All Eyes on The Luxury Sector

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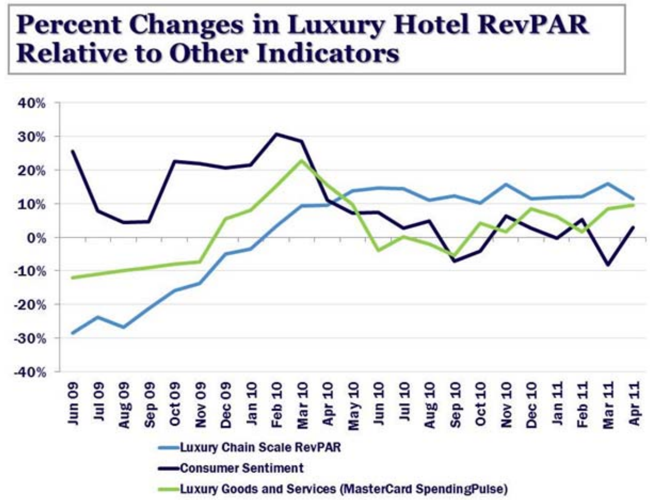
Smith Travel Research recently postulated that the bulk of the US hotels are drafting behind the luxury chain-scale hotels. Can luxury continue to lead the way? If other forms of luxury purchases and travel are any indication, there is still runway for the luxury hotel segment. Sagging home prices and escalating gas prices may undermine consumer confidence, but they appear to have no correlation to luxury hotel revenue per available room ("RevPAR") growth.



The Luxury Goods Bounce

Two years ago, the domestic luxury market was widely believed to have shrunk permanently. The credit-fueled forays by the aspirational shoppers stopped. Frugality was "in" so even the super-rich eschewed conspicuous consumption. Even the vaunted Neiman Marcus re-tooled its merchandise offerings to provide less extravagant alternatives.

After unloading excess inventory and closing stores, luxury retailers were able to walk away from discounting in early 2010.

- In late February 2010, Tiffany & Co had raised its prices for the first time in two years.
- Saks, a self-admitted "poster child for discounting," attributed its rebounding first quarter profitability to "full-price selling."
- After having re-mixed its merchandise for a more value-conscious (but still rich) consumer, the CFO of Neiman Marcus observed that "some of the hottest things we're selling are at the very upper, upper end of our price range."

The Great Recession did not, as The Wall Street Journal forecast, usher in "an age of belt-tightening and less conspicuous consumption." It only temporarily slowed the freight train of luxury goods spending.

Luxury travel commenced a comeback in early 2010, at the same time as the retail resurgence. Carriage trade travel agents surveyed for Virtuoso's January 2010 travel forecast reported rebounding demand.

- 81 percent said their future bookings were up over the same time last year
- 80 percent said sales were up over the prior three months period reference?

Hotels have seen this booking activity translate into increased room night demand. Since April 2010 luxury hotel RevPAR has grown in the 10 to 15 percent range, which was achieved mainly through occupancy growth.

Travel Industry Parallels

The Virtuoso agents surveyed for the January 2011 forecast reported that 2010 agency sales were up a whopping 36 percent over 2009. The rich are back and buoying airline revenues though higher demand for first-class and business-class seats.

And, airlines moved prices up mightily. American Express Business Travel reports that the average business-class airfare increased 39 percent during 2010. If there were a material pricing backlash from the luxury flyer, complimentary upgrades would be easier to come by.

But, lacking the ability to economically mothball excess inventory and re-price, luxury hotel operators didn't begin to push pricing into positive territory until May 2010, and pricing improvements have been in the single digits.

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Though luxury properties have been winning the year-over-year improvement derby, they are still off considerably from prior highs. As The Wall Street Journal pointed out, first quarter 2011 luxury hotel RevPAR is still down 15.7 percent from first quarter 2007.

By way of contrast, premium air travel is down only ten percent from its pre-recession high. They didn't wait for demand to fully recover to drive double-digit price increases. What, then, is driving the more tepid response by luxury hotels: supply and demand… or fear?

What about Gas Prices?

Fuel-cost driven increases in airline ticket prices are having an effect on airline travel: the pace of growth is slowing. In March revenue-passenger-miles flown increased 3.7 percent across North America.

After reviewing the airline's first quarter performance, Morningstar's airline analyst observed that "Revenue was up nicely, led mostly by higher ticket prices, while surging fuel costs erased almost all of the profitability."

In March, available-seat-miles increased 9.9 percent across North America, so the recent fuel-driven announcements regarding capacity reductions of 1.0 and 2.0 percent are not overly disturbing.

The Air Transport Association (IATA) reports much less price sensitivity among premium travelers. World-wide premium travel grew by 7.7 percent in February, as compared to 8.8 percent in January. Economy travel grew by 4.9 percent in January, but only by 3.3 percent in February.

That same imperviousness is likely to manifest in juggling spending to accommodate increased gas pricing. The American Automobile Association estimates that the average American buys approximately 533 gallons of gas each year. The difference between $2.50 per gallon and $5.00 per gallon gas is $1,300 per year, which is a lot of disposable income for someone earning $50,000 a year… but it's only cocktail chatter for someone earning $500,000 a year.

Success Stories in Counter-Intuitive Pricing

Economists have long theorized that there is negative price elasticity in luxury goods; that is, if the price declines, the appeal declines also.

The two luxury leather goods brands that fared the best during the recession actually raised prices and logo visibility. Marketing professors at the University of Southern California's Marshall School of Business studied trends in luxury handbags and observed that "those who are still in the market for luxury goods still like the 'loud' products and are willing to pay a hefty sum for them." Their research shows that both Gucci and Louis Vuitton reduced their selection of handbag offerings between January 2008 and May 2009 to achieve manufacturing efficiencies, but held or increased pricing. And, in spite of the concerns about conspicuous consumption, both increased the prominence of the logos on the new items introduced to the US market. Both retailers held or increased pricing.

- Gucci's retained products were increased an average of 0.5 percent but the new, louder items were priced an average of 16.7 percent over the average of the discontinued items.
- For Louis Vuitton, the retained products were priced 12 percent higher, and the average price of a new item was 47.7 percent higher than the average for discontinued items.

The luxury hotel take-away? One may be to figure out a way to tastefully bestow bragging rights for customers who can afford your product.

The Feel Good Business

Skeptics of the handbag research findings would do well to remember an anecdote told by Bud Konheim, Co-founder and Chief Executive Officer of Nicole Miller.

> *"My Uncle Louis got rich during the Depression. He was in the hat business. Why did he get rich? Because for women, hats were a feel good thing…In times of tough business conditions, everybody said the reason behind them was 'price, price, price' and everything should be 'cheap, cheap, cheap.' Tell me something, what business do you think we're in? You think we're in the cheap business? No, we're in the feel good business."*

Price like it's 2007

There is no reason to believe that consumer behavior changes materially between luxury goods or premium airline purchases and hotel room purchases. Demand for both is being sustained.

Luxury leisure travel is back, business travel is back, group meeting budgets are up, and incentive travel is resurging.

Increasing luxury hotel rates may trigger modest, temporary declines in occupancy, but these will be driven mainly by the marginally profitable guest. The experience will be enhanced for the true luxury traveler and margin improvements will likely offset volume declines. Most important – the inherent value of the product will be reasserted.

Most telling? Wall Street bonuses are back and as big as ever. Price luxury hotels like it's 2007.

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About Warnick + Company

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