Lodging Industry Fundamentals Remain Strong Despite Cautious Stance on New Development

by M. Chase Burritt

ABOUT THE AUTHOR

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While U.S. lodging fundamentals are generally strong, increasing economic trepidation may begin to affect lodging industry performance, as the Consumer Confidence Index has softened due to high oil prices, recently announced layoffs and a volatile/declining stock market.

If corporate and leisure travel expenditures begin to moderate as a result, the impact on hotel occupancy levels would be partially tempered by a development pipeline already thinned by the tight capital markets.

As the pace of business change increases, the lodging industry in 2001 will continue to confront new challenges in areas including, but not limited to, finance, development, marketing, and operations.

CAPITAL MARKETS GAP

With the lodging industry coming off one of its most productive years ever in 2000, and with many per unit revenues and profits at historically high performance levels, traditional development theory postulates that capital for new development should be forthcoming to ease tight lodging markets. However, several factors are affecting the availability and cost of capital for both acquisitions of existing properties, and most particularly, new development.

The perception that most hotel assets are performing at or near their peak, with more moderate growth potential, has created a widening gap in the perception of hotel asset values between buyer and seller, with buyers commonly believing that hotel value has peaked and sellers believing that more optimistic current/prospective value appreciation should be reflected in asset pricing. This disconnect has contributed to a softening of transaction activity with respect to existing hotels.

Additionally, the tightening of the capital markets that began in fall 1998 continues, with the financial community taking a cautious stance (i.e., more equity required as a percentage of total capitalization) with respect to lodging investments. These dynamics have created a general impasse on many lodging industry transactions and developments.

However, as of the beginning of this year, rumors of increased activity have emerged. A few large mergers and acquisitions are in the works; lenders have come forth with competitive terms and a willingness to lend, particularly on cash flowing properties; and equity, although highly selective, is available. Construction lending is still the most challenging—although there are a few banks ready and willing. For those equity investors who are well-capitalized, significant and compelling value investment opportunities do exist.

In general, it is safe to say that capital in the lodging sector is still highly selective—with most capital targeting existing cash flow properties; mixed-use development projects (with in-place leases); development projects with high barriers to entry and some public financing component; or leased properties with credit-rated hotel companies.

While the continued capital crunch may have a negative effect on new lodging development on the horizon and on pricing for existing properties currently on the market, a slowdown in new supply should have positive effects on existing hotels and those already far along in the development pipeline.

Although the lodging industry continues its nearly decade long streak of increasing revenues and profits, there is some disagreement among industry analysts about the industry's prospects in the near future, particularly with the recent rise of oil prices, the volatility in the stock market and the slower growth rate of the gross domestic product. Of immediate concern are recent declines in the

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Consumer Confidence Index (which as of January 2001 fell for the fourth consecutive month and is at its lowest level since December 1996), as well as limited downward revisions of corporate earnings expectations and the effect, though less evident, on corporate travel expenditures.

Despite these macro economic factors, it is anticipated that in 2001 the lodging industry will continue to post relatively steady performance characteristics, although with more modest overall RevPAR growth in 2001 than 2000. Between 1997 and 2000, demand in the industry experienced a cumulative increase of 10.6 percent, with growth in 2000 at 4 percent. In 2001, industry demand growth is anticipated to increase by approximately 2 percent, almost at the same pace as supply, as moderating economic growth tempers lodging demand.

Profit growth in the industry should continue to exist, increasingly becoming a function of efficient expense management and process re-engineering, as well as some development. In 1999 and 2000, industry profits were estimated at $23 billion and $24.3 billion, respectively, and for 2001, profit levels are anticipated to increase to approximately $26 billion.

While nationally the industry exhibits stable performance, there exist some local markets that are experiencing weaker supply and demand fundamentals such as Philadelphia and Seattle. These markets in particular experienced a decline in revenue per available room from 1999 to 2000. Both markets are combating the imbalance of the supply demand equation through the development of additional demand generators, including expansions of their conventions centers and other projects underway.

Between 1997 and 2000, the U.S. lodging industry added approximately 411,459 rooms, representing an estimated cumulative growth of 11.6 percent. In 2001, industry supply growth is anticipated to increase by 2.3 percent, compared with an estimated 2.9 percent in 2000. The 2.3 percent increase represents the lowest growth since 1995. Concerns about new additions to supply are warranted in certain markets - particularly, secondary markets with limited demand generators (i.e., markets that rely heavily on overflow demand or a solitary demand generator such as a convention center). According to *Lodging Econometrics*, 1,261 properties with a total of 139,064 rooms are scheduled to be completed in 2001.

Although concerns exist from a macro economic and micro market perspective, overall, the lodging industry is better prepared to confront these forces and remain profitable. The tightness of the capital markets helps to keep supply and demand in balance and has caused hotel developers, owners, lenders, and management companies to implement new strategic capital plans to maintain growth and increase profitability.

NEW PSYCHOGRAPHY OF AGING

The changing demographics of the U.S. consumer are anticipated to have a significant impact upon lodging demand and particularly the resort segment. While it is possible that in the short term the recent decline of the stock market and portfolio values (and subsequently the recent drop in the Consumer Confidence Index) may somewhat affect baby boomer leisure travel, it is more likely that longer term psychographic trends will more profoundly shape the industry.

The baby boomers are heading for retirement; Gen-Xers are heading into their peak earning years; and the Generation Y or "Echo Boomers" are moving into their adult years. As the baby boomers retire over the next 10 years, more people than ever before will find the means and the time to sample the best that the lodging industry has to offer.

Each generation has its own definition of a vacation, as well as their own unique expectations as to the ideal trade-off between work and leisure time. This substantial demographic shift in the today's consumer will create many opportunities for resorts, but will also create many changes.

The baby boomer generation currently comprises approximately 29 percent (80.5 million) of the U.S. population. As recently reported by the American Automobile Association (AAA), baby boomers account for 40 percent of all travel, and this is expected to increase. Estimates for the annual income of baby boomers generally exceeds $2 trillion, giving this generation 52 percent of the personal income for the U.S.— this is expected to reach 65 percent in 2005, according to research by B.T. Alex Brown. Not only do baby boomers control the majority of the country's income, they are also entering their peak spending years. This generation is wealthier and healthier and is expected to live longer and enjoy more years of retirement than any generation before it. Baby boomers and their tendency to spend will clearly dominate the U.S. economy (and the resort business) during the decade, with an estimated growth rate of 30.1 percent, and reaching a peak in 2015.

Baby boomers are driving the concept of rentability of condominium-style living versus traditional hotel units. The baby boomer generation is investing more in service-oriented real estate. The concept of "rentability" primarily refers to the interest in real estate fully serviced by management companies and located within master planned leisure communities, allowing owners the ability to maintain an established lifestyle at their primary residence while minimizing the perceived risk of investing in a second single asset. As a result, the opportunity exists for resorts to extend the value of their asset by offering condominium style products to their customer base.

While resort operators need to focus on baby boomers for the immediate future, they should not lose focus of the 56 million Generation Xers that follow, (those born between 1965 and 1978). These are the boomer's younger, affluent siblings and children. This generation, as a result of the Internet and the Information Age, are more consumer savvy and have less consumer loyalty than boomers. As they are just entering their peak earning years, they will not dominate leisure travel, but they will certainly have a significant impact in the future. There will be some resort operators that will benefit from this generation through niche marketing and catering to their needs.

Generation Xers' expectations for a vacation experience are quite different than the baby boomers. According to consumer research, Generation Xers are more predisposed to taking all-inclusive vacations than boomers; to staying at the *best* hotels and resorts than boomers; to visit places they have never visited before; and are more likely to utilize spa and other activities of a resort than boomers.

Additionally, Generation Xers are more experience-oriented and as a result are looking for experience- and entertainment-oriented vacations. Being a beneficiary of the Information Age, high-tech amenities, entertainment, and instant gratification is most important to Generation Xers, when it comes to vacationing.

Universal among every segment of the population is lack of time. Time is becoming the most important commodity in a consumer's decision-making process. As a result, consumers are more willing than ever to trade dollars for time. According to research by Yankelovic Partners, today's' consumers are taking more frequent trips, but for less time. Americans are also vacationing closer to home, within 3.5 hours' travel being the optimal distance.

Today's consumers are also more willing to spend more for superior service. This translates to: resorts which can provide their guests with maximum experiences in the most convenient manners will thrive.

OCCUPANCY—FLAT TO SLIGHTLY NEGATIVE

Between 1997 and 2000, occupancy in the industry ranged between a low of 63.2 percent in 1999 and a high of 64.5 percent in 1997, exhibiting a downward trend during the past three years. In 2000, occupancy for the U.S. lodging industry increased slightly, reaching 63.9 percent. In 2001, occupancy is anticipated to decrease slightly to 63.7 percent as a result of continued supply growth.

ADR (AVERAGE DAILY RATE) — FLAT TO POSITIVE

Between 1997 and 2000, ADR in the industry ranged between a low of $74.76 in 1997 and an estimated high of $84.99 in 2000, increasing at a compound annual growth rate of 4.4 percent. Positive ADR growth is anticipated to continue in 2001, resulting in an ADR of approximately $88, an increase of 4 percent over 2000.

REVPAR (REVENUE PER AVAILABLE ROOM)—FLAT TO POSITIVE

Between 1997 and 2000, RevPAR in the industry ranged between a low of $48.19 in 1997 and an anticipated high of $54.32 in 2000, exhibiting a consistent, upward trend during the past three years at a compound annual growth rate of 4.1 percent. In 2001, RevPAR growth is anticipated to moderate, with RevPAR increasing by 3.7 percent.

Increasingly, services offered by lodging companies are overlapping with other real estate and service-oriented industries such as time-share. This competency extension strategy has also created a more complex form of customer relationship management, prompting lodging companies to measure consumers in terms of their lifetime value to their total brand portfolio.

THE INTERNET AND WEB ENABLEMENT

The Internet continues to create new opportunities for the lodging industry and to change the marketplace in innovative ways. On the revenue side, online travel information access and booking are likely to boost the overall amount of travel expenditures, but at the same time make the distribution landscape more complex. Relative to operations, hotel companies are now busy installing high-speed Internet access in guestrooms and are beginning to realize the marketing potential of such services. Online procurement/B2B networks are anticipated to generate cost efficiencies in areas such as purchasing, accounting, energy and repairs, and maintenance. Lodging companies are teaming with service providers to improve profitability and to sell the promise of greater efficiencies to other companies. As Web enablement technology advances, these efficiencies will become more tangible.

MANAGEMENT COMPANY SELECTION

Management company selection has become an increasingly important process in today's lodging industry environment. Encouraged by the Tax Act of 1981, significant hotel development occurred in the early 1980s, putting into place many management-friendly deals that were largely not performance based. Now, with many of these management deals up for review and more industry attention being paid to operating efficiencies through performance clauses (as well as management now often sharing in some of the ownership work), a formal review of the options is becoming more important. Also, today's widespread public/private activity often requires a more structured management company selection process.

BRAND & CUSTOMER EXTENSION

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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.

CONSOLIDATION

At least one or two international transactions are anticipated in 2001, as the difference between public stock values and asset values drive activity. The British company, Bass PLC, which operates or franchises more than 2,900 hotels internationally under brands including Holiday Inn and Inter-Continental, could make a large hotel acquisition with the $3.8 billion of proceeds from the divestiture of its brewing business.

LUXURY SEGMENT

Barring any major economic slowdown that could significantly impact corporate group and individual lodging demand, the luxury segment should continue on its relatively steady growth pace in terms of occupancy, ADR, and RevPAR. While several local markets are likely to experience oversupply, in most metropolitan areas the consistent upward RevPAR trend exhibited by this segment is anticipated to continue, enticing only selective new development based on highest and best use issues.

FIRST CLASS SEGMENT

In 2000, first class supply growth was modest, superceded by supply growth in the mid-scale and economy segments. During 2001, the segment's fundamentals are anticipated to neutralize a bit more, with occupancies stabilizing. As interest rates inch upward, project pipeline development will likely become more selective as financing remains difficult to attain.

UPSCALE SEGMENT

The thinning of the development pipeline and a continual focus on operating efficiencies through innovate new distribution and procurement channels will ensure the health of the upscale segment in the near term. Such innovative operational programs will continue to support increases in profitability at a time when the strong growth in the U.S. may begin to raise human capital costs.

MID-SCALE WITH FOOD & BEVERAGE

The mid-scale with F&B segment continues its stable to slightly negative performance, as its new entries have yet to develop the critical mass to offset the conversions and defections of older, more traditional properties. While there is anticipation of a limited number of new projects developed in the segment, overall there is less attention to product and market innovation occurring in this segment.

MID-SCALE WITHOUT FOOD & BEVERAGE

As historic supply growth has been intense, the continued stability of the mid-scale without F&B segment depends on its ability to moderate and better qualify its development pipeline. It remains to be seen if the segment can calm its zeal for further development as opportunities for dramatic additional operational efficiencies lessen.

ECONOMY SEGMENT

With operations having become more efficient, and additions to supply continuing but moderating, the question remains: How much more value can the economy segment engineer into its properties? As the cycle of U.S. economic expansion continues to moderate, the benefit from the waterfall effect of corporate travel tradedown activity could partially offset other impacts on demand; if the expansion continues, increasing labor costs and interest rates could begin to impact profitability.

RESORT SEGMENT

Favorable consumer demographics, particularly from the aging baby boomer generation, and spending patterns over the next two decades, are anticipated to have a significant positive impact on resorts. At the same time that travel is increasing, however, entertainment and vacation alternatives are also expanding. Increased resort development in 2001 is anticipated to somewhat impact segment fundamentals, however continued high barriers to entry in most markets, as well as tightening capital, continue to protect the supply/demand balance in this segment.

CONCLUSION

Although the lodging industry continues its nearly decade-long streak of increasing revenues and profits, there is some disagreement among industry analysts about the industry's prospects in the near future, particularly with the recent rise of oil prices and the decline in the stock market. It is anticipated that in 2001 the lodging industry will continue to post relatively steady performance characteristics, with more modest overall RevPAR growth than 2000.

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