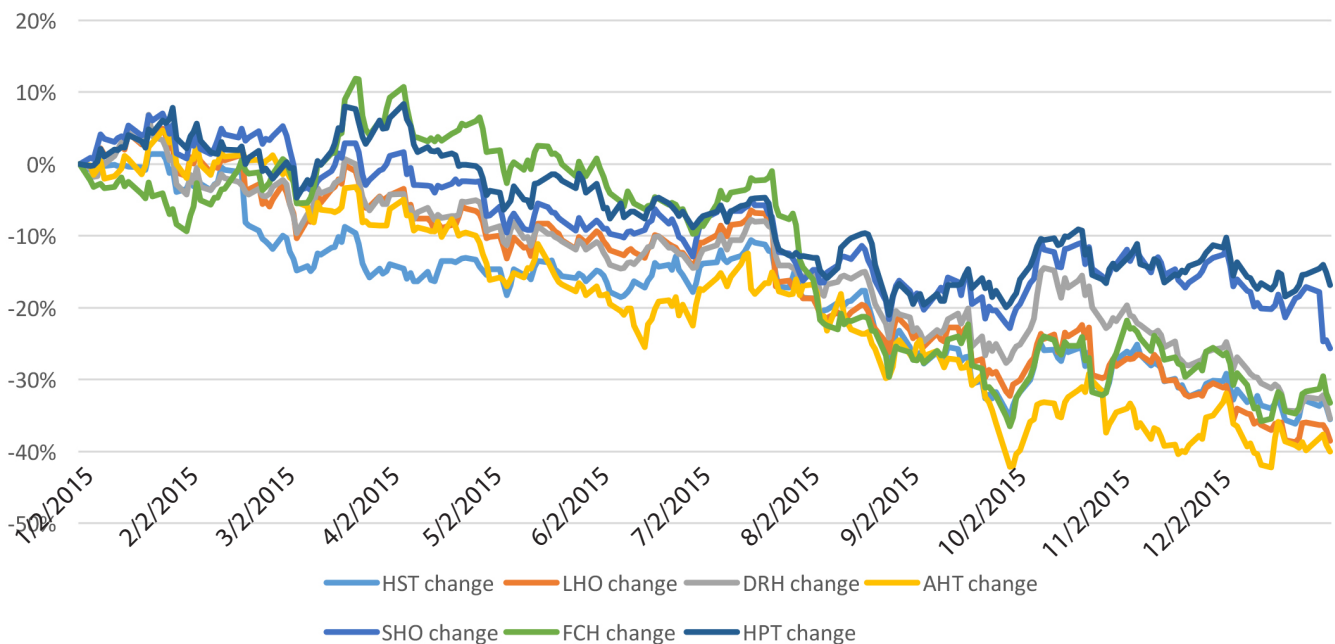
## Alternative to Buybacks: #2 Sell company

Near the peak of the last lodging cycle, approximately half of listed lodging REITs were taken private through a company sale. At least one additional lodging REIT reports that a planned sale was interrupted by the tightening of the credit markets in the second half of 2007.<sup>14</sup> The average pre-announcement premium received by shareholders was approximately 20%.<sup>15</sup> One prominent lodging REIT, Strategic Hotels & Resorts, agreed to be acquired on September 8, 2015 to Blackstone; the offer price represented a 13% premium to the stock's trading price the day before Strategic announced its intention to pursue a sale on July 23, 2015.<sup>16</sup> Strategic, which announced an exploration of strategic alternatives in the summer of 2015, is the only listed lodging REIT whose shares showed a gain in 2015.

### Veteran Lodging REIT share prices from January 2007 to January 2016



### Veteran lodging REITs see stock prices slide in 2015 (Average decline -32%)



## Endnotes

- 1 Dow Jones US Hotel & Lodging REIT Index, <https://www.google.com/finance?cid=15591941> 1-year returns, accessed January 26, 2016
- 2 Third quarter market cap estimates obtained from Google Finance profiles for listed companies, accessed January 25, 2016. Share repurchase authorizations: Q3 10-Q reports for CHSP, DRH, RLJ; Press releases for HT (October 5, 2015), Host (November 16, 2015), RHP (August 20, 2015) and Xenia (December 10, 2015).
- 3 [http://www.hotel-online.com/News/PR2007\\_1st/Feb07\\_AverageMarket.html](http://www.hotel-online.com/News/PR2007_1st/Feb07_AverageMarket.html)
- 4 Lodging, 2016 Outlook, JP Morgan, January 6, 2016, p. 3
- 5 Lodging, 2016 Outlook, JP Morgan, January 6, 2016, p. 2
- 6 <http://www.wsj.com/articles/SB118713051419697771>
- 7 <http://www.wsj.com/articles/SB118713051419697771>
- 8 <http://www.reuters.com/article/fitch-more-share-buybacks-and-risk-may-b-idUSFit69718020140429#740iSQ6ARbqjX0xT.97>
- 9 Ashford Hospitality Trust completed a stock-financed merger towards the end of 2007, leading to pronouncedly different stock dynamics in the following years, and has therefore been excluded from this analysis. Shares repurchased and issued do not include equity awards; the shares issued total for Host includes shares issued as dividends in 2009. Source: Diamondrock 10-K, “Consolidated Statements of Stockholders’ Equity, Years Ended December 31, 2009, 2008 and 2007,” p. F-7, filed with the SEC on February 26, 2010; Host 2010 10-K “Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007,” p. 92, filed with the SEC on March 1, 2010; Sunstone Hotel Investors, Inc. 10-K “Consolidated Statements of Stockholders’ Equity, 2009, 2008 and 2007,” F-5 to F-7, filed with the SEC on February 23, 2010;
- 10 Yahoo Finance historical dividend reports for listed stocks, accessed 1/26/2016
- 11 <http://www.forbes.com/2009/04/15/reits-stock-dividend-markets-real-estate.html>
- 12 Diamondrock and Sunstone: See <http://www.forbes.com/2009/04/15/reits-stock-dividend-markets-real-estate.html>; Host: See 2010 10-K “Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007,” p. 92, filed with the SEC on March 1, 2010.
- 13 Value of 2008 share repurchases as reported in company 10-ks, divided by shares outstanding as of 12/31/2008: Host: See 2010 10-K “Consolidated Statements of Equity and comprehensive Income (Loss), Years Ended December 31, 2009, 2008 and 2007,” p. 92, filed with the SEC on March 1, 2010; Sunstone Hotel Investors, Inc. 10-K “Consolidated Statements of Stockholders’ Equity, 2009, 2008 and 2007,” F-5 to F-7, filed with the SEC on February 23, 2010; Diamondrock 10-K, “Consolidated Statements of Stockholders’ Equity, Years Ended December 31, 2009, 2008 and 2007,” p. F-7, filed with the SEC on February 26, 2010
- 14 See Diamondrock 2008 Proxy Statement, p. 12: <http://www.sec.gov/Archives/edgar/data/1298946/000104746908003255/a2183487zdef14a.htm>
- 15 See discussion in the DEFC14A, filed by UNITE HERE for Chesapeake Lodging Trust on 4/21/15: <http://www.sec.gov/Archives/edgar/data/1034426/000103442615000046/chspdefc14aedgar042115.htm>
- 16 [http://www.streetinsider.com/Corporate+News/Blackstone+to+Acquire+Strategic+Hotels+%26+Resorts+\(BEE\)+in+~\\$6B+Deal/10872768.html](http://www.streetinsider.com/Corporate+News/Blackstone+to+Acquire+Strategic+Hotels+%26+Resorts+(BEE)+in+~$6B+Deal/10872768.html)