THE ROAD TO RECOVERY: A LOOK AT THE LODGING INDUSTRY, POST-SEPTEMBER 11

by M. Chase Burritt

The hospitality industry's ability to reclaim some semblance of normalcy after the events of September 2001 is compounded by the travel industry suffering through the worst short-term prospects since the Persian Gulf War.

The U.S. lodging industry could lose as much as $2 billon as a result of the attacks on New York and Washington, D.C., and their detrimental impact on consumer confidence, the economy, and U.S. air travel. The attacks' direct disruption of economic production reduced third-quarter U.S. gross domestic product alone by approximately $24 billion. Consumer confidence in the economy decreased to 82.2 in November 2001, the lowest since February 1994.

More than one-third of the 260,000 hotel and restaurant workers represented by the Hotel Employees and Restaurant Employees International Union have lost their jobs. The economic slowdown prior to 9/11 already prompted Walt Disney World to furlough approximately 1,400 employees, with the majority of layoffs in the management ranks. In response to the immediate and anticipated continued decline in attendance, Disney has avoided additional layoffs by reducing the hours and wages of part- and full-time employees, while Universal Studios recently announced layoffs of 100 full-time office workers.

The three major demand segments—leisure, business, and conference and group activity—will experience both short- and long-term effects.

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Leisure travel will see heavy cancellations due to air-travel restrictions, plummeting consumer confidence, and a fear of flying. However, leisure demand should rebound in the coming months as consumers regain confidence in travel and the state of the economy. Domestic demand will recover more quickly than international leisure travel.

Business travel also will see heavy cancellations as corporations implement travel restrictions in addition to already-restricted travel budgets. In the future, business travel should resume but at more moderate levels than pre-September 11. However, business travel correlates highly with the state of the U.S. economy, which has been shaken even further.

Lastly, conference and group activity experienced extensive cancellations and postponements, which resulted in loss of room nights nationwide. Attrition will become a factor as convention turnout weakens and the rebooking of events extends over a longer time period.

THE NUMBERS

Occupancy Stabilizes

An economy first weakened by the economic slowdown and then further by the shock of the events of September 11 and the ongoing United States war in Afghanistan will continue to cloud the industry's prospects for recovery in 2002. Supply growth has slowed to 2.4 percent in 2001, while room demand has observed negative growth of 3.5 percent, significantly weakening fundamentals. U.S. occupancy declined significantly from 63.7 percent in 2000 to an estimated 60.1 percent at year-end 2001, lower than 1991 levels of 61.8 percent, the year of the Persian Gulf War.

In 2002, supply growth is anticipated to moderate as the development pipeline had already thinned last year in response to a tighter lending environment. There are less hotel rooms under construction today than at any other time during the past three years. Furthermore, markets on the verge of oversaturation prior to September 2001 are anticipated to experience more modest supply growth as additional challenging market fundamentals weed out those with weaker deal structures.

In terms of demand, reductions in air-travel, corporate belt-tightening, and a fear of flying, and continued layoffs are anticipated to contribute to an elongated recovery timetable. The following factors are anticipated to be the primary drivers of recovery:

- The general state of the U.S. economy;
- The scope and length of U.S. military action; and
- Air capacity in light of recent airline cutbacks.

The second half of 2002 through early 2003 should bring improved performance to the lodging industry as supply growth slows significantly to 1.5 percent and demand exhibits growth of 1.2 percent, resulting in soft but stable occupancy expectations of 59.9 percent for 2002.

ADR (Average Daily Rate) Slightly Increases

In 2000, the national ADR reached $86.12. Rates declined during 2001, as a slow rebooking pace subsequent to 9/11 forced hoteliers to offer more attractive room rates for both transient leisure and commercial segments, resulting in an estimated ADR of $85.11 in 2001— a 1.2 percent decline from the prior year.

Significant declines in ADR will continue throughout the first and second quarters of 2002 as operators have already renegotiated group and contract rates for this period. As demand slowly recovers, we expect hoteliers to be able to maintain their rate integrity in the second half of the year, resulting in little or no overall rate growth for 2002 (approximately 0.3 percent). Luxury and first-class lodging properties will continue to feel the impact of corporate belt-tightening, while economy and limited-service properties will remain more resilient to travel cutbacks.

RevPAR (Revenue Per Available Room) Stagnates

Revenue per available room in the industry reached a high of $54.88 in 2000, a 6.0 percent increase over the prior year. In the aftermath of recent events, RevPAR declined considerably to $51.15 in 2001, an estimated decline of 6.8 percent compared with 2000.

During the first and second quarters of 2002, RevPAR should decline and then recover slightly, resulting in little overall change for the year. Airport, urban, and resort markets such as Miami and Hawaii—typically more dependent on air transportation—continue to be most susceptible, while hotels situated in regional "drive in" markets may be able to rebound better into 2002.

Industry Profits: Good-bye Glory Days

After nearly a decade-long streak of increasing revenues and profits, the lodging industry's watchword is caution. Profits for 2001 are estimated to be approximately $18.4 billion, down significantly from $22.5 billion in 2000, while 2002 profits are anticipated to be $19.9 billion. Profit growth will increasingly become a function of efficient expense management, as well as extremely limited new development in select areas.

CRITICAL ISSUES

Insurance Recovery

The total estimated insurance costs from the events of 9/11 are $75 billion, according to insurance-industry sources. Owners affected by recent events will have to contend with many difficult business issues, including relocations, lost profits, extra costs to maintain operations, disrupted operations, damaged facilities, lost records, lack of access to premises, and even liability issues in some cases. Insurance premiums for hotel operators are expected to jump 50 percent – 70 percent in 2002.

Erosion of Hotel Values

Given the increasing volatility of cash flows, we expect substantial erosion in hotel values, particularly for the upper-upscale sector, in the near-term. This should allow owners to seek reductions in assessed values and provide substantial real estate tax savings. Hotel values will recover in the mid-term, but trade at discounts to construction costs. Transactions, however, will not be as deeply discounted as in the early 1990s (1991 values were down 28 percent) due to more responsible underwriting criteria in recent years. We would expect a 15 percent to 20 percent reduction in hotel values in the near future.

Defaults are Likely

Declines in U.S. lodging industry RevPAR have squeezed cash flow available for debt service obligations. Lending standards today are 50 percent to 60 percent of value (compared to 70 percent to 80 percent a few years ago). Hotel chains without broad distribution in multiple segments are at an increased risk for loan defaults. We would expect loan defaults to more than double in 2002.

Upper-upscale properties are at greater risk as they strive to maintain rate integrity and service levels. Cost-cutting measures are occurring, but at a slower pace relative to the limited-service/economy sector.

Deal-Making Heats Up Slowly

Transaction activity has already come to a halt, and many lenders remain skeptical of our industry, as evidenced by a reduction of LTV ratios and an increase in capitalization and discount rates. While there will be many opportunistic buyers, we do not expect to see willing sellers immediately. Transaction activity is expected to be very limited in the near-term as owners and investors are waiting to see how quickly the industry will recover.

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Wall Street Fizzles

According to Ernst & Young's Lodging Stock Index, lodging stocks (small cap, large/mid-cap, and REITs) outperformed the S&P 500 through August 2001. Following the events of September 11, stocks plunged to all-time lows for the year. Small-cap stocks have continued to outperform the S&P 500. Large and mid-cap stocks and lodging REIT performance have fallen below the S&P 500 with REITs exhibiting the weakest performance. Despite improvements in lodging stocks as of early November 2001, mid-term performance is expected to remain below pre-September 11 levels due to an exacerbated decline in the economy and continued reluctance to travel.

As with any long-term investment you buy when the market is down, there should be good "buy" opportunities among the major hotel flags.

SOLUTIONS/STRATEGIES

Operational Enhancement

Operational enhancement initiatives and cost containment strategies are critical. These efforts may include short-term measures, such as staff furloughing or schedule reductions, or long-term solutions such as revenue and yield management, inventory control, and improved service standards.

This is also a good time for operators to consider innovative ideas such as e-procurement.

Human Resources Strategies

Payroll has been the primary focus of cost containment. Hotels have already cut staffing levels by furloughing, (temporarily laying off), employees. Reducing schedules of hourly employees, requiring mandatory vacations, and cutting overtime have proven to be effective and inexpensive solutions.

Clustering employees is another effective solution to reduce costly overhead. Examples include sharing employees among area hotels—one Area General Manager who oversees three properties and three Assistant General Managers, or pooling banquet servers, housekeepers, etc.—all through one centralized scheduling department.

Given the presence of highly unionized activity in hotels, there is very little flexibility and significant savings from altering benefits packages. In addition, contracting or outsourcing labor may appear to be a viable alternative in the short-term, but does not generate significant savings in the long haul.

Closing food and beverage outlets for certain meal periods and reducing hours of operation for businesses such as health clubs, gift shops, or eliminating 24-hour room service—all which require significant operating expense and often minimal revenue—are additional cost reduction measures to implement. Another example is removing turn-down services, a labor-intensive and non-revenue generating activity.

Energy Savings

A successful energy strategy (supply sourcing, conservation, implementation, capital financing) can also result in substantial savings for the bottom line in the long term. These measures can reduce operating costs, increase efficiency, and improve the indoor environment without compromising business objectives. Cost savings ranging from 15 percent and 20 percent can be achieved depending on the systems and facilities.

Management Company Selection

The selection of a management company is critical. Management service contracts are the most important relationship an owner can forge. Today, many owners look at this relationship and wonder if more value can be created through a change in management company or contract terms. Owners and developers need to drive business into the property, manage the facility, staff efficiently, and brand the property for long-term success. Selecting the correct management contract is the key to each of these goals, and deserves the highest level of sophistication and advice. Choosing the right management company and structuring a sound contract can turn a lagging market leader, and launch a new property with great success.

Asset Management

In the face of increasingly complex industry challenges, many individual and portfolio hotel owners are recognizing the value of independent professional asset managers that serve as a vital intelligence link between ownership and management. In addition to providing strong, innovative and profit-driven property management, professional asset management provides the potential for increased profit from operations, the convenience of a central, unbiased point of communication, and the creation of an independent strategic plan.

FINAL THOUGHTS

The lodging industry has not experienced zero RevPAR growth in more than a decade; however, the unforeseen circumstance in which the industry finds itself is one of the greatest demand challenges it has ever faced. Before the economy and world events settle to the point where the American public is willing to resume business and leisure travel in force, lodging managers will be left focusing on the expense side of the operation to squeeze additional value from their operations, continuing a decade-long focus on operational re-engineering, financial restructuring, and a highly disciplined adoption of appropriate new technologies.REI