Transcript of
Host Hotels & Resorts Inc
First Quarter 2020 Earnings Call
May 8, 2020

Participants

Tejal Engman, Vice President of Investor Relations
Jim Risoleo, President and Chief Executive Officer
Brian MacNamara, Principal Financial Officer and Controller
Sourav Ghosh, Executive Vice President, Strategy and Analytics

Analysts

Anthony Powell - Barclays
Michael Bellisario – Baird
Rich Hightower - Evercore
Smedes Rose – Citi
David Katz – Jefferies
Robin Farley - UBS
Bill Crow - Raymond James
Chris Woronka - Deutsche Bank
Shaun Kelley - Bank of America
Thomas Allen - Morgan Stanley
Steve Brunner - RBC Capital Markets

Presentation

OPERATOR: Good day, and welcome to the Host Hotels & Resorts First Quarter 2020 Earnings Conference Call. Today's conference is being recorded.

At this time, I'd like to turn the call over to Tejal Engman, Vice President of Investor Relations. Tejal, please go ahead.

TEJAL R. ENGMAN, Vice President of Investor Relations: Thank you, and good morning, everyone. Before we begin, please note that many of the comments made today are considered to be forward-looking statements under federal securities laws. As described in our filings with the SEC, these statements are subject to numerous risks and uncertainties that could cause future results to differ from those expressed, and we are not obligated to publicly update or revise these forward-looking statements.

In addition, on today's call, we will discuss certain non-GAAP financial information such as FFO, adjusted EBITDAre and hotel results. You can find this information together with reconciliations to the most directly comparable GAAP information in today's earnings press release and our 8-K filed with the SEC and in the supplemental financial information on our website at hosthotels.com.

Participating in today's call with me will be Jim Risoleo, President and Chief Executive Officer; Brian MacNamara, Principal Financial Officer and Controller; and Sourav Ghosh, Executive Vice President, Strategy and Analytics.

And now I'd like to turn the call over to Jim.

JAMES F. RISOLEO, President and Chief Executive Officer: Thank you, Tejal, and thanks for joining us this morning. We hope that you and your families are safe and healthy, and we extend our deepest sympathies for those affected by COVID-19.

Introduction

As you are aware, the lodging sector is navigating an unprecedented downturn that is expected to be at least twice as severe as the Great Recession. After a strong January and February, US RevPAR posted its steepest decline on record and is expected to further deteriorate in April, according to STR data. Although we couldn't have anticipated the outbreak of a global pandemic, Host is well-positioned to withstand the magnitude of its impact due to years of prudent capital allocation that emphasized maximizing balance sheet capacity and liquidity towards the end of the cycle. Today, we not only expect to persevere through this crisis, we fully expect to emerge from it with a stronger operating model, the highest-quality portfolio in the Company's history and the ability to capitalize on future opportunities to create value for all our stakeholders.

This morning, I will address our liquidity and cash flow position, key business segment trends and our revised capital plan. Brian will discuss our first quarter performance in depth and provide our forecast for April.

Balance sheet metrics

We began this year with the lowest leverage in the Company's history at 1.6 times net debt to adjusted EBITDA, no near-term debt maturities, $1.6 billion of cash on hand, a fully unencumbered consolidated portfolio and an investment grade balance sheet. We drew down our one-and-a-half-billion- credit facility revolver in mid-March and ended April with approximately $2.7 billion of cash, including FF&E reserves, after paying approximately $140 million in first quarter dividends, which were declared in February.

At quarter-end, our leverage ratio, as defined in our credit facility, was at 2 times, our interest coverage ratio was at 6.8 times and our fixed charge coverage ratio was at 4.6 times, all of which are well within the limits specified in our credit facility covenants. We expect to remain in compliance with all our credit facility covenants through the second quarter and are currently in discussions with our supportive bank lending group to secure greater flexibility on our covenant requirements.

Hotel operating cost mitigation

Moving on to expenses, we and our operators responded to the precipitous decline in revenues in March and April by implementing portfolio-wide cost reductions that are unprecedented in their magnitude. These include reducing the fixed portion of above property allocated costs by as much as two thirds, suspending contributions to hotels' FF&E escrow accounts, suspending most brand standards and, unfortunately, furloughing up to 80% of the hotel workforce.

As of yesterday, operations at 35 of our 80 consolidated hotels representing 43% of our total room count, are suspended. We work with our operators to determine whether to suspend operations at a hotel based on the property's ability to generate revenues that are greater than the incremental costs associated with remaining open. If the hotel is expected to achieve this incremental threshold, it remains open. Our preference is to leave hotels open as long as it is financially justifiable to do so because we believe an operational property is better positioned to capture demand when it begins to recover.

Our scale within several markets such as New York, Washington DC, San Diego, LA, Orange County and Chicago has helped us generate operational efficiencies and to further benefit from consolidating low levels of demand at multiple properties into the hotels that remain operational in that market. For example, we have gained operational efficiencies in Washington, D.C. with leadership of the JW Marriott overseeing the Washington Marriott at Metro Center and the Westin Georgetown. The same has been achieved in New York and other markets. Demand consolidation is benefiting our hotels in LA, San Antonio and San Diego, where we are able to consolidate demand into one property in each of those markets.

For the hotels that remain open, our managers have significantly scaled down operations by closing guestroom floors and meeting spaces and suspending food and beverage outlet operations. Due to timing, we expect to see the full benefit of these operating expense reductions in April, when total hotel operating expenses are expected to be 70% to 75% lower than our initial forecasts from February.

Corporate-level cash conservation

At the corporate level, we expect to further conserve cash by reducing our capital expenditures by $100 to $125 million and our corporate expenses by 10% to 15%. Finally, we expect to either suspend our second quarter dividend or cut it to a penny a share, which is a reduction of approximately $140 million compared to our prior 20 cent per share quarterly dividend.

Monthly cash outflows in worst-case scenario

As a result of these anticipated cash savings initiatives, in a worst-case scenario where all our hotels are effectively closed through the end of 2020 and the dividend remains suspended or reduced, our monthly cash outflow would average $120 to $140 million per month, reflecting average hotel-level expenses of $70 to $80 million a month, as well as estimated capital expenditures, interest payments and general corporate overhead. Importantly, in this worst-case scenario, we would end 2020 with approximately $1.65 billion of cash, including the FF&E reserve, leaving us with ample liquidity to support operations as the economy recovers.

Group and transient business trends

Moving on to group and transient business trends. Through May 4th, we have lost an estimated $1.3 billion of expected 2020 revenues. This represents approximately $630 million of lost total group revenues known to date, and $660 million of total transient revenues forecasted for the first half of the year.

Approximately 90% of our total group revenue cancellations have been for the first half of the year, with over 60% in the second quarter alone. Of the approximately 10% of total group revenue cancellations in the second half, less than 3% are for the fourth quarter. While the low levels of cancellations for the fourth quarter are encouraging, we believe that the near-term pace of group and transient business remains uncertain until the consumer feels comfortable travelling again.

Our operators have rebooked approximately 12% of our total 2020 lost group revenues with the majority rebooked for the second half of 2020. Although we expect a significant portion of our total group revenues to be lost due to timing as they were driven by a favorable 2020 citywide convention calendar, a majority of our group customers have expressed a desire to rebook at our properties. Finally, we have collected $32 million of cancellation fees to date, with $10 million recognized in the first quarter.

2021 total group revenue pace

Shifting to 2021 total group revenue pace, we began this year with 2.3 million definite rooms on the books for 2021 and pace was nearly 3% ahead of the same time last year. Although 2021 group booking activity is half of what it was last year and our total group revenue pace is now flat, we believe group demand will return over time.

With decision makers on the sidelines in wait-and-see mode, we believe the pace of recovery in both group and business transient will depend upon customers feeling safe to travel.

Markets with stronger group for 2021 are San Antonio, San Diego, Seattle, LA and Chicago, whereas New York, Orlando, San Francisco/San Jose, Denver and Boston currently have pace opportunities. Given the current uncertainty, pace by market could change considerably in the weeks and months to come.

We continue to believe in the long-term viability of the group business. While the Association business model relies upon generating income from large group meetings, a more intangible reality is that most group meetings allow members within an industry to connect with and learn from each other while building relationships and trust in a manner that we don't think is possible to replicate digitally. In the long run, we believe using group volumes to compress supply and generate productive yield management will remain a cornerstone of the lodging business.

Leisure portfolio

That said, we are positioning ourselves for the recovery to be led by drive-to leisure destinations. As observed in China and other parts of Asia that are several weeks ahead of the United States, the recovery thus far has been led by domestic leisure stays in drive to destinations. With renovations recently completed, in construction, or planned within the next twelve months, over 70% of our portfolio in our strongest drive to leisure markets will be fully refreshed. Specifically, our hotels in Phoenix, San Diego, Orange County, San Antonio, and Florida, which represent over 13 thousand keys or nearly 30% of our total portfolio, are very well positioned to capture a recovery in drive to leisure demand.

We continue to prioritize the health and safety of our employees and guests. Most of our hotels are managed by large brands who are known for reliably delivering consistent service and standards. These brands are now raising their cleanliness standards to even higher levels with new protocols to address the current circumstances. We believe branded hotels communication around and execution of rigorous cleanliness standards will resonate well with customers. Moreover, we expect the strength of their loyalty programs to be a strong driver of demand to our properties.

Supply outlook

Turning to our supply outlook, while it will take several quarters before we have a complete understanding of the change in hotel supply growth, we've cut our internal net supply expectations for 2020 in half based on broad assumptions surrounding project delays or announcements, and existing hotel closures. We now expect supply growth of roughly 1% in 2020 with average growth over the next three years remaining below the long-term historical trend. Moreover, we believe there is a high probability that several projects that have not yet begun construction will be cancelled or significantly delayed.

Breakeven occupancy

Although no one knows the timing or shape of the recovery, we are hopeful that occupancy declines may have stabilized and found a bottom in April. We are frequently asked what level of occupancy will allow us to break even at the Hotel EBITDA line. As you may imagine, it's difficult to provide a number as it varies greatly by property, requires ADR assumptions and is likely to change on a monthly basis. We have done the analysis based on a single month of operations in the current environment with significant expense reductions remaining in place. In that scenario, assuming ADR's decline 15% to 30% on a year-over-year basis, we would expect to achieve Hotel EBITDA breakeven at 35% to 45% portfolio occupancy.

Our enterprise analytics and asset management teams are working closely with our operators to strengthen the long-term hotel operating model with nearer-term goals of achieving breakeven and generating higher profitability at lower levels of occupancy. In the 2009 recession, several operating expense line items were significantly reduced and continued to improve through the cycle. While we expect our hotels to incur new expenses, especially ones related to new cleaning standards, downturns compel owners and operators to reevaluate brand standards, programs and above-property expenses, an exercise that can result in long-term savings and a healthier hotel operating model that better serves customers' changing needs.

Capital expenditures

Turning to capex, we have reduced our expected 2020 capital expenditures by $100 to $125 million, which represents an approximately 50% reduction to the portion of the capex budget that wasn't already spent, underway or committed. Approximately 85% of our capex savings are derived from eliminating non-essential renewal and replacement capex spend with the remainder coming from suspended ROI projects. We continue to plan on spending $180 to $200 million on the Marriott Transformational Capital Program and now expect to receive $20 million in operating profit guarantees this year.

Marriott transformational capital program

It makes sense for us to complete these renovations for these reasons. First, we benefit from $20 million of operating profit guarantees without experiencing commensurate revenue disruption given the current unprecedented low RevPAR environment. Second, we expect the renovations to position us to achieve meaningful RevPAR gains through the cycle, particularly as most hotel owners are compelled to cut back on renovations due to liquidity constraints. And third, construction bids are coming in below budget and market pricing is expected to decline by at least 6 to 10%, which provides us the opportunity to buy out construction at lower prices. In addition to all of this, as the performance at these properties return, we will receive enhanced owner's priority on this investment, which will reduce the incentive management fees we pay Marriott.
As part of this year's Marriott Transformational Capital Program, we have completed renovations at the San Antonio River Center Marriott, and we will finish the Minneapolis City Center Marriott in just a few weeks. Later this year, we plan to complete the JW Marriott Buckhead. In addition, we expect to start the Ritz Carlton Amelia Island which is scheduled to complete in the first quarter of 2021. Finally, we will complete the second phases at both New York Marriott Marquis and the Orlando World Center Marriott which are scheduled to complete in the third and fourth quarter of 2021 respectively. Combined with the properties completed as part of last year's capital program, including the Coronado Island Marriott Resort & Spa, New York Marriott Downtown, San Francisco Marriott Marquis and Santa Clara Marriott, the Marriott Transformational Capital program will be nearly 70% complete by the end of 2020. While the program consists of a mix of group and leisure dominant hotels and markets, these transformational renovations are expected to have a useful life of 7 to 10 years and will help our properties gain market share and outperform through the next cycle.

While our revised capex plan assumes projects will be completed substantially as scheduled, COVID-19 has impacted our ability to implement renovations as supply chains have been disrupted and certain state and local orders have deemed construction "non-essential". We will continue to provide quarterly updates on our capital plan for the year.

Capital allocation track record

As I reflect on leading Host over the last few years and now through this crisis, it is gratifying to know that our prudent and disciplined capital allocation strategy toward the end of the cycle has served all our stakeholders well. In 2018 and 2019, we sold $3.3 billion of our relatively lower-quality and lower Total RevPAR assets at the top of the market. Additionally, we capitalized on the favorable debt capital markets last year to execute over $3 billion of refinancing, which extended our debt maturities and reduced our borrowing costs at an opportune time. While we also acquired $1.6 billion of high-quality assets, bought back $629 million of stock and invested in developing and redeveloping parts of our portfolio, we deployed each of these value-creation tools in a measured and disciplined manner, not knowing when the cycle would end, but discerning that balance sheet strength and capacity would be of paramount importance when it did.

Conclusion

Today, as we enter a new lodging cycle, we feel hopeful about a future where the threat of this pandemic has passed. In the meantime, we are taking the opportunity this crisis provides to further strengthen our operating model and to learn how to generate higher levels of profitability at lower levels of occupancy. We are excited to be entering a new cycle with the highest-quality portfolio of iconic and irreplaceable assets in the Company's history and likely in the lodging industry. When demand recovers, we believe that the quality of our assets, many of which will be newly renovated, will be a true differentiator that will help us gain RevPAR Index share and outperform the industry. We continue to believe in the strength of both geographic and demand diversity through the cycle. Geographic diversity will serve us through an uneven recovery as various states and markets end their lockdowns at different times. Demand diversity will help us drive optimal revenue management and pricing through the cycle. Finally, we expect our relative balance sheet strength to continue to be a differentiator that will provide us with greater flexibility to capitalize on future long-term value creation opportunities that meet our strategic objectives. With that, I will turn the call over the call to Brian.

With that, I will turn the call over to Brian.

BRIAN G. MACNAMARA, Principal Financial Officer and Controller: Thank you, Jim. Good morning, everyone.

Q1 2020 monthly RevPAR breakdown

Prior to the spread of the pandemic in the United States, business was off to a strong start in 2020. For the total portfolio in January and February, RevPAR was up 220 basis points driven by a 120-basis point increase in occupancy. Total RevPAR was up 490 basis points for the same period. As a result, at that point in the quarter we were ahead of last year by approximately $20 million. March, however, experienced a 65% decline in RevPAR driven by a 52% drop in occupancy. We lost 730 thousand room nights due to shelter-in-place orders and widespread changes in business travel policies. March room revenues declined by $200 million year over year and drove a first quarter RevPAR decline of 23.3% as occupancy fell 17% year-over-year.

Q1 2020 expenses

Our first quarter results include a $43 million wage and benefit expense associated with moves to suspend operations and the necessary changes to hotel-level staffing. These costs include an 8 million cash payment to hotel employees in March and a 35 million accrual for furlough benefits in April and May. If our operators extend those benefits for the approximately 80% of the workforce that is currently furloughed, we would expect the carrying costs for those employees beyond May to average $15 to $17 million per month, for the entire portfolio.

April 2020 expectations

As Jim mentioned, we have worked closely with our operators to reduce operating expenses and expect to realize a 70% to 75% reduction in hotel level operating expenses in April, compared to our initial forecast. As a reminder, our initial forecast in February implied that hotel level expenses at the mid-point would be approximately $3.8 billion for the full year. On the revenue front, we expect that total RevPAR for April will decline by 90% to 95% reflecting the extremely low occupancies in most markets.

Demand in April has largely been restricted to medical professionals and airline crews. For example, the Sheraton New York Times Square and the New York Marriott Marquis achieved occupancies close to 50% in April, primarily driven by medical and first responder business. Being two of the largest hotels in the city to remain open has provided the Sheraton and the Marquis with a great opportunity to capture this business. With New York City thankfully continuing to make progress from earlier peak infection levels, this business is expected to taper-off in early to mid-May.

<u>Hotel suspensions and reduced operations</u>

By the end of March, we had suspended operations at 13 properties. As occupancies continued to decline through April, we suspended operations at an additional 22 properties, bringing the total number of suspensions to 35.

A typical staffing model for properties that have been suspended include a management team of five to seven associates working a schedule that has been reduced anywhere from 20 to 40%. Further, there is management oversight of the security department and, in certain circumstances, properties have layered in additional sales and event department management to assist with the rescheduling and planning of future group business. Hourly positions are generally limited to a single associate per shift in the engineering and security departments.
Properties that are operational will generally have the same base management coverage as suspended properties, as well as minimal rooms management, though again working at significantly reduced hours. Typically, these managers are covering both the housekeeping department and front desk, as well as actively working a shift in one of those departments. Hourly positions in addition to the security and engineering positions previously mentioned, may include a housekeeper shift based on occupancy and front desk coverage. In the very limited cases where food service is provided, one chef or kitchen shift would be added to prepare a limited to-go menu.
Although visibility remains limited, we do not anticipate additional suspensions at this time. Timing with regards to reopening the 35 hotels where operations are currently suspended, however, remains unclear. Our re-opening criteria are based on the timing of state and local authorities, and the pace of our bookings and revenue growth projections. We are working with our operators to determine how costs can be managed through the impending recovery such that we can achieve breakeven levels as quickly as possible with the goal of generating higher levels of profitability at lower levels of occupancy over time.

<u>Top and bottom markets by performance</u>

Shifting to market performance. Our top performing markets in the first quarter were all in negative territory although they outperformed the STR Upper tier segment in their respective markets. Top performing markets include Phoenix, San Francisco, New Orleans, Atlanta, Miami, San Diego, New York and the Florida Gulf Coast. The underperformers were San Antonio, Maui/Oahu, Jacksonville, Orange County, Denver, Northern Virginia, Washington DC, Seattle and Houston.

The majority of the $630 million of total group revenue loss that Jim mentioned has been driven by six markets, San Diego, New York, Orlando, Phoenix, San Francisco and Boston. However, we have experienced cancellations across the portfolio with 24 markets showing greater than $5 million in total group revenue cancellations.

<u>Operating leverage</u>

We are not providing any 2020 guidance at this time. Our lack of visibility regarding the depth and duration of the pandemic, the timing of the reopening of individual states and localities and the expected operating restrictions for businesses, as well as individual company travel restrictions is simply too uncertain at this time. I would note that in prior recessions, peak to trough declines in hotel-level EBITDA have been roughly twice as large as the peak to trough declines in RevPAR. Although this 2 to 1 ratio should have deteriorated considerably in a near- zero revenue environment, we believe it will continue to hold true for our portfolio due to our significant success in reducing fixed costs at the property level.

Access to liquidity

Our confidence in our ability to not only persevere through this crisis, but to be able to drive value for our stakeholders, is based on the strength of our investment grade balance sheet. We have significant liquidity to withstand the worst-case scenario of a complete shutdown of our entire portfolio until year-end 2021, subject to our success in obtaining covenant waivers for our credit facility.

Moreover, we have no significant debt maturities until 2023, and have approximately $2.7 billion of available cash as of April 30th. Finally, the Company has access to other sources of liquidity, including secured debt, asset sales and capital market transactions. To be clear, the Company has no need to tap into additional sources of liquidity, but I mention them to provide reassurance that we do not expect liquidity to be an issue for Host.

Conclusion

Today, more than ever, we believe that Host Hotels & Resorts is the premier lodging REIT in the industry. We have a high quality, well-diversified portfolio whose consistent performance is driven by strong, in-house analytics, and by working with the best operators in the business. With the only investment grade balance sheet among lodging REITs, we are well positioned to deal with this crisis and to continue to execute our strategic vison to create long term value for our shareholders.

Thank you. And with that, we will now be happy to take questions. (Operator Instructions).

Q&A

OPERATOR: (Operator Instructions). Our first question today is coming from Anthony Powell from Barclays.

ANTHONY FRANKLIN POWELL: Just a question on your credit facility amendment that you're seeing. A lot of the other amendments that come with restrictions on dividends, buyback, acquisitions. How do you ensure that you maintain flexibility to take advantage of opportunities and your balance sheet strength, even as you kind of secure an amendment for our credit facility to give you more comfort around your covenants?

JIM RISOLEO:

Sure. We made a conscious decision to let some time pass before we fully engaged with our bank lending group, which I must add has been incredibly supportive.

We have long-standing relationships with all of the lenders in our credit facility, some going back 25 years since the time host was formed. So, we're in a really unique position because, as you heard today, we have the runway in a very worst-case scenario to take us through 2021 from a liquidity perspective.

We do have access to multiple sources of capital should we need it, which we don't believe we're going to need. We're only needed to play offense at the time when opportunities present themselves, and we can see greater visibility going forward.

So, as we're having conversations with the bank group, we're taking into consideration maximum optionality and flexibility to put us in a position to play offense going forward. And we feel really good about the fact that we're going to be in compliance with all of our credit facility covenants through at least the second quarter. And I would expect in the next several weeks, we will be in a position to announce publicly through a press release and 8-K, what the amendments to that credit facility look like.

POWELL: Got it. Just a clarification. I believe you said you expect 2:1 RevPAR to EBITDA decline versus this time. I think STR has a 50% RevPAR decline assumption for this year. Does that mean you expect EBITDA to be 0 this year in that environment with 100% down? Or is that too simplistic to assume?

JIM RISOLEO: Yes. If you believe STR's data, that would be a correct assumption.

OPERATOR: Our next question is coming from Michael Bellisario from Baird.

MICHAEL JOSEPH BELLISARIO: Just sticking on that same type of playing offense. Question is one, what are you queuing off of to make that decision? And then how are you thinking about the different ways to ultimately create long-term value today? Or at least when those opportunities present themselves?

JIM RISOLEO: Yes. Mike, we're in a unique position, given the strength of the company and the fact that we came into the year at 1.6x debt-to-EBITDA with $1.6 billion of cash on the balance sheet.

We are truly in a position to persevere through this downturn, through this pandemic and come out the other side in a position to play offense.

Now when does that happen? I think right now, it's very premature at this point in time. I don't think you're going to see us or anybody else in a position to acquire hotels until we have greater visibility on the cadence of how the U.S. economy is going to perform and how it's going to recover.

I think everyone is in agreement today that we are in a recession. We just don't know the depth of the recession nor do we know the duration of the recession. There are numerous conversations occurring between hotel owners and lenders today with respect to waivers, interest forbearance. It's a question of how that's all going to play out and where the opportunities are going to be.

I think it's a little too soon to know. But when we have visibility and when we start seeing opportunities come to market, we will be in a position to take advantage of those opportunities. We're talking to our bank group about giving us some optionality to acquire hotels as we move forward. Obviously, the hotels are going to have to be a strategic fit for us. They're going to have to be priced appropriately. They're going to have to allow us to believe that we're going to be able to create shareholder value or we're going to continue to be disciplined in our approach to capital allocation. We think it served us very well toward the end of this cycle and giving us an opportunity to play offense.

OPERATOR: Our next question is coming from Rich Hightower from Evercore.

RICHARD ALLEN HIGHTOWER: So, Jim, I want to go back to the breakeven occupancy calculation. And I think you guys said that includes an assumption for a 15% to 30% declines in ADR. And I'd like to maybe hear your opinion on the art of pricing a hotel room. Coming out of COVID, given that everything is at a standstill and starting from scratch, how do you anchor the customers' expectation to that sort of a rate starting from a 0 base? And what do you think the progression for ADR might be over the next few years, kind of in that framework?

JIM RISOLEO: Sure. We are having daily conversations with our operators regarding reinventing the revenue management model. We don't think revenue management is by any means a thing of the past today. We think it's more important than ever. And our primary concern is going to be focused on rate integrity and not rate degradation.
It's tricky in a low RevPAR environment, low occupancy environment, we'll grant you that. But as an example, in the month of April, we ran at a very low occupancy for the portfolio of about 13% -- just north of 12%. We ran $135 ADR. That doesn't sound great, but when you're selling rooms in hotels that, in many instances, if you put New York aside or running at low single-digit occupancies to maintain a rate in that level, it is pretty good from our perspective.
So, as we look at breakeven occupancy and ADRs, it's really a quite a variable exercise that's going to change hotel by hotel. It's going to change as occupancy and demand increase and expenses creep back into the property. So, the numbers we gave you with respect to occupancy declines and ADR declines are really based on the low level of expenses that we're experiencing today. So as those expenses increase, it's going to be a balance between incremental expenses going into the properties against occupancy and ADR gains. Is that helpful to you, Rich?

OPERATOR: Our next question today is coming from Smedes Rose from Citi.

SMEDES ROSE: I just wanted to ask bigger picture. It kind of pegs off Rich's question. I think coming into this, typically, labor costs for our typical hotel have been kind of in the 40% to 45% range. Assuming we return to some kind of more normal business environment. Where do you think that number can go to? It seems like there's going to be a lot of thoughts around maybe not cleaning hotel rooms when guests are using them, that there might be more cleaning outside of the rooms? Or where do you think that could just move to? Or do you think it just kind of stays the same after everything has been reeducated?

JIM RISOLEO: I'll start, I'll give you a couple of thoughts here, but I'm going to ask Sourav to jump in on this one. We view this opportunity, this crisis, truly as an opportunity to redefine the hotel operating model. And there are going to be incremental costs associated with cleaning and sanitizing because we think that is going to be critically important.

It's always been important to the traveling consumer to know what they're getting when they check into a hotel room. And the fact that the majority of our properties are managed by Marriott and Hyatt gives us great comfort because they are at the top when it comes to cleaning and sanitizing standards and their outreach to consumers has been meaningful and it will continue to be meaningful.

So, we think this is truly a distinguishing factor relative to the independent hotel operator because the customers are going to be comfortable that if they're going to say, the Marriott managed hotel or a Hyatt managed hotel, that it's going to be sanitized. It's going to be clean and safety is paramount today. I mean, we talked a minute ago about ADR. And I can tell you, based on some focus groups that have taken place. The customers don't really care as much about ADR as they care about their personal safety.

So, we think that between the brand standards with respect to cleanness and cleaning and the fact that we are affiliated with the best loyalty program in the space is going to give us a true competitive advantage as we come out of this pandemic.

I'll let Sourav give you a little more color on how we're thinking about the hotel operating model.

SOURAV GHOSH: Smedes, I want to start off by saying that our managers are truly committed to taking costs out versus putting costs back in. And where the opportunity really exists is in sort of 3 broad buckets:
One is going to be a reduction of above property costs. Second is the brands are really focusing on brand standards and figuring out which brand standards are archaic and can either be eliminated completely or modified. And the third is really adapting to changing customer preferences, particularly leveraging technology.

So, think about would whether we really need the front desk as we know it today with the touchless technology that does exist. And would the customer want to interact during the check-in experience. So that's 3 broad buckets, I would put it into. The incremental costs associated with cleaning, we believe should be offset by improvement in productivity.

The incremental costs associated with screening, we believe should be offset by improvement in productivity.

OPERATOR: Our next question today is coming from David Katz from Jefferies.

DAVID BRIAN KATZ: I wanted to ask about group business. We are wondering and endeavoring to research around groups that may be postponing or rebooking later on in the interest of avoiding a cancellation fee and/or sort of kicking the can down the road a bit. This may be more of a qualitative question, relying on your experienced intuition, but I just wonder what you think about that?

JIM RISOLEO: David, I think that we think as a management team and in consultations with our operators that – if we agree with the premise that we're going to see a return of the leisure customer first, primarily led by drive-to destinations. Then we'll see a return of business trend in covenant customer. And lastly, we'll see a return of group. We feel that group is not likely to start meaningfully coming back to hotels until mid-2021 at this point in time. A, we talked just a minute ago about the need for cleanliness, and confidence in consumer safety. That's going to be paramount. And I would say that until we have a vaccine, it's not likely you're going to see group come back in any meaningful way.

OPERATOR: Our next question is coming from Robin Farley from UBS.

ROBIN MARGARET FARLEY: Most of my questions have been addressed already about potential M&A. I guess, one question I had. You made a comment in the introductory remarks about group for next year being flat or pace being flat or something. I guess I just wanted to get a sense of how much are you seeing people holding off on booking new group for 2021? So, in other words, maybe you are still flat with prior, but how does that pace look in terms of -- are people holding off on next year already?

JIM RISOLEO: Yes. Robin, I think that our pace, our numbers came down a bit year-over-year in terms of group booking pace. But I believe we said that we have 2.3 million room nights on the books for next year, which is about flat relative to where we were at the same time last year. So, people are still booking.

I think it really goes to the uncertainty surrounding the scope and depth of the crisis. We think group is a very viable part of the hotel business going forward. Associations have to have group meetings to survive. It's part of how they make money. But the intangible is the fact that group meetings are very important for interaction and building relationships and building trust among the people that participate in group meetings. We don't believe that this is able to be replaced digitally. It's just not going to happen over a Zoom call. So, we feel that the group is going to continue to be a viable part of the business. I think Sourav has something he wants to add.

SOURAV GHOSH: So I would just add for, I think, really looking out into the future, '22 to '23, our total our group pace is still pretty strong at positive 2.5 percent.

OPERATOR: Our next question today is coming from Bill Crow from Raymond James.

WILLIAM ANDREW CROW: Jim, I think you mentioned you collected $22 million or $32 million of cancellation fees split between the first quarter and the second quarter. I'm just curious about that because it seems awfully tough to recoup cancellation fees, especially in the second quarter, given the lockdown and the less than 10 people meeting restrictions and things like that. Can you give us some commentary on that?

JIM RISOLEO: Yes. Bill, this the cancellation fees that we collected were collected early in the year, early in the pandemic. And we collected $32 million total. We recognized $10 million in the first quarter. I would not expect that you're going to see that cadence to continue as we move forward. So, we are more interested in working with our customers, many of whom are long-term customers. And we want to maintain those relationships and encourage them to rebook their business at our properties.

OPERATOR: Our next question is coming from Chris Woronka from Deutsche Bank.

CHRIS JON WORONKA: I want to ask you a little bit of a longer-term question. I know you guys have made a lot of progress over the years with food and beverage, efficiency and getting margins up. So, the question is, as we look out 3 to 5 years, do you think it's going to become -- I don't know whether it's necessary or ideal to maybe have smaller food and beverage operations. And I know that you need it in a lot of your convention hotels. But at a lot of the other hotels, it seems like there's always a cap on profitability. So, do you think that's something you look at during this downturn and it looks different coming out?

JIM RISOLEO: Absolutely. We are having conversations already with our operators regarding the need for 3-meal-a-day restaurants in many of our hotels, we're having conversations around eliminating breakfast buffets in the restaurants, maybe only opening the restaurants for breakfast. This is an opportunity to rewrite brand standards going forward. So, you're spot on that this is something that we're thinking about and talking about.

OPERATOR: Our next question is coming from Shaun Kelley from Bank of America.

SHAUN CLISBY KELLEY: Jim, I was hoping we could spend a little bit time on. I think in the prepared remarks, you talked about your sort of opportunistic sales on some of the noncore assets in the portfolio. And obviously, you're quite successful on that over the last couple of years. Is there anything remaining in that bucket that you think needs to be addressed? I appreciate it's not the kind of ideal time, but sort of maybe just – what's the comfort range with where you're at with, let's call it, the go-forward portfolio, number one? And then number two, in that group of hotels, that if there is anything that doesn't fit the profile going forward, is there a need to reopen in this environment? How do you think about sort of longer-term closures and maybe property type obsolescence for some of those, let's call it, noncore assets?

JIM RISOLEO: Sure. Shaun, I've said over time that we are very comfortable with the composition of the portfolio we have today. Our sales are always opportunistic. We will sell a hotel when we feel that the price we're receiving exceeds our hold value, which we do on a regular basis for each property in the portfolio. So we'll continue to be opportunistic in the future.

Today, there's no need for us to sell any properties in this environment, where we think pricing would be very challenging. We'd much rather be an acquirer and take this opportunity to add to the portfolio that we have today to continue to upgrade the quality through acquisitions as opposed to sales. So the short answer is, we'll be opportunistic when the time is right.

OPERATOR: Our next question is coming from Thomas Allen from Morgan Stanley.

THOMAS GLASSBROOKE ALLEN: You talked earlier about some optimism – more optimism around drive-to-resort markets. There was some positive data out of STR earlier this week. Are you seeing any increased bookings for your resorts? Any data points you can give?

JIM RISOLEO: Sure. Thomas, that's a green shoot that we saw in May. We feel that occupancy hit a bottom in April. As Brian mentioned in his comments, the business that we booked in April was really related to medical and airline crews and some first responder business at certain of the hotels, some National Guard business, things of that nature.

But in 2 of our drive-to properties, in particular, we're seeing very good booking numbers for Memorial Day weekend. At the Ritz-Carlton Amelia Island we are seeing business on the books that would leave us as we sit here today to 60% occupancy over Memorial Day weekend. And at the Don Sesar in St. Petersburg Beach, another terrific resort property, we expect to see occupancy in the 50% as we sit here today. And hopefully, those numbers will continue to grow. We're also seeing good booking activity in June and July. In June, we're seeing booking activity in the 13% to 15% range. In July, it's significantly higher. So, let's keep our fingers crossed and hope that, that business continues to grow.

OPERATOR: Our next question today is coming from Steve Brunner from RBC Capital Markets.

STEVE BRUNNER: Guys, hope everyone is doing well. So, I know you guys stated that you don't have, at this time, timing of reopening by specific markets. But if you guys had some sort of high-level estimate and you're going to make, I guess, an educated guess, which markets do you guys see openings first?

JIM RISOLEO: It's a tough question to answer because 14 of the top 20 markets still have restrictions in place with respect to when people can get back to business as normal.

So, we just don't know. What I will tell you is that, as we've discussed, and as everyone believes that drive-to leisure demand is going to be the first part of the business to return.

We have over 13,000 rooms in drive-to markets today. And those markets include Florida, San Antonio, Phoenix, Chicago for the summer, Los Angeles, Orange County and San Diego. So, we are closely watching when restrictions are lifted. And we would hope that those hotels in all those markets that I just mentioned, the 13,000 rooms that we have, will be some of the first to reopen. But at this point in time, it's just difficult to really put a date on when that's going to happen because it's out of our control.

OPERATOR: We have reached the end of our question-and-answer session. And ladies and gentlemen, that does conclude today's teleconference.

JIM RISOLEO: Well, thank you all for joining us on the call today. We appreciate the opportunity to discuss our first quarter results with you. And we look forward to virtually -- and we look forward to virtually seeing you at NAREIT and talking with you in a few months to discuss our second quarter results. Have a great day, everyone, and stay safe. We will all get through this pandemic and look forward to seeing you in person soon.

END