Challenges Have Only Just Begun For Hotel Owners and Operators

By Rick Swig

THE MIDYEAR 2010 MARKET REPORTS FOR HOTEL performance are in, and the picture is not pretty. Blame and denial for declines in valuations and operating performance are rampant, but those tactics will provide no solutions to existing issues. The bottom line is that the hotel business segment has gone through a gigantic reset. Valuations do not relate at all to construction costs, expense and revenue growth are not in balance, customer buying habits have permanently changed and the availability of the most lucrative customer segments has diminished demand compression.

It may be perverse, but the big winners may have been hotel owners, who unknowingly sold their hotels in return for cash yielded from high leverage refinancing between 2005 and 2007, even though those same owners may now be facing foreclosure. Then, they were actually paid more for their hotels than those same hotels are worth now.

Hotel operators have done little to help their own cause. In denial of their miscues of the early 2000s, many operators have given over control of guestroom inventory to third party online travel agents, who not only demand deep discount pricing, but then further command commissions or fees of up to 25% for special promotions with prime positioning.

Even though it maybe sound rational for an operator to poach market share with price incentives during equally low demand and compression periods, it's tragic when they offer discount rates to conventioneers who opt out of their pre-negotiated room rate block to buy down to a lower rate in the same hotel. It's no wonder that hotels cannot return an adequate profit to their owners, and it questions the wisdom of expensive revenue-management system investments made by hotel operators with their owner's money.

The only real solution to hotel business woes is demand compression, which would tip the supply/demand balance in favor of hotel operators. Compression will not return, however, until the most lucrative customer segments, commercial transients and meeting groups, return. Until then, reliance on business traveler scraps and price-driven leisure travel will continue to yield frustration for any hint of revenue and profit growth.

And when will compression return? Just look to the unemployment statistics and job growth. Significant compression growth will be visible only about six months after any three-month period of consistent private-sector job growth. That is when companies will redeploy travel and meetings activities.

Owners are either in survival or transition mode. The focus of hotel ownership has moved away from retail profitability to financial engineering to enable continued ownership. Some owners are managing by continuing to pay debt even though other loan covenants are not being met, while some have negotiated debt relief through pay downs and other balance sheet horse-trading. Of course, there are those who are expecting or have already realized the pain of the loan executioner's sword.

Owners are either in survival or transition mode. The focus of hotel ownership has moved away from retail profitability to financial engineering to enable continued ownership.

Ironically, the worst possible owner is probably a lender, special servicer or other like party without real hotel experience. As most have shortcut their takeover activities by not engaging professional advisors, these "tweener" owners will be taking over assets without anticipating the effects of survival-mode predecessor owners who milked their assets dry.

As a result, should it really be surprising that the next wave of owners should expect to pay lower-than-historical prices for transitioning assets? At this moment there are hotel assets selling for unexpectedly high multiples of NOI and transaction-starved buyers who for some reason can rationalize 20 times or more multiples of NOI for an acquisition. This is even in the face of at least one or two more years of unexciting operating performance. Whether these aggressive buyers are superstars for their clairvoyance or suckers will ultimately be recognized. Inevitably, there may be more properties in need of transition than there will be buyers, so the valuation re-set should be realized.

By some estimates, there was a 90% reduction in hotel asset transactions in 2009, as owners were not ready to accept reduced values, debt was not available or potential buyers were spooked by the sick health of the hotel sector. Lender and owner balance-sheet issues, debt-covenant compliance, cash shortages and even owner fatigue are now forcing more properties to be made available for sale. Regardless of whether these are the deals of the century, successor owners will be challenged with the residue of aforementioned operator protocols, the hazy timing for the return of demand compression and physical buildings with expensive product improvement deferrals. ◆

Rick Swig is president of RSBA & Associates, a hospitality industry consulting firm based in San Francisco. He may be contacted at rickswig@rsbaswig.com. The views expressed here are the author's own.