



Hospitality trends 2017

Observations from
the EY Mexico City
Hospitality Roundtable



Building a better
working world



About this report

EY surveyed representatives from leaders in Mexico's hospitality space, including real estate investment trusts (REITs), private equity firms, institutional investors, developers, brands and asset managers, and invited these individuals to a roundtable, held on 3 May 2017 in Mexico City, to discuss the survey results and industry trends.

Discussions focused on investments, transactions, capital markets, development and brand trends affecting Mexico's hotel markets in 2017 and beyond.

All respondents' and participants' names have been kept confidential and their responses were used only in combination with others to protect anonymity.

EY would like to thank the individuals who took the time to complete the survey and attend the 2017 Mexico City Hospitality Roundtable.

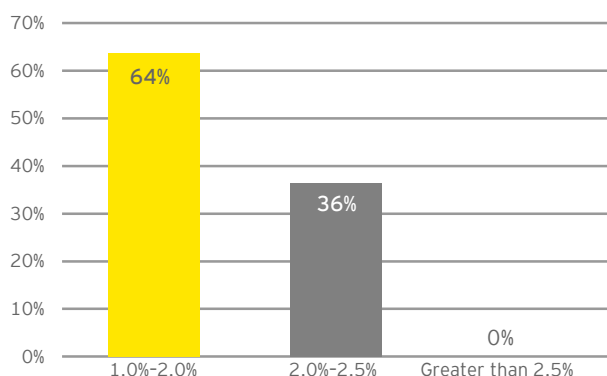
Your comments may be sent to Henry Gonzalez (henry.gonzalez@mx.ey.com), Mike Straneva (michael.straneva@ey.com), Juan Nunez Sanchez (juan.nunez@mx.ey.com) or Robbie Karver (robert.karver@ey.com).



The economy

Mexico experienced 2.1% GDP growth in 2016, and 2017 GDP growth is projected by Oxford Economics to be slightly slower (at 1.9%). A lower GDP forecast is influenced by higher anticipated inflation levels weighing on personal consumption. Based on survey responses, this lower GDP growth forecast is corroborated, with more than 60% of respondents anticipating growth between 1.0% and 2.0%. Oxford Economic expects GDP to grow between 2.0% to 3.0% between 2018 and 2020.¹

How much GDP growth do you anticipate for 2017?



Source: EY

Furthermore, expectations that the peso might increase in value in the coming year as a result of tempering trade rhetoric and the Mexican Central Bank's decision to raise rates by 25 basis points in the second quarter of 2017.² suggest investments could yield value-accretive returns. According to Oxford Economics, rates could be raised an additional 50 basis points by end of year 2017.³

In May 2017, the Wall Street Journal reported Mexican annual consumer price inflation reached an eight-year high (at 6.16%)⁴; this inflation news is widely expected to result in the Mexican Central Bank having a compelling reason to raise rates further.

Post-election pulse

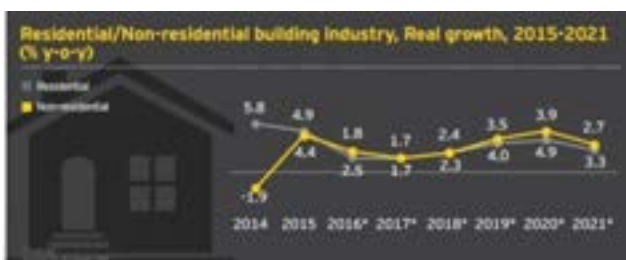
The peso has recovered more than 13% against the dollar since Trump's inauguration⁵, driven by increasing market conviction that trade tariffs will not be imposed. Rather than impose tariffs, or withdraw from NAFTA, analysts at Oxford Economics expect the new US administration will continue to put pressure on individual US companies to claim political victories.

"Construction sector faces important challenges in 2017 due potential slowdown in fixed investment."

EY Emerging Markets macroeconomic update - Mexico | January 2017

Energy reform is expected to continue driving greater opportunities for construction, office space and hotels, among others, as private investors (domestic and international) in the hydrocarbons and electricity sectors set up their operations in Mexico. These sectors have already been buoyed by regulatory changes and the growth in investment vehicles such as structured equity securities (CKDs), retirement funds administrators (AFPRES) and infrastructure and real estate trusts (FIBRAS), which have contributed to the growth in supply catching up with demand over the past five years.

Furthermore, the 2012 public-private partnership law offers investors greater security and should contribute to unlocking private investment potential.



Source: EY

See footnotes on page 3

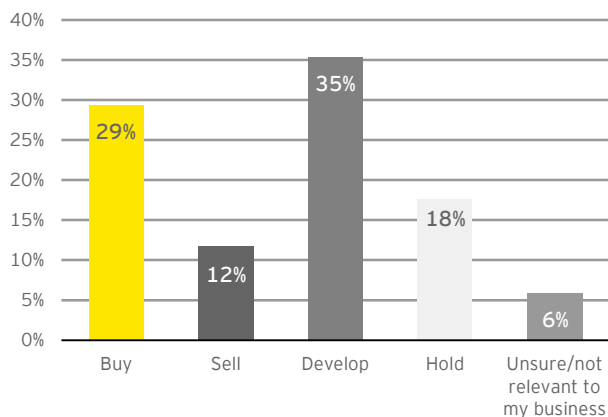


Transactions

Survey respondents feel bullish on the market, with 35% explaining they intend to develop, followed by 29% planning to buy and 18% planning to hold. Only 12% of respondents feel that selling today would be the optimal investment strategy, suggesting a long-term outlook for Mexico where market optimism, along with high acquisition costs, are spurring development interest.

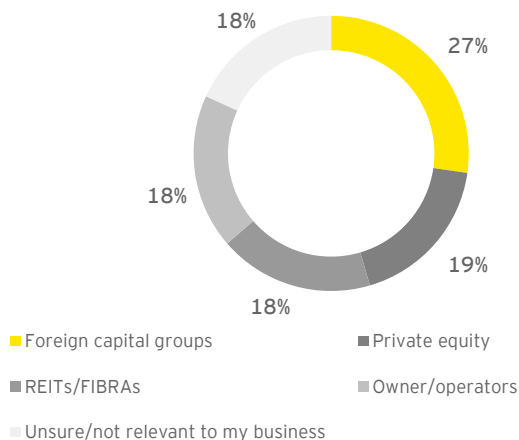
Responses from the survey indicate that the greatest pricing competition for asset acquisitions is coming from foreign capital groups. As the peso increases in value, pricing competition from foreign capital sources may decrease.

Which of the following best describes your investment strategy thus far in 2017?



Source: EY

Which of the following investment groups have you faced the greatest competition from in terms of acquisition pricing?



Source: EY

“Geopolitical changes and financial volatility have created a more unstable and uncertain environment, which requires market participants to consider different approaches and be cautious; however, we visualize a favorable medium- and long-term view.”

Henry Gonzalez | EY Mexico and Central America Leader - Real Estate, Hospitality and Construction

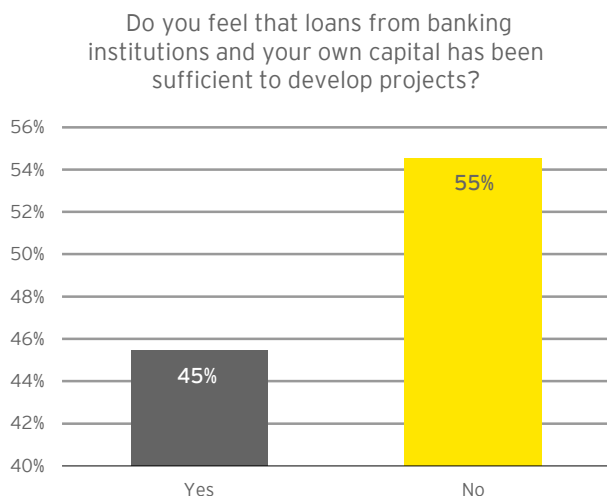
Footnotes from page 2

- ¹ “Country Economic Forecast Mexico,” *Oxford Economics*, 21 March 2017.
- ² “Mexico’s Rising Inflation Shows Signs of Relief in June,” *The Wall Street Journal*, 7 July 2017.
- ³ “Country Economic Forecast Mexico,” *Oxford Economics*, 21 March 2017.
- ⁴ “Mexican Inflation at Eight-Year High in May,” *The Wall Street Journal*, 8 June 2017.
- ⁵ “Country Economic Forecast Mexico,” *Oxford Economics*, 21 March 2017.



Capital markets

Fifty-five percent of survey respondents believe loans and/or capital from banking institutions has been insufficient to develop projects. This dearth of debt availability may explain why the preferred source of alternate financing among investors is equity, a costlier substitute.



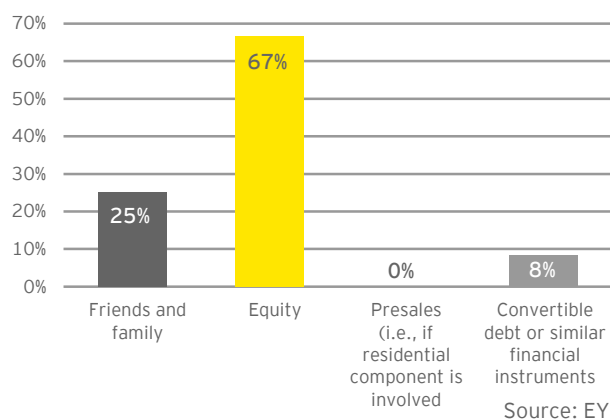
Source: EY

Two-thirds of survey respondents who obtain debt financing for deals are doing so under 60% debt-to-equity ratios, which may indicate that the current lending environment leads to equilibrium leverage levels primarily at 60% or less.

"I consider US investment in Mexico will continue given the growth of domestic capital and increasing leisure and business visitation to the country. We see hotel market behavior that is active for development and purchase."

Mike Straneva | US National Director, Real Estate, Ernst & Young LLP

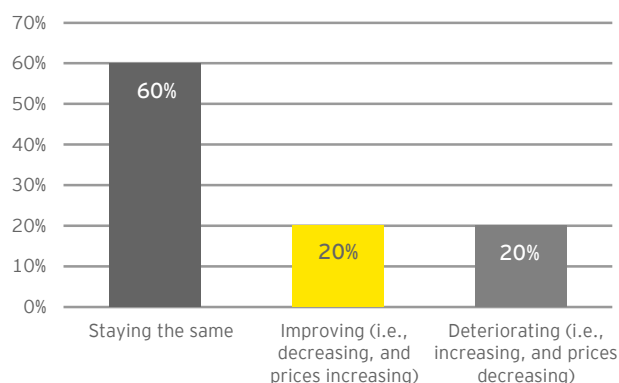
What have been your primary sources for alternate financing?



Valuation metrics

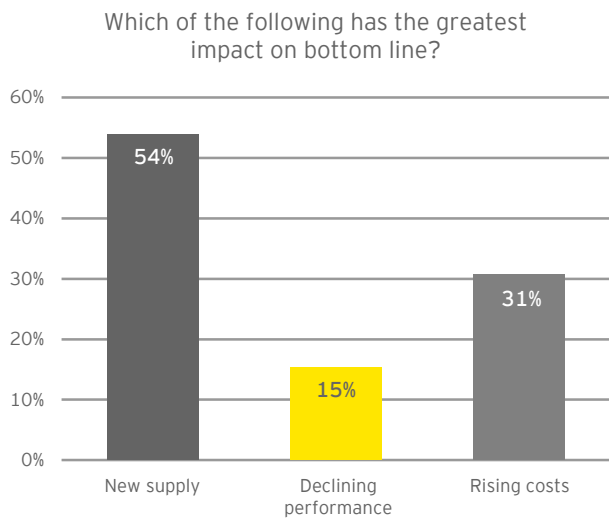
Sixty percent of investors surveyed believe that in the next one to two years capitalization and investment metrics will stay constant.

What do you see happening to capitalization and investment metrics in the next 12-24 months?



Development

Survey respondents are most preoccupied with the effect that new supply will have on operating performance. Supply concerns appear particularly high in resort markets such as Cancun and Riviera Maya. Rising costs are the second most noted concern among investors.

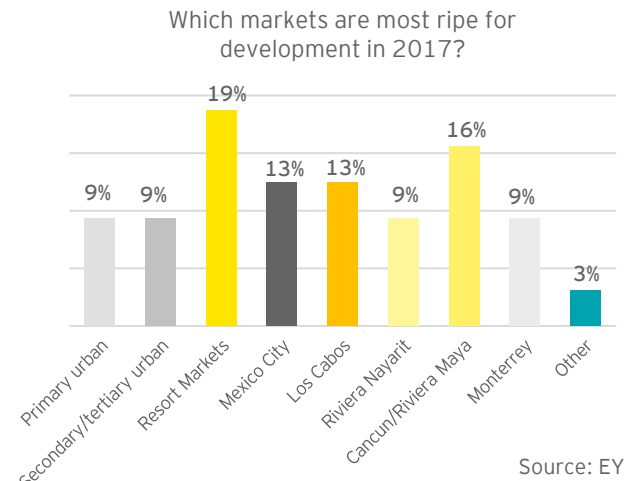


Source: EY

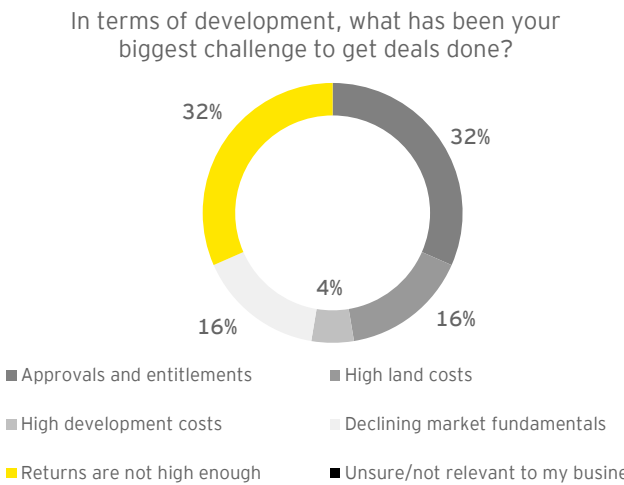
Survey respondents have cited resort markets as the most ripe for development. Mexico City follows closely behind these established resort markets.

“Given the growth in international visitors to resort destinations is increasing at a rate above 5% annually, as well as occupancy and room rate increases, it is natural that the majority opinion considers beach destinations as fitting for development.”

Aurora de Casas Mota | Senior Manager, Transaction Real Estate and Valuation – Mexico, Mancera, S.C.
Ernst & Young LLP



Anemic risk-adjusted returns are the highest referenced barrier to deal-making among respondents, indicating debt and equity spreads may be compressed.



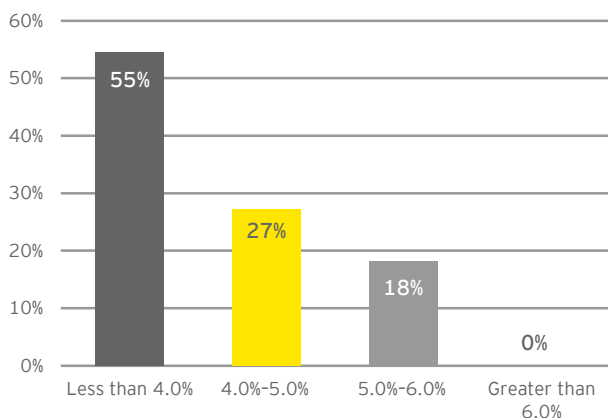


Performance

Hotel performance in Mexico

According to STR, year-end 2016 data indicates that Mexico's year-over-year occupancy rose 0.1% and the average daily rate (ADR) (USD) declined by 0.4% – leading to a revenue per available room (RevPAR) decrease of 0.3%. However, in local currency terms, Mexico's ADR rose 17.0% and RevPAR increased 17.1%, indicating hotels successfully maintaining rates amid a weakened peso.⁶

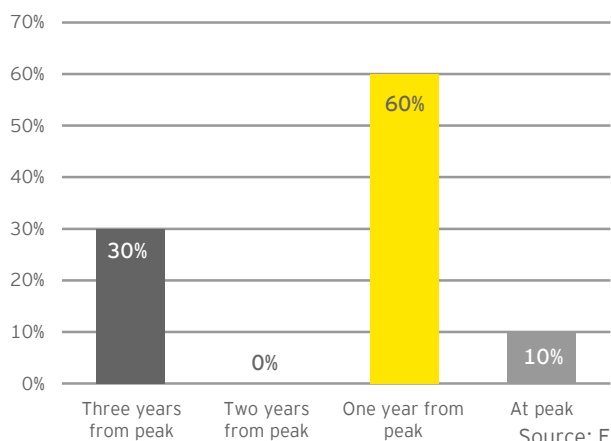
Where do you forecast RevPAR growth for calendar year 2017?



Source: EY

Two thousand seventeen growth estimates remain fairly conservative, with more than half of survey respondents expecting RevPAR growth this year at less than 4.0%.

Where are we currently in the lodging cycle?



Approximately 10% of survey respondents believe the lodging market is currently at its peak, while 90% of survey respondents believe we are one to three years from the peak of the market. The consensus is that while threats to growth, such as protectionist trade policies and a commensurate decline in trade and investment volumes persist, modest GDP growth and continued increases in international leisure visitation are expected to continue driving hotel performance in 2017.

"Today we see that an increasing amount of developers and buyers are convinced that Millennials will come to dominate hotel demand in the following years; as such, the hotel sector should be ready to respond to the development of lifestyle and soft brands according to the project's business plan."

Robbie Karver | Senior Manager and Area Leader for Real Estate, Hospitality and Leisure in Latin America and the Caribbean, Ernst & Young LLP

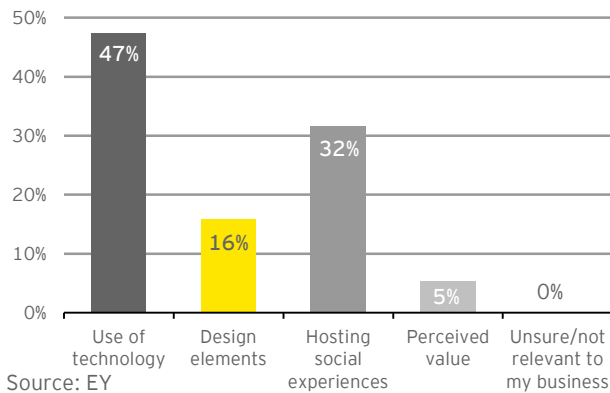
⁶ "Americas Hotel Industry Performance for the Month of December 2016," *STR Global Americas Hotel Review*, 18 January 2017.

Industry focus

Approximately half of survey respondents believe that the most effective method for attracting Millennials is through the targeted use of technology to create a high-tech experience (e.g., branded apps, keyless entry via guests' smart phone or watch).

Hosting social experiences, a particular type of programming that lifestyle hotels focus on, comes in as the second most effective method for attracting travelers of approximately 18-35 years old, just following the use of technology.

What strategies do you believe are the most effective at attracting Millennials?

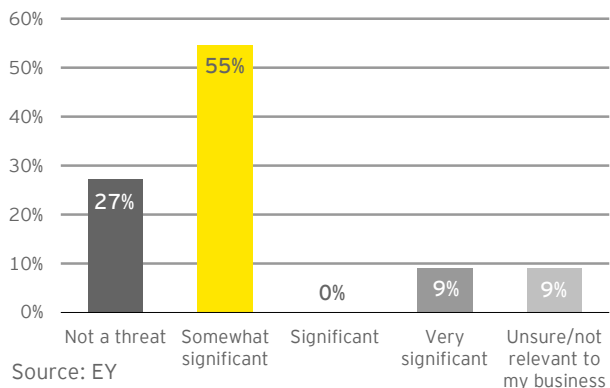


Industry disruptors

Latin America is Airbnb's fastest-growing market; the company has approximately 250,000 properties listed in the region and has said bookings there increased 148% in the past year.⁷ In 2016, Airbnb reported having 5,500 hosts in Mexico City alone.⁸

More than half of survey respondents feel that the sharing economy is a somewhat significant threat, while approximately one-in-four believe it is not a threat at all.

Do you view the sharing economy (e.g., Airbnb, VRBO) as a threat to your properties' performance?



⁷ "Airbnb Looks to Latin America, Now Its Fastest-Growing Market," *Bloomberg*, 12 May 2017.
⁸ "Airbnb, CDMX Sign Occupancy Tax Agreement," *Mexico News Daily News*, 12 May 2017.



Key considerations

- ▶ Competition for assets, especially in gateway cities, is driven most heavily by foreign capital.
- ▶ Many industry players are turning to development as an alternative to acquisitions to enter new markets without overpaying for assets.
- ▶ Given a shift to development-focused strategies, many view oversupply as a threat to their own portfolios and the Mexico lodging industry alike.
- ▶ While Millennial travelers and their expectations are top-of-mind for many in the hotel industry, the importance of Generation X-generated travel demand should remain in focus.
- ▶ Despite market expectations that the Mexican Central Bank will further increase interest rates in 2017, valuation metrics are anticipated to remain constant, narrowing spreads to debt and equity alike.
- ▶ Banks are not issuing debt as readily as they did in the last lodging cycle. As such, equity is the preferred source of alternate financing among investors.



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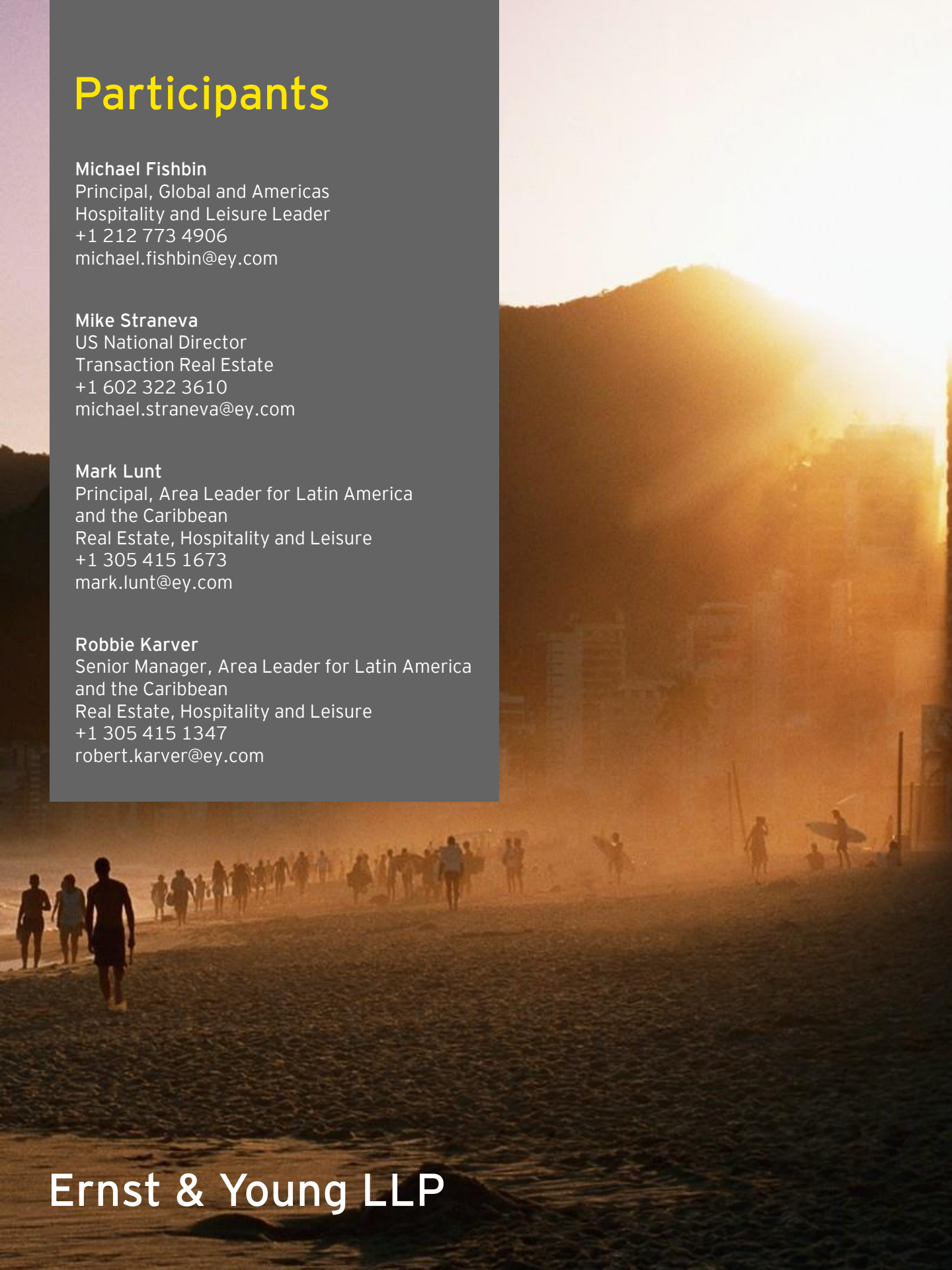
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