Performance Potential of Mid-Scale Hotels: Less May Be More

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During the last decade, mid-scale, limited-service hotels have been one of the fastest-growing and most successful segments of the lodging industry. Relative to their upscale and full-service counterparts, mid-scale properties can provide an equal or even greater return on investment to owners and developers. Taken as a whole, mid-scale, limited-service hotels have also fared better than higher-end properties during the course of the current economic downturn.

Recent Performance

Cutbacks in corporate and consumer spending have hurt performance in all hotel chain-scale segments, but the impact on mid-scale hotels has been mitigated in part as budget-conscious travelers trade down from upscale to mid-scale brands. The table below shows weekly RevPAR declines for the month of August. Overall, it’s clear that the mid-scale, limited-service segment has fared better than the upscale segments and the collective market.

Weekly RevPAR Change in August of 2009 from Previous Year

Week Ending	All Segments (%)	Mid-scale without Food & Beverage (%)	Upscale (%)	Upper Upscale (%)	Luxury (%)
August 8th	-16.5	-14.7	-17.4	-18.0	-20.3
August 15th	-16.2	-13.9	-17.1	-18.6	-24.7
August 22nd	-16.7	-15.2	-18.0	-19.0	-25.1
August 29th	-22.0	-21.9	-21.3	-21.2	-26.8

Source: STR Weekly Hotel Reports as reported in the Daily Lodging Report

Transactions Market

The recession has brought to bear a major distinction in the financing and transactions markets for limited-service and full-service hotels. While the sale and financing of larger, more expensive properties virtually ground to a halt as banks called a moratorium on large-scale loans, the market for limited-service assets, which typically range from $3 to $10 million, has continued to hum along, even if that humming is faint compared to pre-recessionary years. Even loans of less than $10 million are difficult to chip out of the frozen credit market, and the terms are significantly more conservative than those that were available before the credit crunch. Yet, most of the financing for these transactions comes from local and regional banks, which by and large have emerged healthier than many institutional funding sources for larger transactions.

To Buy or to Build?

For investors looking to establish or expand their presence in the realm of mid-scale, limited-service hotels, one fundamental question will underscore investment decisions over the next six to twelve months, namely, whether to buy an existing property or to build a new one. The answer depends on factors specific to an individual market. Markets that have remained relatively insulated from the ongoing recession may be primed for new development in the next twelve months; markets that have been more severely impacted may present opportunities to acquire quality assets at a discount.

Development

Numerous secondary and tertiary markets across the U.S. have avoided the brunt of the economic downturn.

Summary

Hotel stakeholders have to know the right place, time, and hotel category to maximize investments. In the present economic climate, mid-scale, limited-service hotels may be a good bet.

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Smaller markets that are anchored by stable demand generators such as military installations, educational institutions, government agencies, and regional medical centers may be prime locations to begin planning future developments. Even if demand levels are not yet high enough to support new development, the next twelve months may be an opportune time to acquire a site and begin the planning process. A mid-scale, limited-service property can be constructed more rapidly and with less money than a full-service hotel, enabling developers to quickly capitalize on increasing demand levels when the market begins to trend upward. Such timing is crucial to attaining projected revenue levels before other developers flood the market with additional rooms.

Acquisition

Many markets have experienced an influx of new room supply and an erosion of demand over the past two years. These markets may be ideal for exploring acquisition opportunities. Prospective buyers should be wary of markets that have seen demand eroded by the loss of a major employer or industry. In contrast, markets that have relatively stable demand generators but an oversupply of rooms are rife with opportunities for hotel acquisitions. In these markets there may be newly constructed hotels that are unable to cover debt service or refinance out of a construction loan, forcing owners to sell at a discount. With a lower debt load, these properties could be reestablished in the market to generate positive cash flow.

Another type of opportunity is a branded hotel that is beginning to show its age. If current ownership hasn’t initiated updates and renovations, the hotel’s performance has likely declined with the introduction of newer, higher-rated properties in the market. Owners that have not kept adequate reserves may be unable to maintain brand standards and could lose their hotel’s flag. This situation presents an opportunity for a new investor to acquire the property at a discount and perform subsequent renovations. The result is a newly renovated property with a significantly lower debt load than its recently constructed competitors.

Conclusion

Whether you are building or buying, it is essential to know the dynamics of the market and the risks of a particular property type. The rewards of a well-planned investment can provide strong incentive, but there can be plenty of unexpected pitfalls between an initial investment and the projected returns. The guidance of a hotel firm with proven experience in the mid-scale, limited-service product tier is vital in determining the appropriate steps to take. Please contact us to learn more.

About Daniel P. McCoy, MAI

As the HVS Practice Leader for the Midwest, Dan McCoy, MAI, oversees the firm's seven offices in this region. A Senior Managing Director at HVS, Dan is a recognized thought-leader, collaborative advisor, and invaluable resource for the Midwest's lodging industry. He combines a deep understanding of regional hotel markets with strong analytical thinking to provide a wide variety of clients with up-to-date hospitality intelligence and tailor-made solutions. Dan is a Designated Member of the Appraisal Institute (MAI) and a certified general appraiser. Contact Dan at +1 (970) 215-0620 or .