How to prepare for slower growth in 2018

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Opinions

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Signs indicate rate and RevPAR growth won’t be as strong as in past years, so hoteliers need to consider different ways to cut costs and push profits.

By Gary Isenberg

By all accounts, hoteliers enjoyed a very profitable 2017.

Revenue per available room rose a healthy 3% to $83 as of October, according to data from STR (parent company of HNN). Other leading indicators rose skyward as well, with demand up 2.6%, average daily rate rising 2.2% to $126; and revenue climbing 4.5% to $115 billion. So, the industry is set for smooth sailing in 2018, right? Well, maybe not. Along with persistent uncertainty over global geopolitics, predictions for 2018 hint the next 12 months will be good, but not exactly great.

Occupancy, according to STR, rose a scant 0.8%, compared to a 1.8% supply upswing in 2017. And for the first quarter, STR forecasts an occupancy drop of 0.3% to (a still healthy) 60.9%, while RevPAR and ADR will increase, although not to the levels charted in 2017. ADR is projected to advance 1.9% to $126.79, with RevPAR rising 1.7% to $77.21. (To be fair, other industry analysts, such as PwC and CBRE have forecasted higher percentage increases for occupancy, ADR, and RevPAR in Q1.) Even the experts are divided on where the industry is headed this year.

Larger hotels sell

As the lodging market thrived in 2017, so did new development and sales. LW Hospitality Advisors recently compiled its year-end 2017 U.S. Hotel Sales Survey, calculating a 2% jump in the supply pipeline, which matches the level of demand. There were 182 single-asset sale transactions last year, each worth more than $10 million. Roughly 51,000 hotel rooms sold for an average per-key price of $267,000, resulting in a total transaction volume of $13.6 billion.

Last year surpassed 2016 when 173 hotels changed hands for a total of $12.7 billion. The per-key price, however, declined from $300,000 in 2016 for the 42,400 rooms traded. These comparative numbers imply 2016 and 2017 were similar in terms of sales, except for the fact larger hotels with a higher number of rooms sold in 2017.

Downturn ahead?
Predictions of slightly less robust fundaments doesn't mean the lodging industry is on track for a sudden and precipitous decline. Quite the opposite—hoteliers will continue to see growth, but perhaps not at the fevered pace of the past few quarters.

That's because our industry is cyclical and downturns are inevitable. The cycle always resets at some point. What a downturn will look like (a deep drop or just lagging growth?) we don't know at this time. Or maybe we're experiencing a slowdown now in comparison to previous quarters and have yet to recognize its full effect. The recent up cycle may slowly be nearing its end.

Further overshadowing the industry is the possibility of a geopolitical event like a war in North Korea or a domestic economic meltdown. Uncertainty and conflict have never been good for the lodging industry. Anytime there was a "black swan" event between 1999 and 2015 such as 9/11 or the housing and banking collapse, RevPAR's upward trajectory quickly reversed, sometimes for as long as 24 months.

Thanks to a strong U.S. economy in 2017, demand and occupancy have strengthened. And as long as the stock market remains robust and GDP expands, business travelers will continue to sustain our industry, as will people having enough cash to take vacations. Yet rate growth appears to be waning, and that puts downward pressure on pricing. So even if no world crisis or domestic economic crash occurs, the lodging industry likely faces moderate net operating income growth in the year ahead as ADRs stay stuck in neutral or experience only middling increases.

While hoteliers hope the recently enacted tax overhaul will be a boon for the industry, the implications of the tax law have yet to play out. While it promises to stimulate economic growth, a new tax code might—or might not—have a positive effect on our industry. We don't know at this time. The tax reform act of 1987 crippled the real estate industry—and hospitality real estate—for several years. Although the changes instituted then are different from those made late last year, no one can predict with certainty what the ultimate impact of a new tax law will have on the lodging business.

'Upside down' market
This year will have "upside down" markets, meaning the major urban hubs that led the industry in recent years might recede a bit. Markets like New York, Miami and San Francisco, where developers rushed in to put up new supply to match rising demand, might be unable to push rates upward as the surge in new supply impedes pricing power.

New York City, for example, was able to absorb new supply after running average annual occupancy rates nearing 90%. But as those fresh rooms hit the market, Manhattan hoteliers no longer possess the leverage to raise rates as they once did. Statistics from STR show the fading luster of those major cities: New York City, San Francisco and Miami registered RevPAR drops of 0.3%, 3.4% and 2.5%, respectively.

Again, this trend doesn't portend an industry-wide slump. Overtaking those major cities will be suburban, secondary and tertiary markets, especially if the new tax law drives manufacturing and job creation in those areas. This year, demand and occupancy growth shifts to those less glitzy towns.

Time to prepare

A period of potentially dimmer growth shouldn't drive hotel operators into a state of despair. Rather, it provides a perfect opportunity for hoteliers to tighten expenses that may have gotten a bit too high during the good times. Better to do it now than when a true downturn hits. Here are a few areas where hoteliers can streamline operations and raise revenues as the market slightly decelerates:

- **Maximize your TripAdvisor ranking:** Everybody reviews TripAdvisor before booking a hotel stay, so a hotel with a number one ranking in a market on the website naturally attracts more guests. TripAdvisor now serves a truer barometer of where a hotel sits in relation to other similar properties in a city because a top score springs from how guests judge a hotel's customer service. Guests want value for the price they pay, and to the public, good service equals good value. Hoteliers must understand what drives TripAdvisor's algorithm and maximize the property's placement on the booking site by providing superior service and responding to guests' requests. Reputation matters in the hotel business, and TripAdvisor reflects that with its grades.

- **Put your arm around your good clients:** Ensure you have good, open communication with your regular clients and groups and are addressing their needs and concerns. Finding new clients is much costlier than maintaining existing relationships, especially in downturn. Attending to your repeat room blocks and sacrificing a bit of rate growth in peak times goes a long way in preserving the relationship when the downturn occurs. Because you always took care of them, they will find it difficult to take their business to another property to save a few pennies.

- **Shop pricing (and not just ADRs):** Hoteliers are experts at researching the rates other hotels charge. Unfortunately, in their haste to match every other hotel's pricing, they sometimes miss opportunities to boost ancillary revenues. For example, does a competitor charge a resort or urban resort fee? How does it compare to your hotel's resort fee? If you don't have a resort fee, should you institute one? Is your banquet gratuity percentage in line with your competition and is there an opportunity to increase that? Also review menu and drink prices and where those numbers stand in comparison to competitors. Just adding 10 or 15 cents to a cocktail price adds up. We're in the business of nickels and dimes, so anywhere we can get an extra nickel or a dime, it creates profitability.

- **Optimize staffing levels:** Payroll is the biggest expense at a hotel, representing 50% of revenue in many cases. Therefore, hotel operators should regularly evaluate their staffing levels. Perhaps the hotel can run efficiently with part-timers instead of full-time positions. Does the front desk require two people, or can it function with one? Evaluate your staffing guidelines, and review your scheduling process to ensure it adheres to your staffing guidelines. If the hotel experiences a drop-off in occupancy, it will require fewer workers. A flexible staffing model that permits hoteliers to contract and expand staff as needed keeps labor expenses within a manageable budget regardless of whether the economy is up or down.

- **Evaluate other large expense categories:** Examine your utility costs as well to find areas where you can reduce energy consumption while being environmentally friendly, such as LED lighting. We also recommend contacting an energy consultant and researching energy conservation rebates in your local area. In addition, many locales have deregulated utilities, which has created a competitive marketplace. Therefore, there may be opportunity to obtain better utility pricing by shopping other providers. Many municipalities and states also offer rebates for conservation during peak periods. An energy consultant can assist in identifying these opportunities. Utilities represent about 5% to 7% of gross revenues, so a 10% savings can have a fairly significant impact on revenue. Assuming $10 million gross revenue per year, 5% spent on utility costs equates to an annual expense of $500,000. A 10% savings equals an additional $50,000 to the bottom line.

- **Taxes:** Another large expense category to consider is real estate taxes. Many of our clients have had great success in appealing their taxes and receiving reductions. Knowing the fiscal calendar of your local municipality is key, since there is usually a deadline for filing appeals. It is best to be ahead of this curve because appeals increase dramatically in a downturn for both commercial and residential owners as towns typically seek to recoup revenues during a financial crunch. To quote an old phrase, “The early bird gets the worm.”

The key to 2018 is preparation, because at some point in time there will be a slowdown in our industry. It may be sometime this year, next year, or maybe it’s happening now. Maximizing profits now leads to higher property values and returns even in a slow-growth period. Now is the time to build up cash reserves and strengthen customer relationships for that rainy day by improving profit margins and customer service rankings.

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