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MARKET REPORT

The Prognosis for Occupancy and Average Rate in a Slowing Economy

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Given the current state of the economy, and the growing consensus that a recession is near, if not here, what is the outlook for the hotel industry? This article reviews past cycles, to gain some insight into future occupancy and average rate trends.

Occupancy is influenced by two factors: supply and demand. Of these two, supply has historically been the more influential, by far. Since 1978, a majority of the decreases in the average occupancy have occurred when the rate of supply growth has outpaced the rate of demand growth. Data compiled by Smith Travel Research and HVS indicates that, on a national basis, occupancy has decreased in 16 of the past 30 years. In only six of these years did demand actually decline. In the other 10 years, the decrease in occupancy was caused by a supply growth that was in excess of demand growth.

The Demand Side of the Equation

A review of the statistics indicates that demand has historically decreased only in times of severe stress. A period of prolonged economic malaise, followed by a brief recession that was characterized by high inflation and interest rates, caused demand to decrease in the first four years of the 1980s, which was the only extended period of demand declines in the 30-year period reviewed. Demand decreases occurred in 1991 and 2001, when a specific factor exacerbated the economic downturn. In 1991, it was a national recession combined with a war. Most recently, the demand decreases recorded in 2001 were precipitated by the events of September 11th, and the temporary cessation in air travel which was followed by a period of dramatically reduced travel activity. Looking back to the early 1970's, the combination of a recession and an energy crisis that consisted of severe gasoline shortages and sharply higher prices caused demand to decrease in 1974.

Historical Rates of Change, 1978 – 2007: Occupancy, Average Rate, RevPAR and the CPI

Year	Supply % Change	Demand % Change	Occupancy % Change	ADR % Change	RevPAR % Change	CPI % Change	Differential: ADR vs CPI	Differential: RevPAR vs CPI
1978	1.4 %	4.1 %	2.9 %	14.0 %	17.0 %	7.6 %	6.4	10.6
1979	1.4	5.3	3.8	17.0	21.5	11.3	5.7	15.9
1980	0.8	(1.0)	(1.8)	15.2	13.2	13.5	1.7	11.5
1981	1.5	(2.4)	(3.9)	10.0	5.8	10.3	(0.3)	6.1

1982	0.7	(1.2)	(1.9)	6.1	4.1	6.2		(0.1)	4.2
1983	1.2	(2.1)	(0.9)	5.2	1.7	3.2		1.9	(0.2)
1984	1.5	0.9	(0.6)	6.9	6.3	4.3		2.6	3.7
1985	2.8	1.3	(1.5)	4.6	3.1	3.6		1.1	2.0
1986	3.3	2.3	(1.0)	3.2	2.2	1.9		1.4	0.8
1987	3.8	4.1	0.7	4.1	4.8	3.6		0.4	4.4
1988	4.2	4.2	0.3	3.5	3.8	4.1		(0.6)	4.5
1989	3.6	4.9	1.4	3.4	4.9	4.8		(1.4)	6.3
1990	3.2	1.9	(1.5)	3.2	1.7	5.4		(2.2)	3.9
1991	1.5	(1.2)	(2.8)	0.0	(2.7)	4.2	%	(4.2)	1.5
1992	0.8	2.1	1.3	0.6	2.8	3.0		(2.4)	5.3
1993	0.4	1.9	1.6	2.7	4.3	3.0		(0.3)	4.5
1994	1.2	3.1	1.7	3.9	5.9	2.6		1.4	4.5
1995	1.5	2.1	0.6	4.8	5.4	2.8		2.0	3.4
1996	2.4	2.3	(0.3)	6.5	6.3	3.0		3.6	2.7
1997	3.6	2.8	(0.8)	5.9	5.1	2.3		3.6	1.4
1998	4.2	3.1	(0.9)	4.6	3.6	1.6		3.1	0.5
1999	4.1	3.0	(1.1)	4.0	2.9	2.2		1.8	1.2
2000	3.1	3.7	0.6	4.9	5.5	3.4		1.5	4.0
2001	2.4	(3.4)	(5.7)	(1.3)	(6.9)	2.8		(4.1)	(2.8)
2002	1.6	0.3	(1.2)	(1.4)	(2.6)	1.6		(3.0)	0.4
2003	1.2	1.7	0.5	0.1	0.6	2.3		(2.1)	2.7
2004	0.9	4.5	3.5	4.0	7.8	2.7		1.3	6.5
2005	0.3	3.3	2.9	5.4	8.5	3.4		2.0	6.5
2006	0.3	0.7	0.5	7.2	7.7	3.2		4.0	3.7
2007	1.4	1.2	(0.2)	5.9	5.7	2.8		3.1	2.6

Source: Smith Travel Research; Bureau of Labor Statistics

What are the risks of an actual decrease in demand in the current environment? History would suggest that, absent a precipitating event or circumstance, there is limited likelihood that the industry will experience an actual decline in demand. However, there are some cautionary points that must be recognized. The current escalation in gas prices is reminiscent of the experiences of the early 1970s, and while the threats of an actual fuel shortage are not compelling, the forecast for continuing increases in gas prices may result in an effective shortage as people choose not to purchase gas. These factors would almost certainly result in decreased levels of domestic leisure travel, which would contribute to a downturn in demand levels. Rising fuel costs are also affecting airline prices, which could curtail both leisure and business travel, further threatening demand levels.

The experience of the early 1980's must also be considered. The current expectation is for a recession of relatively limited duration; interest rates are low and the outlook for inflation is not alarming. However, the so-called credit crunch has already lasted longer than initially forecast, and is having more widespread impact than originally anticipated, undermining even triple-A investments and investors. The real estate market has softened dramatically, and the levels of residential foreclosures are rising toward historic peaks. Employment levels have held up thus far, but the prognosis is far from clear. Perhaps most telling, consumer spending – which accounts for an estimated 70% of the US economy – is softening, and consumer confidence levels have fallen dramatically. These circumstances could be the genesis of a prolonged period of economic malaise, which would almost certainly result in sluggish demand levels, if not actual decreases in demand.

Offsetting these points are the strong levels of international tourism from which the US is currently benefitting, thanks to the weak dollar. This dynamic has had an extremely favorable impact on the nation's top international destinations, in the form of strong demand levels and escalating prices.

The Supply Side of the Equation

The good news in the present scenario is on the supply side of the equation. Although supply growth has been escalating over the past several years, the most recent data indicates that this phase of the development cycle is rapidly coming to a close. The rate of increase in the number of construction starts and projects in the pipeline has dropped, while the attrition rate (the rate of proposed projects that do not reach fruition) is rising. Contributing to the favorable outlook is the increase in the construction timetable (start to open), which has climbed since 2000, from just over one year to over 19 months. The credit crunch is playing a positive role in this area, in that financing for new construction is even more difficult to obtain than financing for existing properties, suggesting that the attrition rates will likely continue to climb, and construction periods lengthen further.

Additional encouragement can be found in the slower pace demonstrated by this development cycle, which has not reached the levels attained during the peak years of the last development cycle. Supply increased at a rate in excess of 3.0% in four successive years (1997 to 2000); by comparison, supply growth in this cycle was a minimal 0.3% in 2005 and 2006, and rose to only 1.4% in 2007. Current forecasts anticipate that the rate of supply increase will peak in the low 2% range in 2008 and 2009.

That being said, there is a not insignificant amount of supply that is currently under construction and expected to enter the market over the next two years. As of December 2007, sources [1]; indicate that there were almost 212,000 rooms under construction, as compared to roundly 156,000 as of December 2006. These rooms, along with a majority of the 84,000 in final planning as of December 2007, and a portion of the 320,000 in planning as of that same date, can be expected to affect supply through 2010.

The number of rooms currently in planning that are actually built is the largest question affecting the supply side. The good news is that further deterioration in the economic picture is likely to be amplified in terms of the impact on the

pace of construction. Moreover, given the prevailing uncertainty regarding the economic outlook, even the absence of good news will likely be sufficient to further retard supply growth. These factors, combined with the severely limited amount of construction financing available, should keep attrition levels high and the pace of new supply additions low.

The Prognosis for Occupancy and Average Rate

With demand growth slowing, and supply still growing, it seems clear that occupancy levels are likely to decrease over the next one to three years. The magnitude and duration of the decrease will depend on the various factors discussed above. However, even with the potential for actual decreases in demand, the moderate supply growth that characterized this development cycle can be expected to keep occupancy levels in the low 60% range. This is a relatively mild decrease from the 63.1% to 63.4% levels recorded in the past three years, and a significnat improvement over the last downturn, when occupancy levels fell below 60% in both 2002 and 2003.

Average rate is a more complex question. On a national basis, average rate has outpaced inflation (as measured by the CPI) in 19 of the past 30 years. In fact, annual average rate growth has been less than 3.0% only six times during this period, and was only negative twice – in 2001 and 2002. The industry recorded annual average rate increases in excess of 4.0% 16 times over this period; in 11 of those years, the rate of growth exceeded 5.0%. There is no absolute correlation between occupancy and average rate, although it can be said that average rate increased at a pace below the inflation rate in each year that demand decreased. And, as a rule, stronger rate growth has occurred during periods of strong occupancy.

Were it not for the actual decreases in average rate recorded in the first years of the last downturn, history would suggest that the worst-case scenario is that average rate growth will not keep pace with inflation. But the 1.3% and 1.4% decreases recorded in 2001 and 2002, respectively, raise the specter of decreases in average rate. A review of the dynamics that contributed to these decreases is warranted.

In the run up to the peak average rate levels attained by the US lodging market in 2000, the industry achieved average rate increases in excess of inflation in each year since 1994. This growth was fueled by price increases, as well as more widespread implementation of yield management strategies and more sophisticated yield management technology. The increasing proportion of newer properties also contributed to this growth. These new hotels were more appealing in terms of condition, configuration and array of amenities, and benefited from the support provided by strong brands and marketing programs. The combination of higher quality inventory and improved management tools would likely have enabled the industry to maintain positive, albeit slower, growth through a typical recessionary cycle.

This scenario was undermined by the precipitous events of September 11th, which accelerated what had been a moderate decrease in travel activity into a dramatic downturn. According to Smith Travel Research statistics for the US as a whole, the number of rooms sold in the year to date through August of 2001 had been off by 0.6% as compared to the previous period; with a 2.6% increase in supply, this equated to a 3.0% decrease in occupancy. In the month of September, occupancy fell by almost 16%, and a drop of over 20% was recorded in the last 19 days of the month [2]; virtually all of this decrease was due to a drop in demand. Although air travel resumed late in that month, the prognosis for a resumption of travel activity at any where near the previous levels seemed grim; much reduced reservation volume and a dramatically shorter pre-booking window contributed to the bleak outlook.

In the face of these seemingly dire circumstances, the internet travel service providers such as Priceline, Expedia and Travelocity emerged as a potentially immediate solution to the problem. These third party services had been playing a growing roll in the industry, largely through their popularity with bargain-hunting consumers who appreciated the opportunity to get the “best deal” in a given destination. Faced with falling occupancies, soft demand and with little evidence of a recovery on the horizon, hotels throughout the US began to make a significant proportion of their inventory available through these sites, which provided the opportunity to stimulate demand by offering a bargain directly to the consumer. As the “bargain” characterization suggests, the marketing strategy of these sites was price driven, and consumers were attracted by rates that were typically well below a hotel’s published rates. However, the rates actually achieved by the hotels were even lower than the price would suggest, as the fee structure then in place between the travel service and the hotels dictated that the service retained as much as 20% of the rate paid by the consumer, as a commission. Moreover, the logistics of these sites gave the hotel’s virtually no control over their own inventory. These

sites attracted not only new consumers, but also some of the industry's core business customers, with the result that an increasing percentage of the customer base was able to take advantage of these lower rates. At the same time, the traditional demand segments were also under rate pressure, as larger corporate clients and groups sought discounts as well. The net effect was significant downward pressure on average rate.

The circumstances in place today differ from those that framed the 2001/2002 downturn in several ways. Recognizing the increasing consumer preference for internet-based booking, the hotel companies have dramatically enhanced their own web sites, and now guarantee that the "best available rate" is only available through the company's own web site, thereby retaining control of both inventory and price discounts. The third party internet sites are still an active part of the industry, but the fee structures have changed, with the net result that a far lower commission is retained by the third party site. The hotels also have better inventory control through the third party sites, enabling management to curtail the number and degree of discounted room nights sold. These measures are expected to go a long way toward preventing the widespread discounting that adversely affected the industry in 2002 and 2003.

Also enhancing the industry's ability to weather the coming storm are the dramatic improvements in technology and resources that have become available to hotel companies and managers. It is now possible to get statistics that measure travel and lodging activity on a daily basis – and in many cases this information is available almost immediately. While these statistics won't predict the future, they do provide hotel management the opportunity to identify trends and react on a timely, proportionate basis, thereby curtailing the risk of a dramatic over-reaction.

Finally, as of the present date, the pace of the economic downturn is measured, and while it is not possible to formulate the "best" response to any downturn, the current progression toward a recession provides at least some opportunity for longer term planning. These factors should go a long way to limiting the possibility of substantial decreases in average rate. With the technology and infrastructure in place today, it is reasonable to anticipate that the worst case scenario is for average rate growth to slow to below inflationary levels.

What Does All of This Mean for Individual Hotels?

While all hotels are subject to the same broad economic influences, each market and property is most directly affected by the supply and demand factors in its own back yard. Markets facing significant supply increases will likely experience a greater degree of stress than previously anticipated. Conversely, those with little to no supply increases underway can be expected to weather the storm with less difficulty.

For individual hotels, the slower periods of the economic cycle present opportunities as well as threats. The reality is that demand doesn't just grow or decline, it also moves – from market to market, and from hotel to hotel. Meetings once held in a more distant, more expensive market may relocate to a more affordable local alternative. Business travelers whose expense accounts once ran to a full-service hotel may seek out less expensive – and often equally suitable – alternatives among the select- or limited-service lodging sector. And so on. In these circumstances, one property's decrease can be another's opportunity for growth. This opportunity extends to average rate, as well. With the yield management tools available at the property level, property managers now have a greater ability to effectively manage pricing so as to achieve an optimal balance between occupancy and average rate.

1 Data as compiled by Smith Travel Research/TWR/Dodge Construction Pipeline

2 Smith Travel Research, Lodging Outlook, *November 2001*