Hotel Investment Strategies

Don't Worry About Room Rates

Every time the hotel industry experiences declining occupancies followed by falling room rates, many hotel owners, operators and lenders fear room rates will never fully recover. They think that some major underlying change in travel patterns and pricing has occurred, and the glory days of rapidly rising room rates are gone forever.

Based on my 35 years of following the hotel industry through a number of major cyclical changes, I do not think the recent decline in room rates is any indication of a long-term problem. Rather, over a relatively short time frame, I predict a rapid room rate recovery will occur that will significantly enhance hotel profits and values.

When you look back at annual trends in hotel occupancies and room rates you discover that in most cases, as hotel occupancies increase, average room rates rise—usually at a rate faster than the area's overall rate of inflation. This produces real rate growth that translates into more bottom line profits. The reverse also can be true. As hotel occupancies decrease, average room rates either rise at a rate that is lower than inflation, or in some rare cases, room rates actually decline.

The table below illustrates the cyclical nature of hotel occupancies and average room rates for a sample representing all hotels in the United States along with the relationship amongst the movement of hotel occupancy, average room rate and the Consumer Price Index (CPI = inflation).

HOTEL OCCUPANCY, AVERAGE ROOM RATE AND CPI RELATIONSHIPS

Year	Occupancy	% Change Occupancy	% Change Average Rate	CPI	AR/CPI Index
1973	70.6%		4.2%	6.2%	0.68
1974	64.4%	-8.8%	7.6%	11.0%	0.69
1975	64.0%	-0.6%	7.3%	9.1%	0.80
1976	66.2%	3.4%	8.2%	5.7%	1.44
1977	66.7%	0.8%	8.1%	6.5%	1.25
1978	69.6%	4.3%	14.0%	7.7%	1.82
1979	72.3%	3.9%	17.0%	11.3%	1.50
1980	71.1%	-1.7%	15.2%	13.5%	1.13
1981	68.3%	-3.9%	10.0%	10.3%	0.97
1982	67.0%	-1.9%	6.1%	6.2%	0.98
1983	64.8%	-3.3%	5.2%	3.2%	1.63
1984	64.5%	-0.5%	6.9%	4.3%	1.60
1985	63.5%	-1.6%	4.6%	3.6%	1.28
1986	62.9%	-0.9%	3.2%	1.9%	1.68
1987	63.4%	0.8%	4.1%	3.6%	1.14
1988	63.5%	0.2%	3.7%	4.1%	0.90
1989	64.3%	1.3%	3.9%	4.8%	0.81
1990	63.5%	-1.2%	2.8%	5.4%	0.52
1991	61.8%	-2.7%	0.3%	4.2%	0.07
1992	62.5%	1.1%	1.4%	3.0%	0.47
1993	63.4%	1.4%	2.7%	3.0%	0.90
1994	64.7%	2.1%	3.8%	2.6%	1.46
1995	65.0%	0.5%	4.8%	2.8%	1.71
1996	64.7%	-0.5%	6.5%	3.0%	2.17
1997	64.2%	-0.8%	5.9%	2.3%	2.57
1998	63.5%	-1.1%	4.6%	1.6%	2.88
1999	63.0%	-0.8%	3.8%	2.2%	1.73
2000	63.4%	0.6%	5.5%	3.4%	1.62
2001	59.8%	-5.7%	-1.0%	2.8%	-0.36
2002	59.2%	-1.0%	-1.6%	1.6%	-1.00

Source: Smith Travel Research

The first point to observe is the fact that during the 30-year period from 1973 to 2003, average room rate actually declined only two of the years—2001 and 2002. There were 13 years where the rise of average room rate was less than the increase in the CPI, as shown by the Average Rate/CPI index, which is calculated by dividing the percent change in the average rate by the percent change in the CPI. When the index was less than one, the underlying rate of inflation exceeded in the growth of hotel room rates. When the index was greater than one, hotel room rates grew at the rate greater than inflation, which generally meant growth in bottom line profits (assuming occupancy was not declining).

As hotel occupancies rise, average room rates have also risen—usually at a rate greater than the rate of inflation. During the past 30 years, occupancies rose 12 times and hotel room rates increased faster than inflation in eight of those 12 years. Two of the four years where occupancies increased but room rate growth was less than inflation occurred in 1992 and 1993 when the industry was coming off the major depression of 1991, and operators were slow in raising their rates.

A down turn in occupancy does not necessarily mean an adverse relationship of room rate growth and the CPI. During the past 30 years hotel occupancies declined 17 times but there where only eight years the room rate growth was less than CPI growth.

Hotel operators tend to react to changes in occupancies by adjusting their room rates. The first reaction by most managers after the events of 9/11 was to reduce room rates to hold on to their dwindling occupancy. This strategy was not particularly successful because most people who did not want to travel would not have changed their minds because of a lower room rate. As a result, the industry experienced two years of declining room rates for the first time in several decades.

The big question in everyone's minds is when will hotel room rates start rising again? If history is any indication of the future, I predict hotel room rates will be flat in 2003. They will start growing in 2004, but at a rate less than inflation. By 2005 and 2006 we will see hotel room rates growing at rates significantly above the CPI. Assuming an underlying inflation rate of 2.5%, I project hotel room rate growth for 2003 at 0%-.5%; 2004 at 1.5%-2%; 2005 at 3.5%-5%; and 2006 at 4%-7%. ◆

By Stephen Rushmore, *MAI, CHA, president and founder of HVS International, a global hotel consulting firm with offices in New York, Miami, Denver, San Francisco, Vancouver, Mexico City, London, New Delhi, Singapore, São Paulo and Toronto. Mr. Rushmore can be contacted at 1.516.248.8828 Ext. 204.*