By Rick Swig

Shortage of Sites, Rising Expenses Should Keep Development in Check

THE HOTEL BUSINESS IS WELL AGAIN. THE LAST SIX months of 2005 indicated strong performance in most markets throughout the country, and hotel owners and managers should enjoy greater growth in 2006. Additionally, previous supply excesses have now been absorbed. This should stimulate room rate growth as developers will try to bring more hotel rooms to the market.

In terms of development, this industry has never gotten the process right in the past, so the odds are good that there will once again be an oversupply of guestrooms. Before supply abuses can occur, however, developers will have to overcome several critical hurdles.

Location is still the most important component of new development. It has been proven that any hotel that is not located near primary demand generators will not prosper.

Competition has sent land costs skyrocketing, and when added to the cost of construction, the potential for return becomes difficult.

Currently, potential urban hotel locations are fewer and farther between, if only due to other real estate segments that are competing for the same sites. In resort locations, there is both the competition from other segments and regulation related to land usages, environmental protection and density.

All of this competition for location has sent land costs skyrocketing, and when these expenses are added to the cost of construction, the potential for a good investment return becomes even more difficult.

The disastrous hurricane season of 2005, which left the coastal areas of the Southeastern and Southwestern US in tatters, only brought more focus on the fact that China is gobbling up all of the world's construction materials. Additionally, anyone developing a building of substantial size has quickly realized that cost and availability of cement and steel are equal issues.

The Katrina disaster has put further stress on both building materials and human capital. The requirements to rebuild the city of New Orleans, much less the entire Gulf Coast, will certainly create competition for these valuable resources. Although beneficial for some regional economies and residents of these areas, these events will surely place a financial premium on hotel and other real estate development in other parts of the country.

Hotel development and supply expansion may be hampered by the lack of available brand affiliations. Although there is no shortage of flags, there is a shortage of brand products with geographical critical mass and customer loyalty. Loyalty carries the most importance, since customers seek value beyond a good room rate and a free breakfast. Hotel products unfortunately resemble commodities due to their generic designs or their emphasis on pricing, so the differentiator has in many cases become the guest recognition program. The program's success is based on the ability of the customer to actually use his or her rewards. The business road warrior collects his or her frequent guest points as one of the few satisfactions of being on the road a hundred or more days a year. Their prize, in the form of room nights in their favorite resort location, is a real employment benefit.

This ties back to hotel development, since it seems that the brands with the most guest-recognition program power are also the ones with the greatest geographic distribution and density, which may mean that they are reaching saturation points within many markets. As a result, they may have difficulty expanding further into some markets without breaching existing contract covenants of geographic restriction.

As developers and equity sources continue to seek out major brands with the most powerful guest-recognition programs, these brands will have to discover methods of diversification to soften the blow on their existing unit owners. Whether this will come in the form of new sub-brands or the continued merger and acquisition of existing brands remains to be seen.

Based on these conditions, current hotel owners are the happiest investors, because their existing and well-performing hotels are valued at far less than replacement cost. This creates significant barriers to entry for new supply and provides owners of existing hotels a nice profit. ◆

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