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IN FOCUS: SAN FRANCISCO HOTEL MARKET – BEST OF THE WEST

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San Francisco's hospitality industry has a lot of momentum in 2014, with visitation, occupancy, and per-key transaction prices at peak levels. What are the current development and transactions trends? How might the continued lack of new inventory combined with record average daily rates affect future demand?

San Francisco's lodging market continues to surge with record double-digit RevPAR growth driven by growth in average daily rates. It ranks 3rd in the nation for occupancy rate.¹ Year-over-year occupancy was up nearly 3% and ADR increased over 9% in 2013, leading to a RevPAR increase of more than 13% as compared to the prior year. San Francisco County saw \$876 million in transaction activity in 2013, up from nearly \$750 million in 2012.²

San Francisco is a major hub for tech and biotech employment, a popular tourist destination, a significant cultural leader, and an important gateway to the Asia/Pacific region. As such, the city is a considerable draw for leisure, group, and convention guests. Its hotel stock tends to be older, due to very limited hotel development since the 1980s, and clusters in five general districts near demand generators. Full service hotels and conversions to lifestyle boutique hotels are predominantly grouped around Union Square and the Financial District. South of Market (SoMa) is the home of the city's convention center and has seen the most new development over the past two decades. The tourist beacon of Fisherman's Wharf contains primarily branded hotels, of which a select few are also undergoing major renovations/rebrandings. Finally, the Lombard Street/Van Ness Corridor features mostly limited-service hotels and value motels.

DOWNTOWN SAN FRANCISCO



MARKET DRIVERS

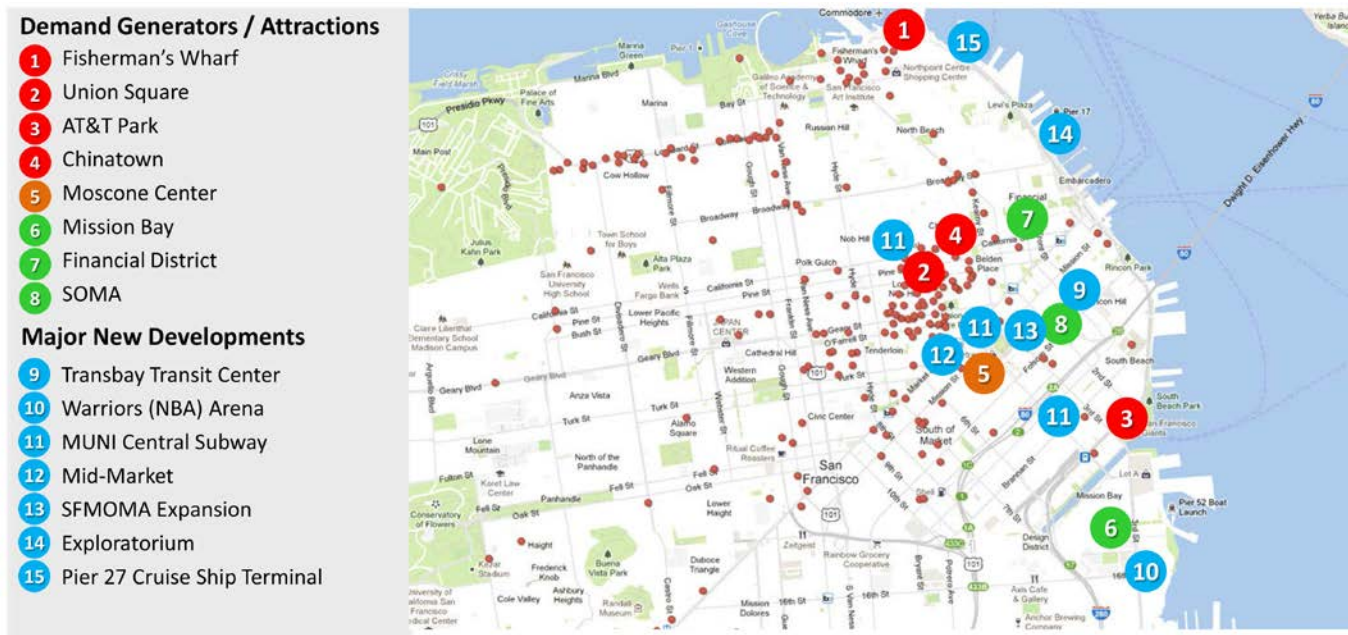
The city's current tech industry boom, convention center popularity, and strong year-round tourism are driving near-record demand. Eighteen tech companies in the Bay Area are valued at \$1 billion or more, which makes the region flush with startup capital for IPOs in cloud-delivered services, mobile apps, data analytics, biotech, and healthcare. Most major tech companies, such as Salesforce, Google, Twitter, Dropbox, Zynga, Adobe, Pinterest, and Airbnb, have either their headquarters or a significant base of operations in the city. San Francisco also has one of the lowest unemployment rates of major cities in the nation (5.1 % in March 2014).

¹ Based on data in *Pacific Business Times*, *Miami Herald*, *Wall Street Journal*, and California Hotel & Lodging Association.

² HVS and Real Capital Analytics.

In proportion to the surge of tech money, real estate values in the city are skyrocketing. San Francisco looks to log more than \$3 billion in office sales in 2014, which is up from 2013's \$2.3 billion but notably down from strong 2012 office sales (\$6.1 billion).³ No less than four office towers in SoMa are under construction, with a high percentage of the space already pre-leased. The technology sector has also picked up a significant amount of office space as it is vacated by banking and legal tenants, making the city's Financial District much less financial. For the hotel industry, this means we are seeing increased investor demand fueled by a potent blend of abundant debt and equity, low interest rates, peak occupancy levels and continuing strong average rate growth. Booms don't last forever, but it still looks like hotels will continue to experience strong net operating income gains throughout 2014.

MAP OF SAN FRANCISCO HOTELS OVERLAYED WITH DEMAND GENERATORS AND NEW DEVELOPMENTS



According to San Francisco Travel, the city's convention and visitors bureau, San Francisco welcomed 16.9 million domestic and international visitors in 2013, which represents a year-over-year increase of 2.3%. (The prior peak was 17.3 million in 2000.) This means a daily average of 134,231 visitors spending a collective \$25.7 million. In total for 2013, visitors spent \$9.4 billion, an increase of 5.1% over 2012 and the new spending high water mark. Roughly 5.24 million guests (or 28%) stayed in San Francisco hotels with an average stay of 3.5 days. Their fiscal impact on the city is huge, especially in regards to tax revenues - \$607 million (up 8.1% from 2012).

For the third year in a row, **San Francisco International Airport (SFO)** set a new record for passenger traffic with 45 million passengers in 2013. (Prior record was 44.5 million in 2012.) International and domestic deplanements also reached a new record level at nearly 22.5 million, an increase of 1.3% over 2012⁴. Carriers that expanded service include Virgin, United, China Eastern, AeroMexico, and

³ J.K. Dineen, "Brisk 2014 San Francisco Office Sales Market Could Hit \$3 Billion," *San Francisco Business Times*, February 11, 2014.

⁴ San Francisco International Airport, "Analysis of Scheduled Airline Traffic, Comparative Traffic Report," December 2013.

Scandinavian Airlines. In May 2013, SFO announced a 10-year, \$4.3 billion capital improvement plan for airport facility upgrades; plans include a new 400-room luxury hotel.⁵ SFO will also close two of its four runways this summer to complete a federally-mandated safety project.

TOURISM DEVELOPMENTS

Recently Completed

Recently completed major projects in San Francisco have focused on reinvigorating the Embarcadero waterfront near Fisherman's Wharf. **The Exploratorium**, an interactive museum of science, art, and human perception, moved to Pier 15 in April 2013. The city is also welcoming 74 cruise ships in 2014, and starting in September they will berth at the new **Pier 27 Cruise Ship Terminal**. This site served as the primary viewing area for the 2013 America's Cup races, which lured 1 million visitors to the city.

In Process or Proposed

The **Transbay Transit Center**, a \$4 billion transportation project that is being called the "Grand Central Station of the West," will replace the current downtown Transbay Terminal with a modern regional hub as the nexus of 11 transit systems. Phase 1 began in 2011. The project will be anchored by the 1,070-foot Transbay Tower that will exceed the iconic Transamerica Pyramid by more than 200 feet to become the city's tallest structure.

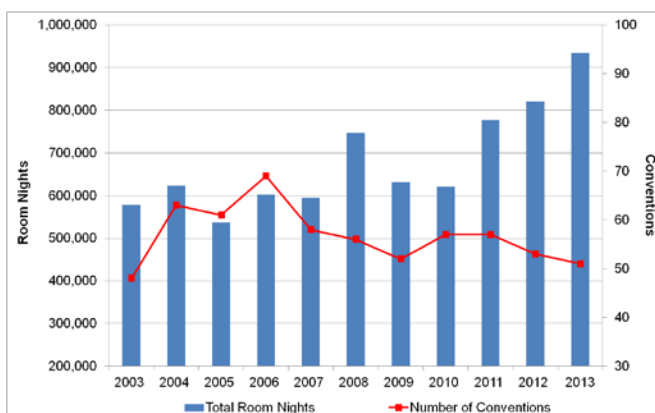
A proposed \$500 million **Moscone Center** expansion aims to break ground in 2015 with an opening anticipated for 2017/18. Plans include adding 200,000 ft² of contiguous exhibition space, improving pedestrian conditions, and enhancing connections to the neighborhood. The expansion will allow it to remain competitive in attracting and retaining large conventions. The majority of San Francisco hotels voted in favor of creating a new business improvement district to help fund the project; final city approval is expected in Fall 2014 with project completion expected in Fall 2018. Economic benefits are projected to include an increase in hotel tax revenue of \$20 million, over 3,400 permanent new jobs and 3,407 construction jobs. Net economic impact of the expansion (both Moscone net operating income as well as total visitor spending impact) is calculated to be over \$734 million through fiscal year 2026..⁶

MOSCONE CENTER EXPANSION ILLUSTRATION



Source: Moscone Center

MOSCONE CENTER STATISTICS



⁵ Eric Young, "Sky is the Limit for San Francisco's Airport," *San Francisco Business Times*, February 13, 2014.

⁶ Mosconeexpansion.com

Sports teams are also interested in developing waterfront spaces. A \$1.6 billion development has been proposed for the Giants' 22-acre site adjacent to AT&T Park. Depending on when it receives city and neighborhood approval, construction of the mixed-use **Mission Rock Development** project is slated to begin at Seawall Lot 337 and Pier 48 parcels in 2016, with occupancy slated for 2017-18 and full completion in 2022. In April 2014, the **Golden State Warriors** basketball team purchased a 12-acre site in Mission Bay for an 18,000-seat **arena** with luxury condos and a hotel. The site was sold by Salesforce.com, and sits between Third Street and the waterfront, across from the UCSF Mission Bay campus.

San Francisco Museum of Modern Art (SFMOMA) started construction in May 2013 on its \$610 million, 235,000 ft² expansion designed by architecture firm Snøhetta. The museum is expected to reopen in late 2015.

The **Central Subway** project is a 1.7-mile "crosstown" extension of Muni's T-Third line along 4th and Stockton Streets connecting Mission Bay, SoMa, Chinatown, and North Beach. The project expands transit access to the premier commercial district and tourist attractions of the city. Construction has already begun and is expected to be complete by 2019.

The San Francisco Planning Department announced plans to explore new infrastructure for the **4th/King Rail** in the SoMa neighborhood that serves Caltrain and future high speed rail. The planning phase of the project will also evaluate the economic effects and opportunities of replacing the elevated portion of I-280 with a surface boulevard, which if pursued, would radically redesign that neighborhood and create roughly 24 acres of development opportunities.

Although it's not located in the city proper, the San Francisco 49ers won the bid to host the 50th annual Super Bowl on February 7, 2016 at the brand-new **Levi's Stadium** in Santa Clara, which is expected to draw \$300-500 million in economic benefits to the surrounding region. The stadium is currently under construction.

HOTEL MARKET PERFORMANCE

San Francisco's lodging market continues its tremendous performance and remains one of the top markets in the United States. Occupancy in 2013 – the third highest in the nation behind Manhattan and Oahu – was 83.0%, an increase of 2.7 percentage points from the prior year. Average daily rate in 2013 was up 9.3% year-over-year at \$187.79. This market (which statistically includes San Francisco and San Mateo) achieved 12.9% RevPAR growth in 2013 with an overall \$155.83 RevPAR.⁷ The city's RevPAR growth is driven by high year-round occupancies, generated by the strong appeal of the city across various demand segments. As the city has not experienced any significant new additions to supply in the past decade, capacity constraints have led to market compression. We expect ADR and RevPAR for San Francisco's hotels to continue to grow through 2014, while occupancy hovers near capacity at 83-4%.

⁷ "California Lodging Industry Performance," California Hotel & Lodging Association, December 2013.

HOTEL SUPPLY

The San Francisco lodging supply currently includes approximately 215 properties with over 33,000 guestrooms. Room count has remained generally flat for the past 10 years. Compared to other cities of similar size and stature, very few new hotels have been built from the ground up, due to the area's high barriers to entry (high development costs, fierce competition for developable land, lengthy city approval process, and labor issues) and relative scarcity in construction financing.

New development is pushing out from the traditionally established lodging areas of the city (Union Square and Financial District), providing opportunities for new hotels in such urban infill neighborhoods as SoMa and Mission Bay. Current and proposed new hotel construction in this neighborhood has featured primarily independent boutique-style or limited service properties. Only one proposed hotel is full service.

SAN FRANCISCO NEW HOTEL DEVELOPMENT SUMMARY

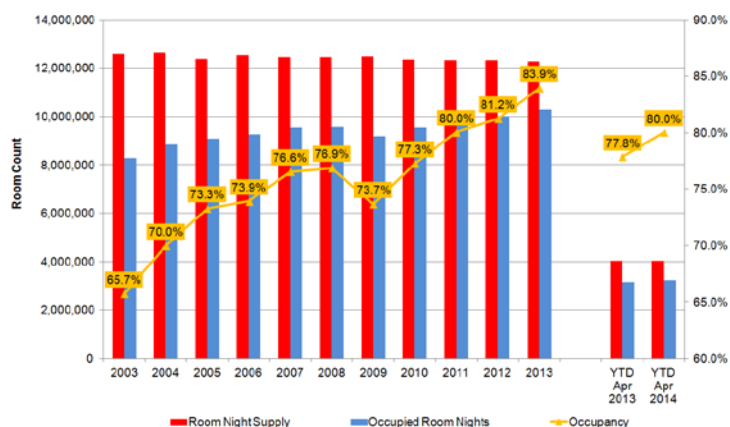
Proposed Property	Product Type	Rooms	Est. Open Date	Developer	Development Stage
Holiday Inn Express Union Square	LS	58	2014 Q3	Rajputana Lodging LP	Under construction
Hampton Inn Moscone Center	LS	174	2014 Q3	Mint Developers LP	Under construction
250 Fourth Street Hotel	LS	200	2016 1Q	250 Fourth Development LLC	Seeking financing
Block 1 Mission Bay Hotel	FS	250	2016 4Q	SOMA Hotel LLC	Construction to begin Q4 2014
1095 Market Street (Grant Building) Hotel	-	94	-	1095 Market Street LLC	Conditional use permits extended
144 King Street Hotel	B	158	2016	O'Keeffe Development & Construction	Construction permits extended to Q3 2014
Personality Hotel @ 72 Ellis Street	B	156	-	Reuben, Junius & Rose, LLP	Construction permits extended to Q3 2014
950 Market Street Hotel	-	250	-	Group i	Early Development
Presidio Building 105 Hotel	B	36	-	Waterford Hotels & Inns	Early Development
Hotel SoMa 690 5th Street	-	66	-	Metrovation	Seeking rezoning approval
1055 Market Street Hotel	-	100	-	G&M Hospitality	Speculative
400 2nd Street Hotel	-	300	-	Cresleigh Development	Speculative
Golden State Warriors Hotel	-	130	-	-	Speculative
Transbay Terminal Hotel	-	300	-	-	Speculative
Total		2,272			

Key: FS=Full Service; ES=Extended Stay; SS=Select Service; B=Boutique

Source: HVS, Build Central, San Francisco Planning Department, San Francisco Business Times, various development websites.

Of the 16 proposed hotels shown in the table above, only two (with a combined 232 rooms) are actively under construction. The **Holiday Inn Express Union Square** and the **Hampton Inn Moscone Center** are two limited-service hotels scheduled to open in mid-2014. The **Block 1 Mission Bay Hotel** will be the city's first newly constructed full-service hotel since 2008 (the **InterContinental San Francisco**). Most new hotel development projects shown above are in early planning stages or speculative with construction still years away.

SAN FRANCISCO HISTORICAL SUPPLY AND DEMAND



Source: HVS

However, the city's lodging supply of late has come to be defined by its high proportion of conversions and extensive renovations. San Francisco, one of the nation's early leaders in the establishment of boutique hotels (think Kimpton and Joie de Vivre), is seeing a trend of raising the quality of these products through major renovations and repositionings. The transformation of the former Hilton Fisherman's Wharf, Radisson Fisherman's Wharf, and Marriott Renaissance Stanford Court Hotel in Nob Hill are three notable recent examples of hotels shedding their flags and reinventing themselves as independent boutique-style properties. Realizing there are a significant number of travelers choosing to forego a formulaic hotel experience, investors consider this market strong enough either to convert an asset from branded to independent boutique or to market a soft-branded asset as boutique. Larger companies like Marriott and Preferred Hotels are behind the soft brands of certain properties like the **Adagio Hotel** and **Pier 2620 Hotel**, testing out new designs and concepts while placing a high value on the uniqueness and differentiation of a property.

Also of note, the six-block long Mid-Market Street area between Van Ness and 5th Street has seen significant redevelopment efforts with roughly 40 recent/current projects, including several mixed-use projects and the establishment of corporate headquarters for Twitter, Dolby, and Uber. The site at **1055 Market Street** was purchased in January 2014 by G&M Hospitality with speculative plans for an approximately 100-room hotel. The space was the home of the former Kaplan's Surplus Store, a one story structure that will be razed to make room for the new hotel.

While not technically located in the city proper, San Francisco International Airport (SFO) has proposed a 400-room **luxury hotel** on the site of the former Hilton Hotel that was razed in the mid-1990's. The new hotel's cost is estimated at \$160 million, and depending on the environmental studies, could be finished by 2017. The Hotel will be financed and owned by SFO, who is currently in the RFP process to retain a hotel operator.

Major Hotel Renovations

One of San Francisco's most exciting conversion projects is the Kor Group's \$40 million restoration of the **Renoir Hotel** in the Mid-Market neighborhood, which will become a luxury 135-room boutique property with a rooftop lounge by the end of 2014. This project was made possible with EB5 funds.

Pebblebrook Hotel Trust transformed the former Hotel Milano on northern edge of SoMa into the posh boutique **Hotel Zetta**. The 116-room hotel reopened in 2013 and is well positioned in the Mid-Market neighborhood. Pebblebrook is also transforming the 355-room former **Radisson Fisherman's Wharf Hotel** into a boutique hotel, spending \$18-20 million to achieve a look similar to Hotel Zetta.

In November 2013, Fillmore Hospitality converted the former Hilton San Francisco Fisherman's Wharf to the 233-room **Pier 2620 Hotel**, part of Preferred Hotels' Sterling Hotels soft brand. The hotel is in the midst of a two phase renovation: the first phase focused on the lobby, entryway, meeting space, and updated technology in the guestrooms; the second phase involves adding a new fitness facility and lounge and renovation of the guestrooms.

The **Hotel G** in Union Square is a luxury boutique brand from Hong Kong that is scheduled to open in the summer of 2014. Now owned by Los Angeles-based investment group Downtown Properties, the hotel

was previously called the Hotel Frank, which closed in 2013 for comprehensive renovations. Union Square's **Powell Hotel** sold in January 2014 to Host Hotels & Resorts for \$75 million, or over \$500,000/key. Host plans to spend \$22 million to renovate the 135-room boutique hotel. Additionally, the Huntington Hotel in Nob Hill was closed for \$15 million worth of renovations in 2013, and reopened in May 2014 as **The Scarlet Huntington**, operating as an independent luxury boutique hotel. Singapore-based hospitality group Grace International is the owner.

TRANSACTION ENVIRONMENT

2013 was a significant year for hotel transactions in the city, with nine properties changing hands, including the trophy property **Ritz-Carlton San Francisco**. This transaction rate is on par with last year, which saw 10 major sales, but transaction dollar volume was up approximately 15% in 2013. The pace has quickened already in 2014 - there have been four sales with two over \$500k/key (**Hotel Vitale**, **Powell Hotel**). With their ready access to the large amounts of capital and desire to acquire quality hotels in strong markets with high barriers to entry like San Francisco, REITs, private equity firms, and foreign investors will continue to be active buyers. Since new development in this market generally has such a lengthy timeline and high costs, buying, renovating, and repositioning a property is a much more common practice than building from the ground up. Financing can also be easier to obtain for stabilized assets that are performing well in San Francisco.

SAN FRANCISCO HOTEL TRANSACTIONS 2012-2014YTD

Name	Sale Date	Buyer	Rooms	Price	Price/Room	Est. Cap Rate
Prescott Hotel	May-14	Pebblebrook Hotel Trust	160	\$49,000,000	\$306,250	6.1%
Hotel California	Apr-14	Pineapple Hospitality	83	27,000,000	325,301	-
Wharf Inn	Mar-14	Bharat & Bhavna Shah	51	14,230,000	279,020	-
Hotel Vitale	Feb-14	LaSalle Hotel Properties	200	130,000,000	650,000	5.0%
Intercontinental Mark Hopkins	Feb-14	Woodridge Capital Partners/ Oaktree Capital, JV	383	120,000,000	313,316	-
The Powell Hotel	Jan-14	Host Hotels & Resorts	135	75,000,000	555,556	-
Four Points by Sheraton	Jan-14	Summit Hotel Properties	101	21,300,000	210,891	10.5%
Hyatt Regency San Francisco	Dec-13	Sunstone Hotel Investors, Inc.	802	262,500,000	327,307	-
Radisson Hotel Fishermans Wharf	Dec-13	Pebblebrook Hotel Trust	355	132,000,000	371,831	8.3%
Harbor Court Hotel	Aug-13	LaSalle Hotel Properties	131	17,779,827	135,724	8.5%
Hotel Triton	Aug-13	LaSalle Hotel Properties	140	30,020,173	214,430	8.5%
Serrano Hotel	Aug-13	LaSalle Hotel Properties	236	71,500,000	302,966	-
Ritz-Carlton San Francisco	Jul-13	Thayer Lodging Investors	336	161,000,000	479,167	3.0%
Vantaggio Suites Cosmo	Jun-13	RLJ Lodging Trust	150	29,500,000	196,667	-
Hyatt at Fisherman's Wharf	May-13	Chesapeake Lodging Trust	313	103,500,000	330,671	-
Holiday Inn Express & Suites Fisherman's Wharf	Feb-13	Summit Hotel Properties/InterContinental Hotels Group, PLC, JV	252	60,500,000	240,079	5.6%
Clift Hotel	Dec-12	Hospitality Properties Trust	363	120,000,000	330,579	-
Hotel Rex	Nov-12	DiamondRock Hospitality Company	94	29,500,000	313,830	-
Hotel Palomar	Oct-12	Pebblebrook Hotel Trust	196	58,000,000	295,918	5.4%
Larkspur Union Square	Oct-12	Cartwright Hotel Group, LP	114	16,600,000	145,614	7.3%
Hotel Frank	Sep-12	386 Geary Real Estate, LLC	153	32,300,000	211,111	-
Fairmont San Francisco	May-12	Mason Street Associates, LLC/Oaktree Capital Management, LP/Woodridge Capital Partners, LLC	591	192,000,000	324,873	4.1%
Hotel Milano (now Hotel Zetta)	Apr-12	Pebblebrook Hotel Trust	108	30,000,000	277,778	-
Wyndham Parc 55 San Francisco	Mar-12	The Blackstone Group/Rockpoint Group, LLC	1015	235,000,000	231,527	-
Renoir Hotel	Feb-12	The Kor Group	135	13,500,000	100,000	-
Hotel Abri	Jan-12	MetWest Terra Hospitality, LLC	91	22,250,000	244,505	6.2%

Source: HVS

In May 2014, Pebblebrook Hotel Trust acquired the 160-room **Prescott Hotel** near Union Square for \$49 million, or \$306,250/key, with a 6.1% forward looking cap rate. This per key price seems low relative to other recent transactions in San Francisco. However, after considering that one of the two buildings is a leasehold interest on a ground lease expiring in June 2089 (inclusive of a 30-year extension option with payments starting in October 2017), the implied cap rate resulting from subtracting ground rent payments of \$500,000 from the forward looking NOI is 5.2%. According to broker opinion, after adjusting for the ground lease on the property, the price per key is \$386,000 on an adjusted fee simple basis. The property is also expected to undergo a \$10 million renovation, or \$63,000 per key, which takes the fee simple-equivalent “all-in” price closer to \$450,000/key.

A recent landmark hotel sale, the 200-room **Hotel Vitale** sold for \$650,000/key on a leasehold basis in February 2014. LaSalle Hotel Properties contracted to buy the Embarcadero waterfront property for \$130 million. According to Eastdil Secured who brokered the transaction, after adjusting for the ground lease with the city, it sold at just under \$800,000/key on an adjusted fee simple basis. This is LaSalle’s sixth hotel in San Francisco. In 2013 the group landed a three-hotel portfolio in the city: **Hotel Serrano** for \$71.5 million (nearly \$6 million above original asking price), plus **Harbor Court** and **Hotel Triton** for \$47.8 million. Prior holdings of **Hotel Monaco** and **Villa Florence** round out the list. (For comparison, the 336-room **Ritz-Carlton San Francisco** sold in July 2013 to Thayer Lodging Investors for \$161 million, or ~\$479,000 per key.)

Notable transactions include the sale of the 383-room **InterContinental Mark Hopkins** in February 2014 for \$120 million to a joint venture between Woodbridge Capital Partners affiliates and Oaktree Capital Management funds. Woodbridge Capital Partners portfolio now contains the city’s two largest luxury hotels (along with Nob Hill’s historic **Fairmont Hotel**).

Sunstone Hotel Investors acquired the fee simple interest in the 802-room **Hyatt Regency San Francisco** on the Embarcadero for \$262.5 million, or ~\$327,000/key, in December 2013. This was one of the largest properties in California to sell in 2013 and the most expensive in San Francisco County. The REIT, which owns hotels in the upper-upscale segment of top 25 markets, is planning a \$30 million renovation of rooms and public space. Renovations to the lobby/meeting space are to occur starting in 2015.

CONCLUSION

The San Francisco hotel market has a lot of momentum in 2014 to match its vigorous economy. The city’s acclaimed restaurants and culture, unique tourist attractions, and expanding convention center are expected to continue to attract record numbers of visitors. A continued lack of new inventory in a compressed market driving robust ADRs may begin to moderate demand from certain market segments like group and convention. REITs, private equity firms, and foreign investors will likely be the most active buyers. Renovating and positioning lodging properties as high-end, tech-savvy, independent boutique hotels will remain a trend.



About HVS

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