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HVS Market Pulse: Perspectives on the New York City Lodging Market

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With average rates declining by 1.5% in 2015 and on track to drop at more than double that pace in 2016, the New York City lodging market has received a lot of negative press of late. Between the significant increase in supply and the lackluster average rate performance, the once golden market is now viewed as tarnished. Some hotel owners are selling assets, preferring not to ride out the current downturn; RLJ recently sold two hotels in New York, noting *"While we continue to believe in the New York City market over the long term, in the near term, these sales reduce our exposure as this market goes through a soft period."* Additionally, some investors and lenders have expressed reluctance to even consider getting in to the market.

There is no doubt that the market is down, but it is important to understand the market fundamentals behind the current trends; specifically, what is going wrong, what is going right, and when the trends will be reversed.

The first thing that needs to be pointed out is that, from a demand and occupancy perspective, the New York City market is phenomenally strong. Since 2007, the number of rooms sold has increased by over 7.6 million, or 37.1%, which compares to a 35.2% increase in the number of available rooms; thus, occupancy increased from 85.2% in 2007 to 86.4% in 2015. These are hardly the signs of a market in crisis.

So Why Has Average Rate Declined?

The amount of the new supply. The sheer volume of the new supply in the city is certainly a factor. By year-end 2016, the inventory of rooms will have increased by 29,000 over the number of rooms available in 2007. More rooms mean more choices for consumers, and cost is one of the key elements that influences most consumers. With more rooms available across the market, the number of nights on which a hotel can assume a sellout decreases. The absence of this compression influences the yield management strategy, in terms of both the number of rooms made available at discounted rates and the degree of the discount available. The resulting adjustments in marketing and pricing strategies at an individual property level have resulted in lower average rates across the city, particularly as hotels have prioritized maintaining strong occupancy levels.

The nature of the new supply. Although the new supply comprises a range of property types from economy to luxury, the new inventory includes a significantly higher proportion of hotels in the limited- and select-service sectors than has historically characterized the market. Moreover, many of these properties are affiliated with brands that are marketed as offering good value for the

Summary

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price. The new supply also includes properties with micro-sized hotel rooms (less than 150 square feet) that are offered at a lower price point. Thus, even excluding any discounted rates, the shift in the mix of inventory would put downward pressure on the aggregate average rate.

The location of the new supply. As the established hotel locations in the city have "filled up," developers have looked to new neighborhoods for hotel development opportunities. This is a logical and certainly not a new trend—some of us remember when SoHo was uncharted territory for hotels. But price is an effective marketing tool used by hotels located in emerging neighborhoods. Thus, with more hotels in new submarkets, more discounted rates are currently being made available. Over time, as these locations become established, the need for discounts and the degree of the discounts offered will diminish.

The ready availability of "replacement" room nights. With the new supply putting pressure on the traditional sources of demand, hotels are increasingly open to considering sources of demand that they would previously have shunned. This is part of the yield management strategy discussed above, and includes increased participation in opaque and non-opaque OTAs, tour group business, and other such sources of demand. All of these segments have demonstrated enormous depth of demand and, at the right price, can be lured from the outer-borough and suburban markets where they have traditionally found a home.

Occupancy is king. Another market dynamic that continues to influence the New York City market is the almost universal pursuit of high occupancy levels. This differs from the traditional premise of finding an appropriate balance between occupancy and average rate, for reasons that are tied to the economics of hotel ownership in the city. Given the high cost of ownership—from land costs to construction costs, and/or investment costs to property taxes—an asset needs to be as economically productive as possible. In these circumstances, it is difficult to make a case for letting a room sit empty when occupancy is available, even at discounted rates. The increased competitive pressures imposed by the new supply have added to the perception that occupancy equals revenue and should be prioritized.

The prevalence of frequent guest programs also plays a role in the prioritization of occupancy. As is to be expected, hotels in Manhattan are among the most sought after by program members seeking to redeem their awards for room nights. Under most programs, the amount that the program pays to the hotel for any room nights used by "award" guests is dependent on the hotel's overall occupancy on that night. If the occupancy is higher than a defined threshold (typically around 95%), the hotel is reimbursed based on the overall average rate for that night. If the occupancy does not meet that threshold, the reimbursement rate is significantly lower, roughly on par with the cost of servicing the room. In Manhattan, the difference between these two reimbursement rates is significant, ranging from $100 to $250 and possibly more, depending on the season. As a result, hotels that participate in these programs are highly motivated to maintain high occupancy levels, and will commonly accept some guests at discounted rates to ensure their occupancy level meets the required threshold.

The Bad News

The bad news is that there are still another 40 hotels with approximately 10,000 hotel rooms expected to enter the market in the next two years. As such, the pressure on average rate will continue in the near future. HVS anticipates that average rates will decline again in 2017 and remain essentially flat in 2018.

The Good News

The good news is that the trends that are putting downward pressure on rate are temporary and can be reversed. The local economy is strong, and demand from all sources is expected to continue to grow. As demand from traditional higher-rated segments increases, the need to rely on discounted sources of demand will diminish. Using the same yield-management strategies that have sustained occupancy levels in the mid-80% range, hotels should be able to achieve rate growth. Even without price increases, average rates should increase. Moreover, as the new submarkets become established, the need for lower introductory prices will diminish.

The other good news is that there are investors that see the upside in the end of the cycle and want to be a part of it. The buyer of RLJ's two hotels purchased those properties at a reported cap rate of 4.7% on 2016 net income, which was presumably lower than 2015 levels but higher than would be expected for 2017.

About Anne R. Lloyd-Jones

Anne R. Lloyd-Jones, MAI, CRE, is Senior Managing Director of the New York office and a Director of Consulting & Valuation at HVS, the premier global hospitality consulting firm. Since joining HVS in 1982, Anne has provided consulting and appraisal services for over 5,000 hotels. Anne's particular areas of expertise include market studies, feasibility analyses, and appraisals. She is also an expert in the valuation of management and franchise companies, as well as brands. Her experience includes a wide range of property types, including spas and conference centers. She has appeared as an expert witness on numerous occasions, providing testimony and litigation support on matters involving bankruptcy proceedings, civil litigation, and arbitration. For further information, please contact Anne at +1 (516) 248-8828 Ext. 208 or