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Hotel industry needs to proceed with caution

GUEST COLUMN

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The hospitality industry is in the midst of great but uncertain times. On the one hand, the United States has seen strong RevPAR (Revenue Per Available Room) growth for three consecutive years, hotel occupancy rates continue to rise briskly in key national markets (including Boston, New York, and Washington), and demand for hotel rooms is surging. According to Smith Travel Research, a leading authority of current trends in occupancy and room rate data, current demand growth is averaging 3.7 percent, which is well above the twenty year average of just over two percent.

With all the good news in the market, why the uncertainties? They start with the fundamentals — experts predict that significant increases in room supply in the pipeline are likely to push room rates and occupancy downward. Increasing supply, coupled with the presence of factors such as rising energy costs, potential weakness in the housing market, and the possibility of future terrorist activity could quickly devastate the broader travel industry, of which hotels are an important but dependent part. Accordingly, hoteliers are well advised to plan ahead. Here are some issues owners should consider with that in mind:

Development and "Condo-Hotels"

Due to the spiraling costs of energy, raw materials and land, new hotel development remains a challenge despite the rich capital markets currently available to developers. The lure of hospitality, the significant capital requirements for construction and the strong housing market have enticed an increasing number of developers to build "condo-hotels" in which individuals purchase specific condominium units but allow hotel management companies to rent their units out when they are not in use and the split the revenue. Until recently, there projects were primarily in the luxury segment. Increasingly, however, developers in relatively untested market segments are adding condo hotels to their plans. According to Smith Travel Research, through February of 2006, the condo-hotel pipeline (planned or in construction) comprised of nearly 240 projects with over 100,000 rooms. Despite this growing trend, hotel owners and developers should be very cautious when considering condo-hotels as a financing vehicle.

Condo hotels present several latent dangers that will likely not be apparent until a downturn in the industry or economy; hotel owners must therefore exercise caution when planning and marketing their condo-hotels. Developers should engage hospitality consulting firms to do thorough market feasibility analyses. The general rule is that if a hotel is not likely to work as a pure income producing hotel project, it will most likely fail as a condo-hotel as well. Developers must also make a threshold determination whether to treat their condominium units as securities. If a decision is made not to treat condo units as securities, developers must closely observe federal and state securities laws by fully and completely disclosing the true risks of purchasing a condo-hotel and by maintaining close watch over the brokers and salespersons selling these units. A mere mention of the "amazing investment opportunity" that a condo-hotel unit presents could trigger an avalanche of serious state and federal securities violations. Again, these issues may not surface when the hospitality or condo markets are hot; they surely will surface when the markets cool. Individual owners who purchase units today envisioning strong returns may easily become tomorrow's litigants seeking damages. The "sex appeal" of hotels and condos should not obscure their complexities and dangers during times of economic uncertainty. For example, hotel owners periodically face large capital improvement requirements imposed by hotel brands in order to keep hotel rooms updated and up to ever evolving "brand standards." These capital requirements are a major source of tension between hotel owners and management companies but are usually handled in the course of their dealings. It remains to be seen how non-institutional owners will react when facing such capital improvement requirements, especially in hard economic times.

Hotel Management

Another issue hotel owners may overlook in a heated market is the importance of good hotel management. Deficiencies in management may appear harmless when the overall market lifts occupancy and revenues, but the fruits of the deficiencies can be bitter indeed when the markets recede. At several hundred dollars a night with nearly full occupancy, the management of a hotel might see no immediate need to fix operational problems affecting guest satisfaction, but that would be the wrong approach.

A hotel needs goodwill even in good times, for good will may be its best remaining asset in bad times. Listen to a man who knows. Chip Conley, the President and CEO of Joie De Vivre Hospitality, an innovative hotel management company which operates approximately thirty hotels in (mostly) Northern California, recently recounted a story about the bursting of the dot-com bubble, which affected the San Jose/San Francisco area dramatically. During a particularly bad stretch, business travel to Chip's hotels had dropped significantly. Chip turned to his strongest advocates, people who had stayed at his hotels, and asked them to return to stay at his hotels. Much like the town's support of George Bailey in Frank Capra's "It's a Wonderful Life," people who had received Chip's email came to support his hotels out of loyalty. No points program or brand ever created that kind of loyalty. Rather, Chip had run his hotels well during the economic boom and provided excellent client service that people remembered even when times were tough.

In addition to the market uncertainties that exist today, the issue of "amenity creep" and the growing resurgence of the major brands (and the corollary, a decline in relative bargaining power of individual hotel owners) contribute to the challenges facing today's hotel owners. Taking control of "managing" hotel management, from negotiating a sensible management agreement and performance termination and personnel selection rights to being an effective owner/manager who is concerned about service quality and customer satisfaction, is time well spent. Investment in the creation of a loyal customer base today will pay dividends tomorrow.

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