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Economy Lodging: Always In Transition

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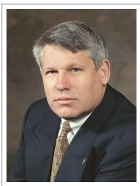

Since its inception, the economy segment of the lodging industry has undergone a continual process of transition. Although most owners, operators and lenders take a “stick to the basics” approach to economy lodging, a problem arises when one attempts to define just what “the basics” are. There are essentially two schools of thought when it comes to defining the basics. In the first, they revolve around price/value, guest satisfaction and market position; in the second, they focus on minimum amenities, minimum services and Spartan physical facilities. Although profitability is the goal of both approaches and both tend to focus on occupancy, the former group additionally recognizes that average daily rate (ADR) plays a role in the room-revenue formula. These two approaches create a dynamic tension in the economy segment. This tension contributes to the excellent price/value that economy-hotel guests enjoy. The entry barriers to the economy segment are relatively low: Less than $2 million, with minimal equity requirements, will develop a very nice 40- to 50-room economy property. Don’t scoff at that size, by the way: In many markets, it’s just about right. Yes, the hotel will be fairly Spartan and yes, the owner will likely be a neophyte to the hotel industry (though not necessarily to the development game). But that neophyte will learn in a few years what the old-time hotelier already knows: The mouse trap must be improved regularly if it’s going to continue to work well. **Enhancing guests' perception of value vs. cost** As amenities and services are added, room rates must rise—but not beyond perceived value nor out of balance with the competitive market. Here is where the tension tightens: As soon as a new developer perceives an opening in the market and can obtain a secondary or tertiary site in a decent location, a new budget hotel appears on the scene. In response, management of the moderately priced hotel nearby moves to reposition it as an economy property by lowering rates. These two events create a market situation that’s viewed as either highly competitive or overbuilt. New amenities and services added to economy/limited-service properties to make them more competitive usually are inspired by their full-service big brothers. The constraints to adding new amenities are cost, staff and available land (or its marginal cost). As a result, pools, hot tubs, and well-equipped exercise rooms have become almost commonplace in economy properties. Complimentary continental breakfasts, rather than just coffee and a doughnut, were adopted years ago from the all-suite model. Executive centers have appeared, complete with Internet access, fax machines, and copiers. Lobbies featuring couches, coffee tables and side chairs have replaced utilitarian entryways. When economy-hotel guests enter their room today, they expect to find Internet access, hair dryers, easy chairs, desks with large work surfaces, and remote-control cable TV with free movie channels. Even pay-per-view-movie firms, once reluctant to market their expensive installations to economy hotels, have discovered big profits in the segment’s guestrooms. **More profitability from investors’ perspective** Clearly, a significant number of investors believe that economy/limited-service hotels are more profitable than their full-service counterparts. All the statistics I’ve seen over the years support this premise as it relates to profit before income taxes as a percentage of sales. This is because the rooms department of any hotel, which is its very reason for existing, has the highest profit margin. Not only do the other revenue departments in fullservice hotels have lower margins, but they also add undistributed expenses disproportional to their departmental margins. The question then becomes one of whether they add significantly to occupancy and ADR (which is, after all, the reason extra facilities and amenities are included in a full-service hotel). It stands to reason, then, that operational profits as measured in cash flow are higher in full-service hotels, while the percentages are higher in economy/limited-service lodging properties. However, this leads to another question: Is return on investment (ROI), another measure of profitability, greater in economy/limited-service hotels than in full-service hotels? In researching this question, I was unable to find any objective comparisons of return on assets or equity. Comparing ROI, by any definition, between the average full-service hotel and the average economy/limited-service hotel is difficult because of the criteria one would

Summary

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have to establish. However, I feel safe in saying that some investors are likely to accept lower returns on economy/limited-service lodging investments compared with full-service hotels because the risk is significantly lower. The primary reason for this is that the capital required to build one medium-size, mid-price, full-service hotel could build three or four economy/limited-service properties in various locations: Thus, the risk is spread over more markets. The higher profit margins on sales would seem to imply that the economy/limited-service lodging hotel would have a higher degree of resiliency in down markets and quicker recovery as demand returns. The minimum staffing levels and other semi-fixed expenses necessary to maintain these hotels' service levels clearly set a very low floor on how much expense-cutting an operator can achieve once the variable expenses and value-added amenities have been cut in a depressed market. Because of the limited cash circulating through these properties, managers tend to be very conservative in their decisions regarding discretionary expense items, particularly in marketing and employee benefits. Speaking of employees, labor costs in economy/limited-service lodging properties appear, on the surface, to be very low. I believe the opposite is true and that the actual cost is obscured by the high number of hours the manager and others work. With few exceptions, employee turnover is very high and is always blamed on local market conditions. The fact is that the typical manager has not been trained to check references, interview properly and effectively orient and train new employees. Often, the environment is such that the manager hires a “warm body” in hopes that the new employee will work out and the manager’s own work load be reduced. The cycle, however, goes on as the new employee often becomes disenchanted and leaves. The hidden costs in poor efficiency and quality of work resulting from this system are obvious to all but the most unsophisticated—and could be corrected by more emphasis being placed on proper recruiting, interviewing, hiring and training procedures. As for marketing, economy/limited-service hotels tend to focus on room rate and location. Due to the low payroll budgets, sales representatives are virtually unheard of in the segment—managers are expected to shoulder the burden of the direct-sales effort. Unfortunately, the typical economy-hotel manager defines “management” as getting reports done, hosting, and holding payroll to a minimum by working at the front desk for an inordinate amount of time. Competent training of staff, inspecting, civic involvement and quality sales calls are not commonly found in these properties. A major factor counteracting this tendency is the substantial support offered to operators by most franchisors in the economy segment. The top franchisors are getting more and more sophisticated in their marketing efforts. TV ads are becoming increasingly more effective, target marketing is implemented in very sophisticated ways, and any chain worth its salt has developed sophisticated Internet marketing and sales programs. **Keeping the ‘Big Picture’ in sight** In my opinion, the key factor in being a successful developer or operator of an economy hotel is simply this: Pay careful attention to every detail of development and day-to-day management without losing sight of the big picture. But just what is “the big picture”? I see it as a continuing, evolving collage that includes ever-changing guest preferences, shifts in the local competitive environment, and the dynamics of the local area’s economy and how it impacts demand for hotel rooms. This last piece of the big picture is probably where the least amount of support is available to the manager from either the owner or the franchisor. As a result, the economy/limited-service lodging operator typically reacts to, rather than plans for, change. But perhaps the most important piece of the economy-segment big picture is this: It will always be a people business, whether the people are guests or employees. And whatever your definition of “sticking to the basics” might be, in the economy segment it should always start with taking care of people.

About Kirby D. Payne

Kirby D. Payne, CHA, President of HVS Hotel Management and HVS Asset Management - Newport, has over 40 years of hotel operations, consulting, and development experience. He was the 2002 Chair of the American Hotel & Lodging Association (AH&LA) and a former Director of the National Restaurant Association. He is a frequent speaker and author. His hotel experience began as a four-year-old living in a hotel on the Amazon River in Brazil, which was managed by his father for InterContinental Hotels. He never lived in a house until he was 13. Payne previously served on the Certification Commission of the AH&LA's Educational Institute. HVS Hotel Management has operated hotels throughout the United States and has served a multiplicity of clients, including lenders, airports and other government entities, and individual investors. HVS Asset Management - Newport oversees upscale and luxury hotels on behalf of clients who use branded management and major independent management companies. Both companies undertake various consulting assignments including, but not limited to, development consulting, brand and management company selections and contract negotiations, Hotel Performance Analysis and litigation support (expert witness). Mr. Payne is frequently appointed as a Receiver for hotels and resorts. Contact Kirby at +1 (401) 625-5016 or .