

# FORCES SHAPING THE HOTEL BUSINESS

The Lanesborough London, Courtesy of Rosewood Hotels & Resorts.



## THE PURPOSE OF THIS CHAPTER

Lodging is a capital-intensive business, and so capital plays a major role in shaping the hotel business. Until the recent recession, lodging enjoyed a major inflow of funds from a variety of sources. As the economy declined, so did these sources of capital. This industry is also cyclical and is characterized by long lead times on projects. As a result, supply and demand changes are not always as straightforward as they might appear.

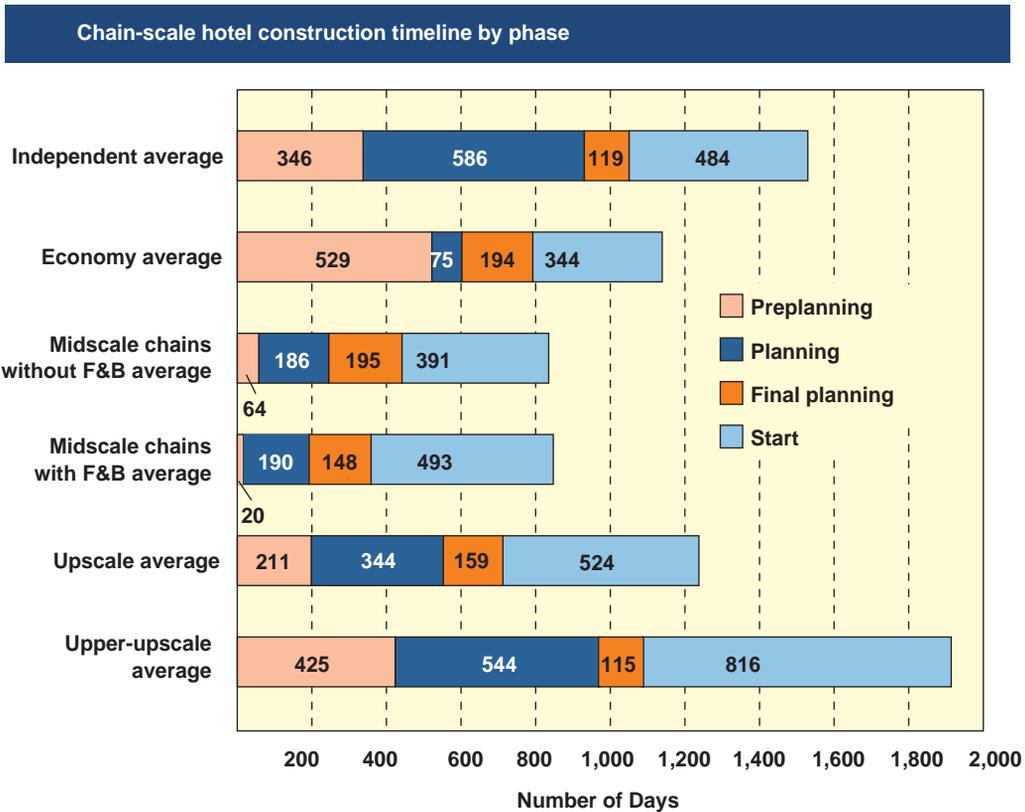
The argument for understanding the economics of lodging and its capital structure are numerous. One day you may want to be an entrepreneur and consider becoming an owner, partner, or franchisee of a hotel operation. You could also one day work in a corporate office of a lodging company where you are directly involved in determining potential locations for new properties and working on the financing packages for the company's growth. Even as a manager in a hotel, it is advantageous to understand the economics of lodging and its capital structure. A thorough understanding of the economic variables involved can facilitate your role in maximizing the profitability of your particular property for the owners or corporation.

## THIS CHAPTER SHOULD HELP YOU

1. Explain the cyclical nature of the hotel industry along with terms such as RevPAR and issues pertaining to *securitization*.
2. Understand the decisions relating to investing in a hotel, including interest rates, inflation, contractual issues, and asset management.

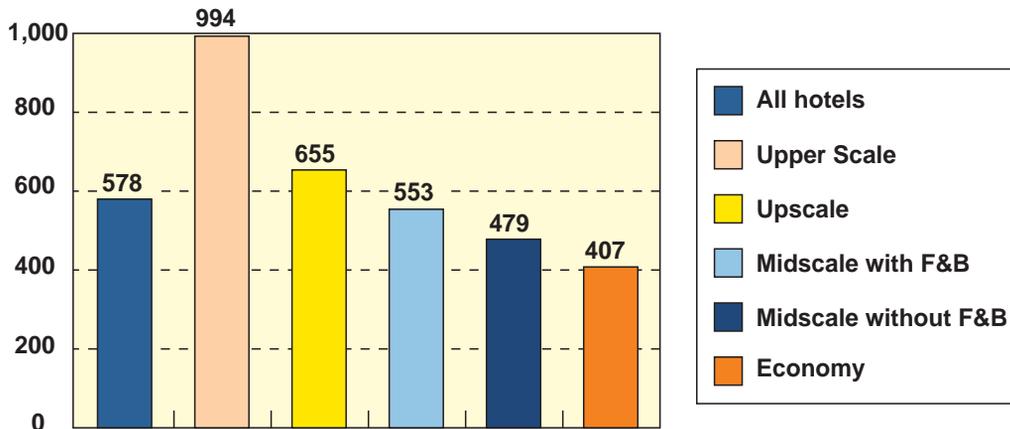
## THE ECONOMICS OF THE HOTEL BUSINESS

Hotel developers build long-term assets on the basis of relatively short-term cycles. Whereas a hotel's lifetime is usually 30 or 40 years (and sometimes 100 years or more), the cycle of hotel building is considerably shorter depending on the type of hotel. Figure 11.1 displays the hotel construction timeline by phase. This figure is based on an analysis completed for each of the segments for hotels in the construction pipeline between 1994 and 2002.<sup>1</sup> Understanding the phase length of the preplanning, planning, final planning, and start-up to completion of construction is important in predicting the room-supply growth of hotel rooms. It is important to note that, between 1994 and 2002, only 25 percent of all projects in the preplanning stage actually were constructed. The percentage of completions increases for each subsequent stage to almost 95 percent of projects in the actual construction stage opening for business at some point in the



**Figure 11.1**

Chain-scale construction timeline by phase. (Source: STR/PPR/F.W. Dodge.)



**Figure 11.2**

Hotel construction—average days from construction start to opening. (Source: STR/PPR/FW. Dodge.)

future (see Figure 11.2). As this pipeline ranges over several years, historically periods of excess capacity are followed by demand catching up with supply, followed in turn by periods of more or less frantic building.

Examples of the difficulty in forecasting the supply of hotel rooms can be seen in the more recent changes in estimated growth. *Smith Travel Research* estimated an added U.S. room supply for 2009 of 435,265 for a total of close to 4.5 million. This is an overwhelming 32.7 percent decrease from 2008. This is completely different from estimates made in 2006 for the remainder of the decade, which showed increased, not decreased, construction. The main reason was the global recessionary condition. Although building costs, including supplies and labor, are easing somewhat, there are still challenges to completing projects on budget and on time. Analysts project that the diminished pipeline totals may not have any meaningful impact on industry operations until 2011, when there will be a larger demand owing to an improved economy.<sup>2</sup>

The hotel business is cyclical. It is also highly **capital intensive**, with, depending on the economy, varying sources and levels of capital flowing into the industry. We consider each of these points—cyclicality, capital intensity, and the impact of capital flows into the industry—in the following sections. In the next chapter, we consider competition in lodging.

## A CYCLICAL BUSINESS

The fact that the hotel business is cyclical essentially means one thing: The demand for hotel rooms rises and falls with the business cycle. Generally, the demand for hotel rooms changes direction in direct relation to the economy but lags behind it by several



Hotels, large or small, require major investments in land, physical plant, and equipment. As a result, expansion is very sensitive to economic conditions. (The Regent [Mumbai, India]. Courtesy of Carlson Hotels Worldwide.)

months. This is not surprising, as both business and pleasure travel are easy expenditures to eliminate in a declining economy and to restore when it improves. In any local market, the hotel business is likely to have its own cycle, related to the supply of hotel rooms as well as the demand for them. However, the cycle generally starts with the demand for rooms, potential or actual. Perhaps the easiest way to see this cycle is to work through an imaginary, but quite realistic, example.

**AN EXAMPLE OF THE HOTEL BUSINESS CYCLE.** Oldtown, a quiet city of 100,000, has been a stable community with a balanced economy for many years. Not long ago, during a period of general economic expansion, a national company built a large factory complex in Oldtown. The ripple effect from this project spread to the suppliers for the factory complex as well as to a number of other companies that, when they heard about the factory complex, learned what an attractive site Oldtown was. Employment soared; some people were transferred to Oldtown; others moved there seeking jobs.

Our study now shifts to Major Hotels' corporate offices, where, in a meeting with the vice presidents of operations and real estate, the vice president for development suggests that Major ought to look into building a hotel in Oldtown. There is immediate agreement to do a preliminary study. Three months later, the preliminary study shows encouraging results, and so several lines of activity are set in motion. A consulting firm is hired to do a formal feasibility study, an architect is hired to do preliminary design work, and informal conversations with Major's bankers begin. Six more months pass. The results of the consultant's feasibility study confirm Major's preliminary study, the preliminary design is a beauty, and everybody agrees this could be a great hotel. The

bankers, having looked at the studies and the design, decide to process Major's loan application quickly. (They have had a surge in deposits and need to get that money into interest-earning loans. They need to lend, just as Major needs to borrow.) Best of all, the ideal location has been found, and negotiations to acquire a site are going well.

At a meeting of Major's executive committee, a formal proposal to go ahead is presented. The discussion touches briefly on the competition, but everyone quickly agrees that Oldtown's existing hotels are tired and will be no match for the proposed property. When somebody asks, "Is anybody else going in there?" the answer is "A few people have been nosing around, but there's nothing firm as far as we can tell." Everyone agrees that it is time to purchase the site and sign a design contract with the architect.

The same series of events is taking place at Magnificent Hotels, LowCost Lodges, Supersuites, and a couple of other companies. However, because each company keeps things fairly quiet until everything is settled, there are only vague rumors that others are also interested in Oldtown.

Finally, 18 months after the first vice presidential meeting at Major, the company announces that a 300-room hotel will be built in Oldtown, and the groundbreaking is set two weeks hence. The story is front-page news. Over the next six months, similar announcements from Magnificent, LowCost, and Supersuites make the front page too.

At Major, these other companies' announcements cause quite a stir. At a meeting of the executive committee, members all shake their heads and agree that those other companies are crazy; they have no sense at all in overbuilding like this. One very junior vice president who is sitting in raises the possibility that Major should abandon the project, but he is quickly shouted down. Thousands of dollars have already been spent on feasibility studies and architectural work, a site has been purchased, and contracts have been signed for construction. "Besides," says the financial vice president, "what would our banks say if we pulled out now? Do you think we'd get another loan commitment as easily next time?" Because everybody has agreed to the project publicly, for any to admit that he or she was wrong would also be publicly embarrassing.

Eighteen months later, Major's beautiful new property opens, and the general manager hands the following situation report to the vice president of operations:

Within four blocks of my office, there are a thousand rooms under construction. Everyplace my sales staff goes, they trip over our competitors' people. Magnificent is slashing its convention rates for next year, LowCost has announced a salespersons' discount when its hotel opens next month, and Supersuites is offering free cocktail parties every evening. I think we will do all right after the first couple of years because our operation is going to be stronger and of better quality, but don't expect much for our first two or three years until we are established. There are no further announcements of lodging construction in Oldtown.

We have spent quite a bit of time looking at this cycle of events to illustrate the significance of factors such as the complexity of the decision to build a hotel, the lead time required, the preliminary expenditures, and the public, corporate, and individual commitment to the decision. This cycle shows that an increase in demand can set off a series of events that usually cannot be stopped even when it becomes clear that the market is or will be overbuilt.

In other markets, it takes years for the demand to catch up with the overbuilding. In some markets, however, the demand keeps increasing, and in three to five years, another round of building starts, this time fueled by all the old faces plus some new ones—for those who didn't get in the first time. All have a need to be represented in the growth market.

Our example was of a local market, but this is usually part of a larger, national market. Different local events related to a general national period of prosperity set off building booms in many local markets because demand for hotel rooms is closely related to general economic conditions. When the national economy turns down, so does the hotel business. Hotel building tends to come in waves or cycles that end, much to everybody's surprise, in an overbuilt industry.

## HOTEL CYCLES AND FINANCIAL PERFORMANCE

In an ideal world for hotels, the demand for rooms would equal or exceed the supply of rooms. Pricing of rooms could therefore be maximized, resulting in higher average room rates. In reality, however, supply and demand cannot be precisely calculated or predicted. As discussed in Chapter 13 (in Global Hospitality Note 13.1, Public Anxiety and the Travel Industry), unexpected catastrophic events have affected the hospitality industry as well as other segments of our lives. The tragedies of September 11, 2001, had a significant negative impact on the number of people traveling, subsequently greatly reducing the demand for hotel rooms. The operating profit for the average U.S. hotel dropped 19.4 percent in 2001. This was followed by a 9.6 percent drop in profits for 2002, marking the first two-year decline in hotel profitability since 1982 to 1983.<sup>3</sup> As evidence of the cyclical nature of the lodging industry, consider that 2000 was the most profitable year in the industry, when it grossed \$24.0 billion in pretax profits. This figure was 9 percent more than in 1999 and double the amount earned in 1996. Total industry revenue rose from \$62.8 billion in 1990 to \$112.1 billion in 2000. In 1990, the industry suffered a \$5.7 billion loss during a recessionary period complicated by Operation Desert Storm and the Persian Gulf War in the Middle East. Total industry revenue declined in 2002 to \$102.6 billion from \$103.5 billion in 2001.<sup>4</sup>

The domestic recovery following September 11 started in the third quarter of 2003. The year of 2005 showed profits in the hotel industry of 15.5 percent and was the greatest

## Hotel Operations after Katrina

*Smith Travel Research* conducted an analysis of the Gulf Coast region one year after Hurricane Katrina, compared to prior to the devastating natural disaster that occurred on August 29, 2005. In June 2005, there were 723 hotels with 79,500 rooms in Louisiana. After Katrina, the room count in that state dropped to 53,000—a 33 percent drop in inventory. In June 2006, the statewide room count was up to 69,500, still 13 percent below the prestorm room count. New Orleans, of course, experienced the most severe impact with almost 70 percent of its room inventory lost because of the devastation. Of the city's 38,322 rooms, only 11,900 remained. In June 2006, the inventory was up to 28,400 rooms, still 26 percent below the pre-August 29 number. The reduction in rooms available and rooms sold led to an increase in occupancy through June 2006 in New Orleans. For the first six months of 2006, occupancy increased 2.2 percent, to 71.2 percent, with an average rate of \$128.63.

In New Orleans, the largest number of lost rooms was in the Central Business District/French Quarter. Of the 24,700 existing rooms there in June 2005, only 5,600 rooms were open for business in September after Katrina. In June 2006, there were approximately 19,500 rooms available.

In the Biloxi/Gulfport area, two-thirds of the hotel rooms were lost due to Katrina. The inventory dropped from 16,000 rooms to about 5,000. As of June 2006, this area was still 58 percent below normal supply. The average daily rate (ADR) had increased to \$93.34 by June 2006 with occupancy (considering the reduced inventory) of 87.1 percent.

Source: J. Freitag, "Roads to Recovery—Revisiting the Gulf Coast One Year after Katrina," *Lodging Magazine*, October 2007.

increase since 1996. Except for the Louisiana and Mississippi areas hit by Hurricane Katrina in the early fall of 2005, hotel occupancies for 2005 equaled or exceeded their long-term averages with strong gains in average room rates. For 2006, there was a 7.5 percent growth in total revenue; for 2007, there was a 4.1 percent total revenue increase, with profit gains for the years of 14.9 percent and 7.0 percent respectively. This equates to U.S. hotels achieving a profit of almost \$14,592 per available room in 2006 and \$15,641 in 2007. This figure slightly exceeds the \$15,674 profit level of 2000 but, in real dollars, still puts the hotels about 20 percent behind where they were in that year. The trend continued in 2009 when, again due to the recession, the industry reported profit per available room of only \$16,725.<sup>5</sup> Industry Practice Note 11.1 discusses the impact of Katrina on the lodging industry of the Gulf Coast of Louisiana and Mississippi.

One factor that is typically considered in analyzing the financial performance and predictions of the hotel industry is the inventory of available hotel rooms. During the hotel industry crisis of the late 1980s/early 1990s when the number of available rooms far exceeded demand, hotel development and financing communities clearly contributed to the catastrophic impact. The illogical growth of the 1980s caused the hotel

market to be excessively overbuilt. Until 1986, the growth was driven, to some degree, by tax considerations, which developers seemed to think made profit a secondary consideration. Another factor explaining hotel growth in the face of losses in operations (between 1982 and 1993, the lodging industry lost a staggering total of \$33 billion) was the increasing emphasis on segmented room products. (The industry has never been segmented to the extent that it is now.) Although the market as a whole in a city might have enough rooms to satisfy demand, if there was a shortage of one specific category—say, limited service or all-suites—developers in that category saw an opportunity, and new rooms were built to satisfy that specialized need. In some cases, rooms were built where there was no shortage of any kind but simply because of competitive pressure for major brands to be represented in an important market. In the late 1980s and early 1990s, property values fell far below replacement costs. Part of the meaning of a cyclical market is that there are good times as well as bad (expressed in terms of profit). The industry broke even in 1992 and had a profitable year in 1993, leading up to the best industry year in 2000. Overbuilding has not, however, been identified as a factor in the downturn starting in 2001. Depressed demand (resulting in lower occupancy rates) and collapsed rates (lower average room rates) were due to a combination of a depressed economy, terrorism, war, travel complications, and outbreaks of severe acute respiratory syndrome (SARS).<sup>6</sup>

With better economic times becoming evident in 2003, one might have expected a surge to follow in hotel development. Unlike what occurred in the late 1980s and early 1990s, analysts, however, saw factors limiting rapid hotel supply growth. These factors included escalating land and construction prices that were not expected to become more reasonable in the foreseeable future. Construction costs were further impacted with Hurricane Katrina, particularly for lumber and wood-related products.<sup>7</sup>

Throughout the downward business cycle of 2001 through 2003, the hotel industry showed that good management can make a significant difference in maximizing profitability with reduced revenue. Since 2001, only a couple of midsize companies have sought protection of bankruptcy laws. PKF Hospitality Research indicated that more than 80 percent of hotels were profitable at the unit level in 2002. Although hotel revenues were down after the peak in 2000, expenses—particularly big ones, such as labor and interest rates—were also down. With this equation, it was possible that hotel income increased as revenues declined.<sup>8</sup> So while profits fell for hotels, according to the Hospitality Research Group of PKF Consulting, the average 2002 profit for properties was 27.5 percent—almost two full percentage points greater than the 25.6 percent average margin earned by U.S. hotels from 1960 to 2001. Subsequently, in 2003, buyers were willing to pay competitively for good hotel properties.<sup>9</sup>

The hotel industry, during the leaner times following September 11, learned how to operate more efficiently, and these lessons have helped in the current financially

difficult times. For example, in 2005, PKF Hospitality Research found in its sample of hotels that an 8.8 percent increase in total revenue was turned into a 15.5 percent increase in profits. According to this source, that was one of the largest annual gains in unit-level profitability in the past 25 years. There was some variance based on the hotel categories, but all hotel segments had gains in total revenue in 2005. Limited-service hotels achieved the greatest increase in revenue (10.3 percent) in 2005 while full-service hotels achieved the greatest increase in profitability (19.3 percent) for the same time period. Convention hotels, while not faring quite as well, still had a 7.8 percent gain in revenue and a 12.2 percent increase in profits.<sup>10</sup>

For U.S. hotel properties in 2005, there was a 6.5 percent increase in total operating costs. The 5.1 percent increase in labor and related costs contributed largely to this total. For the second consecutive year, the increase in employee benefits overshadowed the increase in wages and salaries. Employee benefits increased by 6.4 percent compared to a 4.6 percent increase in salaries and wages. Employee benefits include payroll taxes, payroll-related insurance, subsidized employee insurance (the amount the hotel pays for the particular benefit plan to offset the employee-paid premiums for coverage such as medical, dental, and life insurance), retirement plans, and employee meals (again, which typically are subsidized to offer low-cost or even free meals to employees during their work shifts). Some of these benefits are mandated by government on the federal, state, and local levels. Another reason for the increase in this area is that benefit packages are an important employee recruiting and retention tool. Regarding other operating expenses, the rooms department experienced the single largest increase in 2005 as compared to any revenue-generating department. Part of the increase in the rooms division reflects the higher occupancy (more guests for whom to provide supplies, clean rooms, and staff departments). Along with this increase is the presence of amenity creep—a trend that has been steadily growing in the hotel industry for several years. Guests increasingly expect more in a guest room, from free WiFi to an assortment of bathroom products (no longer just shampoo and soap but conditioners, body lotions, shoe mitts, sewing kits, shower caps, etc.) and enhanced bedding.<sup>11</sup>

Additional increases in hotel expenses for 2005 are worthy of separate mention. In that year, management fees increased by 8.9 percent and franchise fees increased by 9.8 percent. These fees are usually based on a percentage of revenue and reflect the sizable revenue increases for that year. Another big contributor to hotel overhead was utility costs. In 2005, hotel utility costs increased by 13.6 percent, which made these expenses the single largest increase on the financial statement. Recent history supports the prediction that utility expenses will continue to remain high or climb to even higher levels, as shown by the 5.5 percent increase in 2007 and 3.6 percent in 2008.<sup>12</sup>

The controlling of overhead and expenses is vital in order to maximize profitability in any hotel operation, but the key drivers in the profitability of a lodging property are

occupancy and average room rate. A property with high occupancy can still lose money with low room rates. High room rates, however, are not totally the answer if there is insufficient occupancy. Obviously, management skill in keeping overhead costs in line is consistently important to maximize the hotel's profitability.

The average U.S. occupancy rate was the lowest in 31 years in 2002, at 64.3 percent, with an average room rate of \$105.96. This represents a drop of \$9.55 from the previous year. In comparison, for 2008, the overall percentage of occupancy was 70.0 percent, with an average daily room rate of \$155.54. Table 11.1 shows the average occupancies for hotels in the United States from 2001 to 2008 and average room rates during that same time period.<sup>13</sup>

## REVPAR

A well-established measure over the years in evaluating hotel performance has been **revenue per available rooms (RevPAR)**. RevPAR, resulting from the rental of guest rooms, is the key source of revenue for the lodging industry. A logical question would be: What drives profitability greater in RevPAR growth—occupancy or room rate? According to PKF Hospitality Research, when RevPAR growth is dominated by occupancy increases, there are also costs in servicing the extra rooms and guests. Therefore, the gains in profit are less. When RevPAR growth is driven by increases in the average daily rate (ADR), “economies of scale allow for a greater percentage of the rooms revenue gain to drop to the bottom line.”<sup>14</sup> During times of intense competition (as when business drops and every hotel is truly fighting for survival), properties can create an extremely

**TABLE 11.1**

**Average Occupancies for Hotels in the United States**

YEAR	PERCENTAGE OF OCCUPANCY	AVERAGE ROOM RATE
2001	65.4%	\$115.51
2002	64.3%	\$105.96
2003	65.2%	\$107.28
2004	69.4%	\$117.39
2005	71.4%	\$126.12
2006	72.3%	\$133.45
2007	70.8%	\$141.72
2008	70.0%	\$155.54

detrimental situation by lowering room rates to the point that occupancy cannot help pull out the needed profitability.

**INTERNATIONAL HOTEL OPERATIONS.** In an analysis of 2006 European hotel operations, London achieved the highest RevPAR for that year. The RevPAR of €166.63 was up 18.49 percent from 2005. These results were driven by an average room rate (ARR) of €205.30 and a year-end occupancy of 81.7 percent. Moscow was second in the European market with RevPAR of €161.78, an average room rate of €222.53, which equates to an increase of 15.1 percent over 2005. Global figures for 2006 showed improvement worldwide: In Europe, RevPAR growth was up by 11.61 percent; in the United States, it was up by 7.5 percent; and in the Asia-Pacific region, it was up by 20.12 percent. When the Middle East markets are included with Europe, the third in absolute RevPAR was Dubai (€156.03), followed by Paris (€152.36) and Amsterdam (€104.27).<sup>15</sup>

## HOTELS AS REAL ESTATE

Hotels may be built because an area or community development needs the property; that is, the hotel may be necessary to a larger project. At times, hotels have been built in areas slated for mega-events, such as a winter or summer Olympics. A saying in the industry is “You don’t build a church just for Easter Sunday.” Applied to the hotel industry, that is interpreted to mean that it may not be wise to build a hotel just for a three-week sell-out event. A longer-term concern would be whether the travel industry (leisure and business) is going to support the addition of another hotel property in that particular area. Another reason supporting investing in hotels could be that the underlying value of the real estate and its appreciation are a more important consideration to the investors than the profitability of the hotel. For example, a number of foreign investors in North America have apparently, from time to time, been willing to invest money in hotel properties for their longer-term appreciation and as a safe haven for their funds.

Hotel pricing can make hotel real estate more attractive than other real estate, particularly in inflationary times, because of the ability to increase rates literally overnight. The ability to increase revenues is not as flexible in other real estate projects, where rents generally are fixed by long-term leases. As a result, hotels, although they have a higher risk than other real estate, find favor with investors, especially during the optimistic growth phase of the hotel industry cycle.

Hotel companies are highly active not only as operators and franchisors of hotels but as real estate developers. Marriott, for instance, sustains its growth in part by buying, developing, and then reselling land and hotel properties. Indeed, such companies have a real interest in continuing expansion of their brands to gain a greater share of the market and to ensure that their brands have a presence in the widest number of local



The Emirates Palace Hotel, which opened in Dubai in 2006, is reported to be the most expensive hotel ever built at a cost of \$3 billion. (Courtesy of Emirates Palace, Abu Dhabi.)

markets. Naturally, they also want to gain the profits from development. These motives to expand, however sensible they may be from the individual company's vantage point, often lead to the "overbuilding" that has been such a bane to the hotel business generally. Industry Practice 11.2 discusses a growing concept in hotel real estate—mixed-use developments including a special section on condo-hotels. Hotel investments reached \$21 billion in 2005, which was 63 percent higher than the previous year. Hotel investments in 2006 were equally strong but declined in 2007, 2008, and 2009. Investors do not expect a rebound until 2011.<sup>16</sup> Industry Practice Note 11.3 describes the process of a real estate transaction.

## INTERNATIONAL HOTEL DEVELOPMENT

Regarding international hotels, the focus for new hotel development is in Asia. According to Lodging Econometrics ([www.lodging-econometrics.com](http://www.lodging-econometrics.com)), Wall Street considers the "growing offshore development to be a significant component of their analysis of U.S.-based hotel companies and real estate investment groups." As of late 2009, there were 784 "actively pursued" construction projects encompassing 208,847 rooms in China alone. China, too, is the focal point of lodging construction in the Asia-Pacific region and has the highest percentage of projects currently under construction at 73 percent. Correspondingly, China is projected to be the largest tourist destination in the world by 2020. The 2008 Olympic Games in Beijing added momentum to the development trend along with Shanghai, a major world-class financial center. Macau, a major gaming destination, and the nearby resorts of Taipa and Coloane are contributing to the pipeline numbers with the average size property exceeding 700 rooms in these locations.

## Condo-Hotels as Mixed-Use Developments

With the aging of the baby boomers, and the realization that many from this era prefer luxury vacation living, comes the proliferation of the condo-hotel. Although condo-hotels have been around for many years, these developments were traditionally found in the luxury-resort locations of Florida, Las Vegas, and the Caribbean. Now the condo-hotel concept can be found in numerous locations worldwide. Traditional hotels have started adding condominium units to properties, serving both transient guests and condo owners. Buyers of the condo unit are not burdened with any upkeep issues, including furnishings or amenities. Owners of condo units in condo-hotel developments simply have to reserve his or her room and show up to enjoy the services the hotel has to offer.

Condo-hotels do present some operational challenges, however, particularly when involving booking those rooms for nonowner use. Because condo owners are not using their rooms at the same time, coordinating with blocking section in advance for group or convention use to maximize revenue sometimes can be difficult. There are different ways to structure the condo owners' use of their units, which is addressed in the contract with the owner. Remington Hotels manages a condo-hotel in Orlando, Florida. Owners who have elected to put their rooms into the hotel's rental pool for transient use are given a calendar asking them, in advance, to plan when they wish to use the room. The hotel's transient business is then planned around the owners' calendars.

Another area of potential conflict concerns condo furnishings. Most condo-hotels do not allow owners to change the in-room furnishings. Hotels need a consistent, uniform room because this helps keep repair and replacement charges in check.

Despite the challenges, real estate experts say that the condo-hotel option will be attractive, particularly to the baby boom generation. This fact is underscored by major new building projects that include a large number of privately owned condos in hotels such as Las Vegas's new CityCenter (discussed at length later in the book).

Source: Jeff Colchamiro, "Revenue Streams" *Lodging*, September 15, 2010. <http://www.lodgingmagazine.com/PastIssues/PastIssues/RevenueStreams-2054.aspx>.

India is also a major location for new hotels with 44 percent of the new properties planned near outsourcing office centers in the cities of Bangalore, Chennai, Hyderabad, and Mumbai. Thailand is the third largest area in Asian hotel development. New hotel openings peaked at an exceptionally high 856 hotels/140,852 rooms in 2008. These rates have since moderated.<sup>17</sup>

## PRIVATE EQUITY INVESTMENTS

The sweep of private equity through the hotel industry was dramatic, until the 2007 credit crisis reversed this trend considerably. In 2005, private equity firms accounted for

## The Elements of the Hotel Real Estate Deal

A seven-year process was involved in the development of the \$300-million, 950-room JW Marriott Desert Ridge Resort & Spa located in suburban Phoenix, Arizona. The hotel, which opened in November 2002, had more than 450,000 room nights on the books from the start, with reservations booked into 2009. JW Marriott Desert Ridge Resort & Spa is the largest resort in Arizona.

The first step in the development of this resort took place in the mid-1990s. In analyzing the market, Marriott International saw that Arizona was lacking facilities for large-group business. According to J. W. Marriott, Jr., Marriott's chairman and chief executive, "I'm a strong proponent of the big-box hotel. If you build them bigger and better than the competition, people will come."

The initial step was followed by a series of focus group meetings. The objectives of these meetings included testing the concept and creating a vision for the property. Information from these meetings helped determine that a hotel was needed with between 1,000 and 1,200 rooms. In addition, adequate meeting space was essential—in the area of 100,000 square feet. In keeping with the resort setting, multiple golf courses were essential, as was a major spa.

With these parameters defined, the development team went to work looking for the right city in Arizona as a location. The choice of Phoenix was facilitated by the fact that one of Phoenix's civic goals was to make the city a major convention destination. At this point, Marriott began discussions with Northeast Phoenix Partners, which controlled 6,000 acres of land. The master plan project was called Desert Ridge. Talks with the department of transportation were also initiated to clarify plans for expanding the freeway system serving that area of town. By 1999, Marriott acquired an existing golf course and a lease interest in the land for the hotel and a second golf course. Discussions continued over the next several months to determine the hotel's number of rooms, height, traffic flow, and other details.

By early 2000, almost 90 percent of the property design was complete. Marriott approached CNL Hospitality Corp. CNL became a capital partner through equity investments, including a real estate investment trust (REIT). Other financing included a private placement to high-net-worth investors (which raised \$28.5 million), the addition to several major institutional investors, and a mezzanine loan provided by Marriott. Marriott maintained a minority equity interest.

Construction started in early 2001. The second golf course opened in February 2002, with the hotel opening the following November. Seven years had transpired since the project's conception. The resort contains 100,000 square feet of indoor meeting space and 100,000 square feet of dedicated outdoor meeting and gathering areas.

Source: From Ed Watkins, "Anatomy of a Big Deal," *Lodging Hospitality*, July 1, 2003, p. 26.

44 percent of hospitality transactions, but this number was reduced almost in half in the first quarter of 2009. Publicly held companies make up the second largest portion of transactions. *Private equity* is a broad term that can include individuals or families (such as the Pritzker family, who have owned Hyatt Corporation for over 50 years) to pension funds or university/foundation endowments. Pension funds, including

California's teacher pension fund, have made a sizable impact with their investments in hotel properties.

Private equity firms manage pooled money to acquire properties and oversee investments. Examples of large-scale private equity companies when such investments were at their highest during the period from 2001 to 2010, are the Blackstone Group, RLJ Development, and Colony Capital. The Blackstone Group had the second and third largest portfolio acquisitions in 2006 with the LaQuinta Corporation and MeriStar Hospitality. These transactions totaled \$6 billion. Fueling the interest of private equity investments in hospitality has been the increase in travel by both leisure and business segments until the dramatic decline beginning in late 2007. Supply of hotel rooms remains limited because of higher construction costs and land prices. The underperformance of other investment options, such as commercial, multifamily, and retail real estate, has also attracted the private equity firms to the hotel industry. Private equity firms are motivated by high-yield returns and therefore tend to have shorter holding periods, typically of two to four years. For example, the Blackstone Group bought Wyndam Hotels and sold the name, franchising, and management company to Cendant (which is now Wyndam Worldwide) in less than a year.<sup>18</sup>

## THE SECURITIZATION OF THE HOTEL INDUSTRY

The term **securitization** of the hotel industry refers to the influx of funds into the industry in return for equity and debt securities issued by publicly traded hospitality companies.<sup>19</sup> There have always been the Marriotts, the Sheratons, the Hiltons—companies that obtained most of their financing from public markets.<sup>20</sup> However, in the 1990s, financing vehicles emerged that were relatively new to the hotel industry, such as **commercial mortgage-backed securities (CMBSs)** and **real estate investment trusts (REITs)**. These forms of financing led to an unprecedented growth in the funds from public markets invested in lodging. To understand this development, we briefly consider these forms of debt and equity capital. As a point of clarification, when speaking of debt, we are referring to borrowed funds such as mortgages, bonds, debentures, and the like. We use the term *equity* to refer to ownership, here in the form of stock sold to individual and institutional investors. In 2009, publicly held companies made up the second largest group of transactions. Of these, REITs became the preferred investment vehicle targeting in particular properties struggling with falling cash flows and rising defaults.<sup>21</sup>

**DEBT INVESTMENTS AND COMMERCIAL MORTGAGE-BACKED SECURITIES.** For many years, the primary sources from which companies borrowed for purposes of hotel construction were limited to banks and insurance companies—except for a handful of public companies. There are now additional sources of debt for hotel construction.



Well-financed companies are especially well suited to carry out large, complex hotel development. (Courtesy of Trump's Castle.)

Hotel developers can access such funding through **conduit lenders**, which we discuss in a moment. This wider availability of loans, however, poses some real questions about the dangers of overbuilding. A commercial mortgage-backed security is “a security, often a bond rated by bond agencies, backed by a pool of commercial mortgages” and the future income those mortgages will generate from payments of interest and principal.<sup>22</sup>

CMBS debt is assembled by conduit lenders who use their own funds to lend initially to the borrower. When a sufficient dollar amount has been assembled, the mortgages are “packaged” and sold to the public and institutional investors. Specialized firms engage in this business. Banks, brokerage firms, and other financial institutions also have divisions that act as conduit lenders. The CMBS market was one of the best sources of financing for hotel owners post-September 11. With corporate bond markets turning away from hotels and portfolio lenders reluctant to take concentrated risks in hotel assets, the CMBS market found that, if properly sized and priced, hotels can produce profits.

**OTHER SOURCES OF DEBT FINANCING.** Owners may find that they can obtain at most a 65 percent first mortgage on a property. To decrease the amount of their own funds required, they resort to what is called **mezzanine financing**.<sup>23</sup> Mezzanine financing, sometimes referred to as **gap financing**, “bridges the gap between the first mortgage and the amount of equity committed to a project.”<sup>24</sup>

Mezzanine financing is very much like a second mortgage. It is not secured by a mortgage—or else it is subordinated to a first mortgage. It carries a higher interest rate than mortgage financing because of its higher risk. In the previous example, however, if the owners could obtain 65 percent first-mortgage financing and another 20 percent mezzanine financing, the amount of their own capital required to build the property would be reduced from 35 percent to 15 percent of the cost, effectively increasing their power to expand. The primary advantage of mezzanine debt is that it provides additional capital while allowing current ownership to maintain control of the asset without having to take on additional equity partners. The cost of these funds can range from 15 to 20 percent interest with three- to seven-year terms. Mezzanine funding does add another debt obligation to the hotel. Overall leverage is thereby increased, and downside risks are elevated. Even with these added risks considered, such funding can be advantageous, because long-term mezzanine funding is less expensive than having equity partners if a project is successful.<sup>25</sup>

**SOURCES OF EQUITY INVESTMENT.** Principal sources of equity investment in lodging include real-estate investment trusts, **initial public offerings (IPOs)**, and secondary stock offerings.

*Real estate investment trusts.* As noted earlier, REITs are companies that own and, in many cases, operate income-producing real estate. Real estate may include residential properties, shopping centers, offices, lodging/resort properties, and malls, for example. Although some REITs finance real estate, others directly own and/or operate income-producing real estate. To be a REIT in the United States, a company must distribute at least 90 percent of its taxable income to its shareholders annually in the form of dividends. The growth of REITs has been so significant that Standard & Poor’s added REITs to its major indexes, including the S&P 500.<sup>26</sup>

REITs do offer benefits over merely buying and selling real estate, including hotel properties, individually. One of the advantages of this type of investing is that it helps reduce the risks of owning a single property while reaping the benefit of income generated from multiple properties. If one property is doing poorly, it can be offset by others that could be more profitable. For example, in 2009, REITs, in general, had a return of -0.8 percent. However, hotel REITs showed a +16.1 percent return.<sup>27</sup>

An example of a lodging REIT is FelCor Lodging Trust (New York Stock Exchange: FCH), which acquires, renovates, redevelops, and rebrands hotels. FelCor owns approximately 87 consolidated hotels in 23 states and Canada with a total value of \$2.3 billion. This company consists primarily of upscale hotels, which are flagged under these global brands: Embassy Suites Hotels, Doubletree, Hilton, Marriott, Renaissance, Sheraton, Westin, and Holiday Inn.<sup>28</sup>

*Other publicly held companies.* As we noted earlier, companies such as Intercontinental Hotels and Marriott have long been publicly held (i.e., owned by stockholders whose shares are publicly traded). These and other publicly traded corporations are often referred to as **C corps** to distinguish them from REITs, which are also corporations.<sup>29</sup> Host Marriott was initially created in 1993 in the split of Marriott; Host Marriott became owner of lodging real estate and operator of airport terminal concession businesses, and Marriott International was the manager of lodging and contract-service businesses. Later, Marriott created two separate companies, with one focused on lodging real estate. In 1999, Host Marriott reorganized to qualify as a REIT. Based in Bethesda, Maryland, Host Marriott typically buys conservative four- and five-star hotels in major urban areas and owns properties that carry the brands of Marriott, Ritz-Carlton, Renaissance, Four Seasons, and Hyatt. Starting in 2003, Host Marriott became very active in selling and buying properties. One purchase in 2003 was the Hyatt Regency Maui Resort and Spa in Hawaii, purchased for \$321 million. By August 2003, the REIT had already sold four hotels, with plans to sell several more hotels bringing in proceeds of \$100 million to \$250 million. Proceeds were planned to repay debt, invest in their current portfolio, or acquire additional hotels.<sup>30</sup> Late in 2005, Host Marriott Corporation announced an agreement to purchase 38 hotels. The seller was Starwood Hotels & Resorts, and the price tag was \$4.1 billion for the properties located around the world. With the increased diversity, Host Marriott changed its name to Host Hotels & Resorts and became the world's largest lodging REIT and one of the largest owners of high-end hotels and resorts with 128 properties encompassing 67,000 rooms.<sup>31</sup>

*Secondary offerings.* When a company that is already publicly traded issues additional shares, those shares are referred to as secondary offerings. From 1991 to 1997, REITs and C corps raised \$11.5 billion through secondary offerings. Including both debt and equity, that amount reached nearly \$27 billion during the seven-year period, the vast majority of it in the last four years of that time span.

*Equity investment and joint ventures.* As the economy slowly improves, more investors are turning to hotels and real estate as stocks and mutual funds have not provided meaningful returns. This has resulted in a great deal of capital seeking hotel investments

often from nontraditional hotel investors. Instead of selling the asset outright, an option is to sell a portion of a hotel. This capital can then be used for expansion, renovations, or new projects. New investors benefit by enjoying the current yield while entering a new industry, as long as skilled operators are involved.<sup>32</sup>

**Public funding.** *Public funding* refers to public tax dollars. The use of public tax dollars particularly in the building of convention center hotels has been a contentious issue for some time. Typically supported by city leaders, investment bankers, convention bureaus, meeting planners, and some hotel management companies, many hotel owners feel that use of public funding to compete with their own hotels is unfair. These hotel owners contribute to the pool of public funding with the bed, corporate, and other taxes they pay to the city, county, and state. In essence, they are contributing to underwrite or subsidize a hotel to compete with their own. Advocates of such funding emphasize that such projects can infuse new vitality and revenue into a city's convention market, thereby benefiting more than the convention center hotel. In many cases, the average building price of \$175,000 to \$225,000 per room cannot be handled by the private sector without some type of assistance from the government. An example of such funding is with the 1,100-room Hyatt Regency Denver at the Convention Center. Tax-exempt revenue bonds totaling \$350 million were secured for this project; otherwise, it was unlikely to become a reality.<sup>33</sup>

**SECURITIZATION AND COMPETITION.** Although we defer most of our discussion of competition in the loan business to the next chapter, this is a good point at which to consider the impact of the huge influx of capital on the hotel business and its competitive structure. When more funds flow into the industry, it becomes easier to build more rooms, increasing competition. When capital has been more readily available and, in a rising stock market, effectively less costly, mergers and acquisitions (M&A) of hotel chains has increased as well.

Real estate investment trusts have been active players in the M&A field too. The financial power of REITs is substantial. Because of their ready access to the public capital markets, they can manage large acquisitions with new stock issues. The stock either can be used to raise cash toward the purchase price or can be given to the seller as part of the purchase price. In effect, REITs have the power to virtually coin money—as long as their stock market value holds up.

An interesting example of financial muscle is the purchase by Starwood Loading of two leading upscale international chains within a two-month period. In early September of 1997, Starwood purchased Westin Hotels and Resorts for just under \$1.6 billion. Then, in October, the company announced the purchase of ITT Sheraton for a price of \$14.6 billion.<sup>34</sup>

Almost overnight, Starwood jumped from being a minor player in the industry to becoming a Fortune 500 company with more than 700 hotels worldwide. The company included the well-known brands of Sheraton, Westin, W Hotels, the Luxury Connection, Four Points by Sheraton, as well as the top brand of St. Regis.<sup>35</sup>

One prominent acquisition that took place after September 11 was the acquisition of Candlewood Suites by InterContinental Hotels Group PLC. Candlewood Suites was the sixth brand in the InterContinental portfolio. Others, in addition to the InterContinental brand, include Holiday Inn, Holiday Inn Express, Crowne Plaza, and Staybridge Suites & Resorts. The acquisition positioned InterContinental in two tiers of the extended-stay hotel market. Staybridge Suites is in the upscale tier, with room rates that average about \$30 more per night than rooms at Candlewood.<sup>36</sup>

Cendant Hotel Group acquired the Baymont Inn and Suites brand and 115 franchised properties in April 2006. In July 2006, Cendant Corporation completed a spin-off of Realogy Corporation and Wyndham Worldwide Corporation. Cendant sold its Travelport subsidiary to The Blackstone Group. With those sales, Cendant consisted principally of its vehicle rental operations through the Avis and Budget Brands and renamed itself the Avis Budget Group. Wyndham Worldwide, one of the largest hotel companies in the world, was comprised of Wyndham Hotel Group, RCI Global Vacation Network Group, and Wyndham Vacation Ownership. Today, the Wyndham Hotel Group includes ten brands including Amerihost Inn, Baymont Inn & Suites, Days Inn, Howard Johnson, Knights Inn, Ramada, Super 8, Travelodge, Wingate Hotels & Resorts, and TripRewards.<sup>37</sup>

Although it may be appropriate to assume that the increase in the concentration of ownership of hotels is a result of the influx of capital and M&A activity, we need to realize that the industry still is highly competitive. Over 80 percent of the industry is still held privately. It does seem clear, however, that ownership in some areas of the industry, particularly in the upscale segments, has become somewhat more concentrated. It is unlikely, however, that the concentration is sufficient for any firm to exert market control (i.e., to control the price level).

## THE HAZARDS OF PUBLIC OWNERSHIP

A number of factors influence stock prices, but there is wide agreement that the most powerful influence is a company's earnings—or the prospect of earnings. For this reason, management in publicly held companies is under constant pressure not only to maintain but to increase earnings each quarter. In some cases, this pressure can encourage a short-term focus by managers. This relentless pressure has been characterized by an entrepreneur from the food service sector of the hospitality industry, Howard Schultz, founder and president of Starbucks:

Alongside the exhilaration of being a public company is the humbling realization, every quarter, every month, and every day, that you're a servant of the stock market. That perception changes the way you live, and you can never go back to being a simple business again. We began to report our sales monthly including comps—"comparable" growth of sales at stores that have been open at least a year. When there are surprises, the stock reacts instantly. I think comps are not the best measure to analyze and judge the success of Starbucks. For example, when lines get too long at one store, we'll occasionally open a second store nearby. Our customers appreciate the convenience and the shorter lines. But, if, as often happens, the new store cannibalizes sales from the older store, it shows up as lower comps, and Wall Street punishes us.<sup>38</sup>

Case History 11.1 describes the experience of Sam Barshop, founder of La Quinta Inns, as that publicly held company became the target of a takeover. There is a possibility, too, that having a significant portion of the industry in public hands, particularly those of REITs, where shareholder expectations are often focused on dividend yields, may pose some long-term problems to industry stability. As one knowledgeable observer put it:

Historically, the hotel business has been cyclical in nature and characterized by widely dispersed ownership operating with a long-term development outlook. Considering Wall Street's preoccupation with quarter-to-quarter growth and ever-increasing yields for shareholders, [the hotel business] would seem an unlikely choice [for public shareholders]. Whether these interesting times are ultimately viewed as a blessing or a curse will depend on how effectively our industry's leadership responds to Wall Street and its fickle ways. A heavily consolidated industry may, in the end, prove a curse if the industry overextends itself and falls out of favor with the investment community.<sup>39</sup>

## DIMENSIONS OF THE HOTEL INVESTMENT DECISION

The decision to invest in a hotel has at least three dimensions, involving financing, real estate values, and operations. Although all three are important, the weight each receives varies with the particular merits of an individual decision and with economic conditions. In the first half of the 1980s, financial and tax considerations often led to building hotels whose profitability was uncertain. A depressed real estate market played a very prominent role in the purchase of hotel properties in the early 1990s. The catastrophic events of 2001 certainly dealt the hospitality industry a severe blow with

## Going Public: Some Good News and Some Bad

In 1968, the first two La Quinta Inns were built by Barshop Motel Enterprises in San Antonio, Texas, to serve visitors to the 1968 World's Fair, HemisFair.<sup>1</sup> Although Sam Barshop had not intended to start a chain, the limited-service concept of La Quinta was so successful that he was approached by developers and investors, and soon his company began to expand. In 1973, in order to secure funds for expansion, the company went public. By 1978, ten years after the first inn opened, there were 56 inns in operation, with an occupancy rate of 90 percent. Another 19 inns were under construction. By the end of the 1980s, there were about 200 La Quinta Inns in operation.

In 1989, however, a Hong Kong firm, Industrial Equity, began to acquire shares of La Quinta, and by early 1990, it controlled 10 percent of the outstanding shares. Shortly thereafter, a second group of investors headed by two Texas financiers, the Bass brothers, began to acquire shares. In January 1991, La Quinta hired Goldman Sachs, a New York investment banking firm, to explore ways to “increase shareholder value”—including the sale of the company.

However, at that time, mergers and acquisitions activity was depressed, as were La Quinta's shares, by a recessionary stock market. La Quinta stock, which had been as high as \$26 per share, was selling in the \$11 to \$15 range, and a suitable buyer for the company could not be found. La Quinta's management spent an estimated \$2 million in fees to attorneys, management consultants, advisors, and investment bankers in its fight to retain control of the company. The company's operations and expansion were seriously compromised as executives spent time fending off what they saw as a hostile takeover bid.



A contemporary La Quinta Inn. (Courtesy of La Quinta Inns.)

In June 1991, an accommodation between La Quinta's management and the dissident shareholders was reached. Five members of La Quinta's 11-person board were asked to resign, and new directors representing the Bass-led group (which by then owned 14.9 percent of the company's shares) were elected in their place. Barshop's supporters on the board retained five seats, and the eleventh seat on the board went unfilled. Working with the new board, the consulting firm of McKinsey & Company conducted a three-month management study of La Quinta. As a result, the company was restructured, reducing its workforce by 72 people, 50 of whom were at the corporate offices. The company also took a \$7.95 million restructuring charge, including \$3.94 million for severances. At that time and shortly thereafter, several senior executives resigned. Then, in March 1992, Barshop turned over the presidency of the company to a former executive vice president of Motel 6, remaining as chairman of the board for another two years until he resigned in March 1994.

In June 1991, at the time of the first compromise with the Bass-led group, Barshop had these comments on being a publicly held company:

There are a lot of advantages to not being a public company. You're not responsible to the Securities and Exchange Commission or a large number of shareholders. You run your own business. You can focus on cash flow rather than earnings per share. . . . It's been stressful. Business isn't as much fun as it used to be. I've never dealt with anything like this before. Things aren't done the way they used to be. I've learned more about proxies than I ever wanted to know. It's been an interesting experience. But I hope it's a one-time experience.<sup>2</sup>

Barshop ultimately lost control of his company, a company that by that time had 220 inns in 29 states. He sold 80 percent of his shares for \$17.4 million and was paid something on the order of a million dollars during the last two years he served as chairman. Finally, we should note that he will go down in hospitality history as the man who invented the limited-service hotel.

1. This note is based, except as noted, on news stories reported in the *San Antonio Express News*, the *San Antonio Light*, and the *San Antonio Business Journal*, between January 1990 and March 1994; the June 1988 issue of *Innput*, an employee publication of La Quinta; and public statements by La Quinta Inns to its employees and the press. I would like to thank Mary Starling, secretary to Sam Barshop, for her assistance with the preparation of this note.

2. R. Michelle Brewer, "The Private Woes of Going Public," *San Antonio Light*, June 16, 1991, pp. A1-A2.  
Update on LaQuinta Inn:

LQ Management LLC is one of the largest operators of limited-service hotels in the United States. The company operates and provides franchise services to more than 750 hotels in 45 states and Canada under the La Quinta Inn® and La Quinta Inn & Suites® brands. Its corporate headquarters is in Irving, Texas, near Dallas. For more information on this brand, visit [www.lq.com](http://www.lq.com)

a recovery that continued for several years. The recession starting in 2007 made limited investment sources severely. Those of us whose chosen vocation is operations—running a hotel—need to be reminded that our own set of interests is only one leg of the hotel tripod.

## FINANCIAL

As we have noted previously, hotels are capital-intensive. Because most of the capital used in building a hotel—or buying one—is borrowed, it is not surprising that interest rates, availability of capital, taxation, and, in the international environment, exchange rates are all important considerations.

**INTEREST RATES, INFLATION, AND LEVERAGE.** One of the reasons given for the popularity of hotel investments in the latter half of the 1990s was unusually low interest rates. When there are fears of inflation, hotels have been seen as a good **inflation hedge**. Although the value of money decreases in inflationary periods, the value of hotel assets often increases enough to offset inflation and perhaps show a gain, even after deducting interest costs.

**Leverage** refers to the ability to invest some of your own capital and do most of the deal with borrowed capital. With \$1,000 of debt attracting, say, \$4,000 of mortgage money, the \$1,000 of equity is able to earn the profits, after fixed interest payments, provided by the full \$5,000. The debt is said to leverage earnings because all of the profit after interest charges goes to the owners. When times are good and profits are high, leverage is looked on very favorably. When profits fall, however, interest charges do not—and so leverage cuts two ways.

**TAXES.** As noted earlier, the U.S. tax laws of the early 1980s encouraged the construction of hotels by offering special tax credits that meant investors sometimes could make money on the project even if the hotel was not profitable.

Although those artificial inducements to construction are gone, the deductibility of interest on loans still constitutes a tax advantage. Take, for example, one corporation that paid interest of 9.2 percent on its debt; after paying taxes of about 40 percent, the cost of the loan, after taxes, was only 5.6 percent.<sup>40</sup> The tax saving arises because although all of the interest must be paid, some 40 percent of it in this example is balanced by a reduction in income tax. In a capital-intensive business such as hotels, this can lend an advantage to borrowers.

## AN OPERATING BUSINESS

The hotel's profitable operation is often the first dimension of a hotel deal that students of hotel management consider. As we have just noted, however, hotel

companies—and other developers—have significant business interests outside of operations in both development and franchising of hotels. This does not mean they are uninterested in operations, however. In fact, Marriott requires the buyer to sign a **management contract** on hotels it develops so that Marriott retains the right to control the operation's quality and to profit from the management of the property while expanding the chain.

## SEGMENTATION: FOR GUESTS OR DEVELOPERS?

Much of the development of varied **product segments**—economy, all-suites, executive floors, superluxury—can be related to specific market segments. For example, economy segments are aimed at rate-conscious consumer groups such as retirees. (Days Inn reports that a significant proportion of its guests are seniors.) Residence Inns has a clearly targeted segment in mind, as do other extended-stay properties, and full-service hotels' upscale range of products, from executive floors to superluxury, is for the expense-account market and the wealthy traveler. Transient all-suite hotels target upper-level executives on weekdays and upper-middle-income families on weekends. Segmentation certainly meets guest needs.

We have noted, however, that many hotel companies are real estate developers, and a strategy of segmentation has also met their business needs as developers. Having several brands that appeal to different consumers permits hotel companies to put more than one hotel in a market. Thus, if Hilton had an Embassy Suites in a city, it could still quite legitimately develop its other brands for other segments—a Hampton Inn for the limited-service market and a Homewood Suites for extended-stay guests. This strategy helps sell hotels and franchises to investors as well as rooms to guests. Although the company's brands are not generally competitive with each other, there is, inevitably, a degree of overlap. It is not as clear, however, that all such development is noncompetitive, particularly when the economy is poor and price reductions are common across segments.

From an ethical point of view, there is nothing even faintly questionable about a company's developing two hotels that will compete with each other. The franchisor is in the business of selling franchises, the franchisee wants to invest in a property, and a developer needs a property to round out a project. Each pursues his or her own interest in an informed way. The resulting increase in competition is a business risk that should surprise no one. Nevertheless, such practices have led to serious problems between franchisors and franchisees.

**ENCROACHMENT.** In the franchise business, the practice of loading additional franchisees into the same market with one or more existing franchisees is called **encroachment**.



Segmentation strategy in the lodging industry seeks to develop a product for a specific customer segment, but it also gives the hotel company another brand with which to expand. (TownePlace Suites, Courtesy of Marriott International.)

The new franchisee is seen as encroaching on the market area of the existing franchisee. (In the hotel business, encroachment is often referred to as *impact*. The sales and profits of the existing franchisee are said to be unfavorably impacted.) Encroachment has been a significant problem in the past for some companies. Specifically, the problem becomes very clear when the additional property has the same brand name and shares the same reservation service. The problem is only slightly less difficult where the brand name is different but the market segment and reservation service are the same. An example is Choice Hotels' Rodeway Inn and EconoLodge properties. Where impact is serious, the property affected suffers a loss in occupancy and average rate. Although encroachment is difficult to prove in a court of law, it has been the frequent subject of negotiation for franchisees, who have often gained concessions in franchise fees to offset the impact of a new property.<sup>41</sup>

As a result of growing problems with encroachment, it is unlikely that any franchise would be written today without specific geographic protection. Michael Levin, when he was president of the Americas Division of Holiday Inn Worldwide, predicted that, in the future, arbitration will be used whenever a new franchise is granted in an area, even before any dispute arises.<sup>42</sup>

## MANAGEMENT COMPANIES

The arrangement between the **management company** and the hotel owner, a management contract, is described by Professor James Eyester of the Cornell Hotel School:

A management contract is a written agreement between a hotel owner and operator in which the owner employs the operator as an agent [employee] to assume full operational responsibility for the property and to manage the property in a professional manner. As an agent, the operator pays in the name of the owner, all property operating expenses from the cash flow generated from the operation; it retains its management fees, and remits the remaining cash flow, if any, to the owner. The owner provides the hotel property to include land, building, furniture and fixtures, equipment, and working capital and assumes full legal and financial responsibility for the project.<sup>43</sup>

The first management company may have been the Caesar Ritz Group. At the end of the nineteenth century, Caesar Ritz, with his famous chef, Escoffier, was “paid a retainer to appoint and oversee the managers of separately owned hotels. That arrangement allowed the hotel to advertise itself as a Ritz hotel.”<sup>44</sup> The first U.S. hotel management company was the Treadway Hotel Company, which began operating small college inns in the 1920s.<sup>45</sup> During the 1930s, the American Hotel Corporation managed bankrupt hotels, but as late as 1970, only three or four management companies were in operation in the United States.

In the 1970s and 1980s, as the number of hotels expanded rapidly, much of the development was undertaken by people whose abilities and experience lay in finance and real estate rather than in hotel operations. To manage the hotels developed by these nonoperator owners, the number of hotel management companies expanded rapidly.

There are two kinds of management companies. First, most chain organizations, such as Hilton or Marriott, serve as management companies for hotels under their franchises. Chains dominate the management contract field for properties with more than 300 rooms. Chains require a substantial minimum fee just to defray their central office overhead. They have difficulty in working with smaller properties that don't generate enough revenue to cover the minimum fee. Accordingly, the second type, which is comprised of smaller management companies, has an advantage in the under-300-room category. Independent management companies are able to operate smaller properties, often under different franchises. They offer owners more control over daily operations and more flexibility in contract terms.

Typically, a management contract fee is based on a modest percentage of sales and a larger percentage of gross operating profit. Management companies enjoyed their greatest growth following the boom in hotel construction in the 1980s when they assumed the management of distressed properties. Under those circumstances, contracts were short term and involved little, if any, ownership interest in the hotel on the part of the management companies. In contrast, contracts being written today may require some form of equity or debt participation in the financing of the property by the management company.<sup>46</sup>



After the economic challenges starting in 2001 and again in 2008 with the strained economy, some hotel owners challenged contractual terms of management agreements. Contracts with management companies tend to be long term, lasting as long as 20 years. One of the most publicized cases initiated in 2002 involved a legal battle between the owners of a Charleston, West Virginia, Marriott and the management company, Marriott International. The hotel owners charged that Marriott had defrauded them by hiding rebates received from vendors and wrongly allocated corporate overhead to the hotel. The settlement, coming a year later, included Marriott agreeing to lend the owners \$1 million to upgrade guest rooms at the hotel and pledging \$2 million toward the development of another of the owners' hotel projects. Parts of the contract were also renegotiated in exchange for the owners extending the contract an additional ten years.<sup>47</sup>

Independent management companies offer several advantages to those starting a career in the hotel business. The company with a successful track record will have experienced and knowledgeable people in its senior ranks. Working with such well-qualified and broadly experienced managers can be an education in itself. Moreover, a larger company will probably have properties of varying sizes and franchise affiliations and thus offer both opportunities for career progression from smaller to larger properties and a broad variety of experiences.

With any company you are considering, it is a good idea to inquire about its reputation before signing on in a responsible position. And again, as with any company, a good way to get to know a prospective long-term employer is through employment in the summer or part-time during the school year.

## ASSET MANAGEMENT

**Asset managers** and management companies are two distinct entities, but both work together for the benefit of the hotel owner. The management company, as described in the previous section, handles the day-to-day operation of the hotel, from hiring and supervising staff, to negotiating contracts with suppliers, to planning menus and determining marketing strategies. The asset manager acts as the “eyes and ears” of the owner. In bridging the gap between the owner and the management company, the asset manager delivers regular reports to the owner. Specifically, the asset manager would be involved with the management company regarding the budget, reviewing the franchise contract, inspecting the property and franchise requirements, and analyzing cash flow. The asset manager can also benefit the management company by helping with the communication process, helping evaluate the management company, and pointing out to the owner when the management company is doing a good job. It is estimated that more than half of upscale hotels and resorts in the United States currently use some form of asset management. This figure is double that of five years ago. Although the

use of asset management companies has been stimulated by a challenging economy, it is thought that their use will continue to increase even in better economic times.<sup>48</sup>

## ENTREPRENEURIAL OPPORTUNITIES

We should pause here to note the significance of the management company's function for those who want to have ownership interest in a hotel. Management companies serve a need for mortgage holders and developers that can also be filled by individuals. Those individuals who, through education and experience, prepare themselves to manage a hotel can regard a time of economic reverses for the industry as a time of opportunity for themselves. In particular, with locally financed (i.e., mortgaged) properties that get into trouble, occasionally there is a real opportunity to secure an ownership position in return for assuming an existing mortgage. This kind of opportunity is more likely to occur with older properties, and so the importance of a good food background—in order to merchandise the property—is clear.

### SUMMARY

**W**e have repeatedly made the point in this chapter that lodging is capital intensive and cyclical. Because of long lead times, supply often continues to grow even after demand has stopped growing or begun to decrease. As a result, in the 11 years ending in 1993, the lodging industry lost \$33 billion while construction continued throughout the period. In 1997, however, hotel profits were once again at a peak.

Securitization is selling an ownership or a debt instrument (such as a bond) in a property through the public security markets. Major developments have included the widening of lodging's access to debt through CMBSs, to equity through IPOs and secondary offerings, and to both equity and debt through REITs. An additional form of financing has involved the public funding through a special tax. The impact of securitization has been to enable a considerable boom in hotel building. Although securitization brings advantages in the availability of capital, it also has the inherent risks associated with a falling stock market.

The hotel investment decision has three dimensions: financial, real estate, and operating. The large amount of debt associated with hotel construction gives leverage, and in the international market, changing currency values can also provide financial advantages. Low interest rates are especially advantageous to leveraged deals. Hotel real estate can provide an inflation hedge, and the speed with which hotel rates can be raised provides flexibility in rentals rates few other forms of real estate offer. Real estate development also offers profits to development companies, including hotel companies

such as Marriott, which are active developers. A final means of profiting from a hotel is from its day-to-day operations, although contrary to popular opinion this is not always the largest source of profit.

The tendency toward overbuilding in a cyclical industry is sometimes exaggerated by the segmentation strategies of major hotel companies. Segmentation can lead to a multibrand hotel company seeking to build one of each of its brands in a market. In some cases, the company may feel that being represented in a major market is more important than the short-run profit potential. Building multiple brands can also lead to problems of encroachment where the same reservation network is divided between two or more properties, and in many cases, multiple properties with the same brand in a market can reduce the advantage of a franchise. Management companies have grown up to serve nonoperator owners. In difficult economic times, the services of these companies are especially in demand as lenders become “involuntary owners.” These same difficult times, however, often offer those with operating know-how major entrepreneurial opportunities.

## Key Words and Concepts

**Capital intensive**

**Revenue per available rooms  
(RevPAR)**

**Securitization**

**Commercial mortgage-backed  
securities (CMBs)**

**Real estate investment trusts  
(REITs)**

**Conduit lenders**

**Mezzanine financing**

**Gap financing**

**Initial public offerings (IPOs)**

**C corps**

**Inflation hedge**

**Leverage**

**Management contract**

**Product segments**

**Encroachment**

**Management company**

**Asset managers**

## Review Questions

1. How does the hotel business react to the business cycle? Explain why hotel building continues after demand turns down.
2. What does *securitization* mean? How is it affecting the hotel business?
3. What have been the major effects of securitization on competitive conditions in lodging?
4. What do the acronyms CMBS, REIT, C corps, and IPO stand for? Describe the role of each as they pertain to the lodging industry.

5. What is mezzanine financing, and what are some of its advantages?
6. What are the hazards of public ownership?
7. What is RevPAR, and what can positively or negatively impact it?
8. What are the main elements of a hotel investment decision?
9. Has segmentation contributed to encroachment? What are the effects of encroachment?
10. Why did hotel management companies come into existence?
11. What is the importance of asset management to lodging owners?

## Internet Exercises

1. **Site name:** Hotel Online

**URL:** [www.hotel-online.com](http://www.hotel-online.com)

**Background information:** Hotel Online is the hospitality industry's online meeting place, providing the latest and most relevant news, trends, discussion forums, employment opportunities, classified advertising, and product pricing available anywhere.

**Site name:** Lodging Econometrics

**URL:** [lodging-econometrics.com](http://lodging-econometrics.com)

**Background information:** Lodging Econometrics is a recognized authority on all hotel real estate, including the development pipeline and the sale and transfer of lodging real estate nationwide. It also compiles and maintains the Industry's Census of Open and Operating Hotels, which includes the names of owners and management for more than 60,000 hotels in the United States and Canada.

**Exercises:**

- a. Find and discuss at least two trends that are occurring in the hotel industry as defined by the consultants on this Web site: [lodging-econometrics.com](http://lodging-econometrics.com)
- b. Based on the news articles from Hotel Online, along with your current readings in the newspaper, textbooks, blogs, and so on, discuss a trend you believe is impacting the hotel industry and indicate why you think it is important.

2. **Site name:** Starwood Hotels & Resorts Worldwide, Inc.

**URL:** [www.starwood.com](http://www.starwood.com)

**Background information:** Starwood Hotels & Resorts Worldwide, Inc. is one of the leading hotel and leisure companies in the world with approximately 960 properties in more than 100 countries and 145,000 employees at its owned and managed properties. Starwood Hotels is a fully integrated owner, operator, and franchisor of hotels and resorts.

**Site name:** Host Hotels and Resorts

**URL:** [www.hosthotels.com](http://www.hosthotels.com)

**Background information:** The vision of Host Hotels and Resorts is to be the premier lodging real estate company. Its focus is the acquisition of high-quality lodging assets in prime urban and resort locations that have the potential for significant capital appreciation.

**Site name:** FelCor Lodging Trust

**URL:** [www.felcor.com](http://www.felcor.com)

**Background information:** FelCor is one of the nation's largest hotel real estate investment trusts and the owner of the largest number of upscale, all-suite hotels in the nation. FelCor's consolidated portfolio is comprised of 87 hotels, located in 23 states and Canada.

**Exercises:**

- a. Browse through the Web sites for the three REITs. What are the similarities and differences among them?
- b. Who is the target market for each REIT?
- c. What hotels and resorts are in the portfolio for each REIT?
- d. Which of the above REITs is/are considered a "paper clip REIT"? How does it differ from a standard REIT?

**3. Site name:** HVS

**URL:** [www.hvs.com](http://www.hvs.com)

**Background information:** HVS provides hotel, motel, and resort management; consulting services; oversight and asset management; receivership services; and technical and reopening services in all areas of the hospitality industry.

**Site name:** American Property Management Corp. (APMC)

**URL:** [www.americanpropertymanagementcorp.com](http://www.americanpropertymanagementcorp.com)

**Background information:** APMC is an opportunistic-focused lodging company, based in San Diego, California. Ranked by *Hotel Business* magazine as the seventeenth largest hotel owner in the United States, APMC is a growing leader in the hospitality industry. The company's 30 hotels and resorts are located from coast to coast.

**4. Site name:** Kevin Regan's Testimony before the Committee on Homeland Security and Governmental Affairs

**URL:** [hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=9f505192-a70d-4105-b814-1c0ed11715f8](http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=9f505192-a70d-4105-b814-1c0ed11715f8)

**Background information:** Testimony of Kevin T. Regan, Regional Vice President of Operations, Southeastern United States and Caribbean, Starwood Hotels & Resorts Worldwide, Inc., before the Committee on Homeland Security and Governmental Affairs United States Senate, Hearing November 16, 2005, "Hurricane Katrina: What Can Government Learn from the Private Sector's Response?"

**Exercises:** Read the entire transcript of Mr. Regan’s testimony. Mr. Regan emphasizes throughout his presentation that the keys to successful crisis management are planning, leadership, teamwork, and communication.

- a. Describe how these four components were evident throughout the description of how Starwood managed the crisis caused by Hurricane Katrina.
- b. What lessons can hotel managers learned from his testimony?
- c. Lead a class discussion on the importance of training staff for crisis situations, whether they are the result of a severe storm, earthquake, terrorist activity, or fire.

## Notes

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