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Cautiously Optimistic: Why Hotel Investors Need To Be Prepared

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The hotel industry is in the midst of one of the longest up cycles in recent decades. Buoyed by a strong economy and robust demand, the fundamentals of the industry stand on solid footing. At three of the major lodging conferences in the last year, the tone was definitely one of optimism — tempered by a touch of cautious reality.

For many lodging industry professionals, the current cycle has dragged on a bit too long and may be nearing its natural end — although no one can predict when that will be. Are we in the bottom of the ninth or the second inning of a doubleheader? At the very least, we detect a definite slowing of revenue growth.

Because of this uncertainty, hotel owners and operators are preparing for an inevitable downturn. To some, these executives may seem to be “doomsday preppers.” Why are these hotel operators worried about an economic crash when everything is smooth sailing? Because owners must be smart and proactive, considering the unique aspects of running a hotel real estate asset.

Fine-Tune The Engine

The current hotel property cycle can be compared to a sailboat. Right now, the wind — the economy — is propelling the boat, or hotel, toward profits. Many owners and operators, however, fret the industry may lose that wind at its back, either from a black swan event or some other storm.

When that happens, hotels will become less dependent on the economy driving revenues and property values. Instead, the focus must shift to the boat’s engine — the actual operations of the hotel. The time to be concerned about the efficiency and the working condition of your engine is *not* after the ship loses the wind or when it’s in the middle of the storm.

It is imperative now that ships’ captains (hotel owners) dive deep into the operations and review expenses, revenues, payroll and customer service for tighter efficiencies. It’s better to optimize operations now so when the slump hits, or outside influences such as rising interest rates cut cash flow, the hotel is able to compensate for those lost revenue dollars by reducing expenses and maximizing revenues. Making those moves now minimizes the impact to the property’s value. The property can weather an economic storm and still reap profits while maintaining its value.

Expense Creep Up

When the industry sails on untroubled waters, expenses tend to creep up, a trend recently documented in a just-released report from STR, the industry’s statistical bible.

The report examined the P&L statements of 5,800 U.S. hotels and concluded that while industry revenues soared to $208 billion in 2017, a $10 billion increase from the previous year, profit margins wilted slightly as expenses outpaced revenue growth for the second consecutive year. Expense increases topped 4% in three areas: franchise fees, management fees and property taxes. For the second year, a 3.2% hike for labor costs outpaced revenue growth.

Expense creep tends to happen during a prolonged profitable cycle. For example, when rooms are filled and the hotel is raking in revenues, hoteliers may overlook the fact the majority of their bookings come through the online travel agencies (OTAs). That’s fine when revenues are healthy and operators can pay the OTA fees. When revenue growth suddenly vanishes, and the hotel is 75% dependent on the OTAs for its reservations, it raises a red flag. All of a sudden, customer acquisitions expenses take a larger chunk out of dwindling revenues. It’s as if the tide is out and the boat (hotel) is left stuck on sand.

Hotels Should Prepare Now

To understand why hotel owners and operators are priming for a downturn now, it's useful to compare hotel real estate to other commercial real estate segments. Hotels are essentially operating businesses wrapped in brick and mortar. A major portion of revenues derives from the income generated from selling guest rooms daily.

Because rooms rent nightly, hotels' earnings react quickly to sudden swings in the economy. A sudden dip in the economy results in an almost immediate reduction in room rates. In fact, due to sophisticated technology, hotels can price rooms on an hourly basis. Of course, the opposite is true too: When the economy overheats, rates rise accordingly.

The point here is that hotels are more susceptible to volatility in the market. Unlike office buildings or industrial properties, hotels do not have the safety net of long-term leases to provide steady and perhaps rising income during a slumping economy. When the economy veers southward, a hotel's income stream plunges overnight. Since hotel operators have a difficult time raising rates in a nosediving economy, the only way to make up for lost revenues is to control expenses. This is why owners want to prepare now for a downturn.

An uptick in interest rates also looms over the lodging industry. Although the recent interest rate increase by the Fed had a negligible effect on hotel operations, two more scheduled rate hikes could have a more detrimental impact.

Again, a hotel's value hinges on the profits it generates from its operations. If expenses exceed revenues, servicing debt becomes a problem. Higher debt prices squeeze profits and net operating income. If a hotel generating $3 million in profits sees its debt costs hit $2 million, that leaves $1 million in profit for the owner. Rising interest rates affect hotel acquisitions, too. Cap rates will rise as buyers are forced to mortgage with higher interest rates.

Rising expenses and interest rates, combined with the foresight that cycles inevitably come to a screeching halt, validates the need to control expenses and put P&L statements in order. If a hotel can raise its NOI by a point or two and the economy stays on its current course, then it simply generates extra cash. On the other hand, by improving operations now, the hotels can weather a storm.