

# **Hotel Investments : Challenges and Opportunities**

**by Lori Raleigh**

The hotel industry has recorded record breaking profits for seven consecutive years and is just completing what is anticipated to be its most profitable year ever. During the 1990 to 1997 timeframe industry pretax profits grew by \$22.7 billion, going from a loss of \$5.7 billion in 1990 to \$17 billion in pre tax income/profit in 1997. And in 1998 further growth is projected with the overall profit for the industry expected to exceed \$20 billion dollars.

As we approach the next decade the questions in many individual s minds are where is the industry headed in terms of profitability?...will capital continue to be available to the industry?...what are the major challenges that we face as an industry?...and where will the opportunities for improving performance be?

Following are some thoughts to share about issues we can anticipate will potentially represent major challenges and opportunities for hotel owners and investors as we approach the year 2000.

## **ONE - Investment Return Performance**

During the past several years the hotel industry has grown from being one of the worst to one of the top performing investment asset classes. And during this same time the strong investment performance of hotels has attracted substantial investment capital.

More recently returns (on hotel investments) have leveled off for most hotels and have actually declined for many types of hotel investments. And as a result the industry is already experiencing the contraction of investment capital.

The on-going availability of investment capital can be expected to ultimately be closely linked to investment return performance (in particular relative to the risk and returns of alternative investments). And accordingly, one of the major challenges of the industry going forward will be maintaining hotel investment returns at levels adequate to continue to attract investment capital.

## **TWO - Hotel Industry Return on Investment (RIO) Performance Barometers**

The information available on investment performance for the hospitality industry historically has been very limited. For several years the industry has tracked the numerator (or overall "profit" or cash flow generated by hotels) but has been unable to relate this number to a denominator (or the total dollars invested in hotels) at a given point in time.

Also in the past the industry has not been able to isolate the capital appreciation versus income return components for hotels nor to develop a total investment return performance barometer/indices for the industry.

In response to the need for better industry investment return performance data, the American Hotel & Motel Association's Industry Real Estate Financial Advisory Council, in conjunction with Cornell University, developed the "*Lodging Property Index*". The index, initially published in 1996, represents the first of its kind in the hotel industry.

While the index represents a great leap forward in the compilation of return on investment performance numbers for hotels, the information available for the industry as a whole is still very limited.

Going forward the industry will need to focus on expanding the return on investment performance data available for the industry as a whole to provide a more reliable barometer for investors to evaluate hotel investment performance.

### **THREE - Financial Performance Monitoring & Analysis**

With advances in technology, there is a tremendous amount of information (financial and sales and marketing in particular) available for review and analysis.

On the one hand the voluminous information available can be very helpful for better understanding and diagnosing problems as well as for identifying areas for improving performance. Unfortunately, on the other, the amount of information potentially available to be reviewed and analyzed can be very overwhelming.

One of the major challenges in the future will be to streamline reporting to both facilitate comprehension as well as to potentially bridge the tremendous communication gaps (between investor and operational reporting; between asset and property managers; between corporate and on-site management and even among executive committee members) emerging.

### **FOUR - Shareholder/Investor Reporting**

The information in many shareholder and investor reports, for REITs in particular, is currently presented at a very high level of aggregation making it very difficult and in some instances virtually impossible to really understand what is going on on an individual property basis. Additionally, in some instances critical information (i.e. on revenue statistics and margin performance) even at the portfolio level, let alone at the individual property level, has been missing in public offering and/or shareholder reports.

With declines in return on investment performance, we can anticipate that owners and investors will increasingly want better information to evaluate performance. And in particular, we can expect that investors will want better information on both the fundamentals underlying performance overall (i.e. margin performance) as well as look for more detail to be provided on the performance of the individual assets (hotels) in a portfolio, to better understand how the performance of an individual hotel is contributing to the performance of the portfolio as a whole.

## **FIVE - Back to Basics**

With the tremendous emphasis in recent years on the deal making or transaction side of the business as an industry we have lost focus on the customer, the employee and the underlying business fundamentals of operating hotels.

*The customer* - recent surveys indicate that hotel customer satisfaction is at an all time low (i.e. since first being tracked in the early 90 s).

*The employee* - employee turnover for the industry as a whole is also at an all time high.

*Underlying Business Fundamentals* - there continue to be substantial opportunities for many hotels to improve both revenue and expense performance. For many hotels there are untapped revenue and yield management opportunities. And on the expense side, promotion and distribution costs and labor management represent areas for further improving performance.

Going forward we can anticipate a return to the basics -- a renewed focus on the customer, the employee and the management of revenue and expenses.

## **SIX - Technology**

There are several technology issues that can be expected to represent on-going challenges for hotel owners/asset managers in the future. First is the basic challenge of staying informed! Technology currently represents one of the largest capital investment areas. To make informed decisions (in committing potentially very substantial investment dollars) it is critical that owners/asset managers understand a hotels basic (or from a managerial perspective) technology needs and the cost versus benefits of alternative approaches to addressing them.

We can anticipate that the issues of the ownership of data along with other proprietary as well as interface issues will continue to evolve as potential major areas of concern. And increasingly we are seeing challenges...particularly in the area of yield management...in bridging the automated versus cognitive or learning application perspectives in technology.

## **SEVEN - Alignment of Interests & Managing Potential Conflicts of Interest**

While historically conflicts of interest have focused primarily on third party management and/or franchise issues, more recently we have seen conflicts of interest develop in other areas. With the significant changes in the forms of ownership of hotels experienced in the past few years, we are seeing potential conflicts emerge in certain investment structures (i.e. certain pension fund holdings and REIT s in particular).

Additionally, with advances in technology along with the significant increase in merger and acquisitions activity in recent years, new areas of potential conflicts have also emerged that will need to be addressed in the future. In the area of technology, the issues of proprietary systems and the ownership of data can be expected to present challenges and possible conflicts between an owner/investor and a third party chain and/or franchisor s interests. And with the substantial recent merger and acquisitions activity, potential conflicts of interest are emerging--in the sales and marketing area in particular.

## **EIGHT - Management Contracts**

Going forward we can anticipate that owners/investors will place much greater emphasis on managing third party operator/manager risk and exposure issues. Delegations of authority and control, indemnifications, default and termination provisions etc. will be expanded and further defined to provide for better alignment of operator accountability with delegations of authority and control and to better address potential conflicts of interest.

We can also anticipate that greater focus will be placed on managing transition and exit strategy issues and concerns. Quite simply, if a major problem and/or conflict of interest develops an owner needs the ability to timely resolve it--or if it cannot be resolved (which is potentially the case with certain inherent conflicts of interest that are emerging) the ability to reasonably terminate the contract.

And as part of better managing transition exposure in the future, the issues of the ownership of books and records, proprietary computer systems, interim reservations system support, employee rights obligations and responsibilities, the handling of business on the books, the managing of public relations exposure etc.---all need to be addressed up front to mitigate what can be tremendous exposure for a hotel owner if for whatever reason a change in management is necessary.

## **NINE - Franchise Contract Relationships**

Shorter term contracts, improved alignment of interests (of franchisor and franchisee), greater focus on direct sales (versus mass advertising and promotion strategies), more potential ala carte value added offerings versus mandatory program requirements--are all areas that we can anticipate the industry will focus on in the future.

Additionally, the internet---and the marketing and distribution alternatives it can provide-- can be expected to potentially greatly level the playing field between franchisors and franchisees for certain types of hotels.

### **TEN - Capital Asset Preservation**

Historically, the hotel industry has lagged far behind other industries in managing the physical assets underlying a hotel investment. There is tremendous untapped potential to improve hotel investment performance via mitigating capital reinvestment exposure through improved preventative maintenance programs and improved capital investment decision making.

Going forward we can anticipate that much greater emphasis will be placed both on better preserving capital assets (through preventative maintenance programs) as well as improving up front decision making when initially purchasing capital items.

### **ELEVEN - Human Resources**

As noted above, with the tremendous focus in recent years on the transaction side of the business, the industry has lost substantial focus on one of the most critical components of a hotel investment... namely the employee.

The hotel business is first and foremost a people business. Neither the most glamorous of hotels nor the most sophisticated or creative financial transactions can insure success in the hotel industry. But rather it is consistently the employees---well trained and motivated employees---that ultimately make the difference in a hotel investment.

Human resource management issues--from recruiting, training and motivating employees to managing turnover and labor costs--can be expected to represent huge challenges in the future. Going forward addressing these same issues is not only the right thing to do but represents one of, if not the single greatest opportunity, for improving investment performance.