CHAPTER 2

History and Dynamics of the Lodging Industry

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2.01 EVOLUTION OF THE INDUSTRY

[1] Coaching Inns, Grand Hotels, and Rooming Houses

The first lodging facilities developed in the United States were coaching inns and taverns. Patterned after the English inns, these facilities were situated primarily in seaport towns and along coaching routes.

As the new colonies began to prosper and the country expanded westward, some lodging facilities were developed with a new degree of opulence. Reflecting the richness of their European counterparts, these grand hotels were situated in both resort and urban settings.

In time, the growth of the U.S. railroad system created a need for overnight accommodations for rail travelers. In response to this new demand, small rooming houses were often built near train stations. These facilities generally had much lower standards of service and cleanliness than did the luxury hotels found in the cities. Transients in many cities then had a choice between high-quality downtown hotels and inexpensive accommodations in railroad rooming houses. Since many travelers

were unable to afford first-class accommodations, the railroad rooming houses were their only real alternative.

[2] Turn of the Century Expansion

The turn of the century in the United States saw an economic expansion that, in conjunction with improvements in transportation and lower travel costs, opened up travel to the middle class. This in turn created a new, large, and growing market. The economic expansion also brought about increased commercial activity and ever larger numbers of business travelers. However, neither of the two classes of hotels then available were acceptable to the growing mid-rate commercial market.

Ellsworth M. Statler answered the needs of this expanding market in 1908 by opening the Buffalo Statler in Buffalo, New York—the first modern commercial hotel. Many of the conveniences taken for granted today were first instituted by Statler in this hotel, which became the model for reasonably priced, efficiently run commercial hotels throughout the country. Standard features in all of Statler's hotels included private baths, full length mirrors, morning newspapers, and overnight laundry. "A bed and a bath for a dollar and a half," Statler's tagline, came to mean a standardized hotel product to U.S. travelers.

The early 1900s saw vigorous growth in hotel construction in America as large luxury hotels (such as the Plaza, built in New York City in 1907) continued to be built in major cities, and the commercial hotel segment continued to emerge. World War I brought on a period of relatively low construction activity as the country focused its efforts on the war, but this lull was followed by a tremendous surge in building activity in the 1920s.

[3] Overdevelopment in the 1920s

As the economy expanded after the war, the middle class continued to grow and had more disposable income to invest. The fact that nationwide hotel occupancy rose from 72 percent in 1919 to 86 percent in 1920, coupled with the perception that real estate was a sound, safe investment vehicle, made many people eager to participate as they listened to hotel promoters who set up shop in their towns and cities. Many times their arguments for investment were based not on economic feasibility but on civic pride, improving a neighborhood, or personal prestige. In some cases, local merchants were promised patronage by the hotel when it opened if they invested in the project. In these "community-financed" hotel projects, real estate bonds for first and second mortgages were sold to local residents. In many cases the financing structures thus created involved high leverage and an inordinate amount of risk.

Despite these conditions, investors were convinced, money was available, and hotels were financed, resulting in a boom in hotel construction throughout the decade. By the middle of the decade, *Hotel Management* (a trade publication that later became *Hotel and Motel Management*) began to print articles by several industry spokespersons warning against "over-hoteling" and urging professional hoteliers to release to the public the "real facts" about their hotel's occupancy level and financial condition to offset the larger-than-life stories that had circulated earlier and contributed to the overbuilt situation. In order to illustrate the extent of the overbuilding

problems a nationwide survey was conducted in 1928–1929 by an objective body, the Engineering-Economics Foundation. This postgraduate college in Boston quantified hotel room supply, guest demand, occupancy levels, rates, and hotel failures over the period 1919–1928. They found that nationwide hotel occupancy dropped from 85.5 percent in 1920 to 67.6 percent in 1928.

Room rates appeared to remain nominally constant between 1921 and 1928, but the Foundation determined that the addition of services for guests over this time effectively lowered the rate achieved by hotels. Hotel failures increased between 1924 and 1928 at an average annual rate of 15 percent.

[4] Depression Years

The real status of the lodging industry quickly became apparent after the stock market crash of 1929. Hotel rate wars became common, leading one industry spokesman to suggest mergers of hotels within cities in order to hold prices firm. However, even low rates could not induce demand when there was none. By 1933, one third of the country was out of work, the gross national product had dropped by almost half, and the lodging industry suffered severely as a result. By 1935, over 80 percent of the hotels in the nation were in foreclosure or in some form of liquidation. Many properties closed entirely.

A major opportunity arose from the collapse of the hotel industry for investors that had available cash, because they were able to buy troubled properties with only a small cash outlay and reasonable financing. It was at this time that some of the most well-known hotel chains had their beginnings.

Conrad Hilton had entered the lodging industry in 1919 with the purchase of the 40-room Mobley Hotel in Cisco, Texas. During the 1920s Hilton had expanded his holdings throughout Texas, and had acquired a total of eight hotels by 1929 when the stock market crashed. Because his hotels were highly leveraged, Hilton suffered as a result of the crash. Despite cutting costs to the bone—including removing guestroom telephones and shutting off entire floors—he was only able to retain control of five hotels in his chain. By 1935, however, profits from oil leases provided Hilton with cash to satisfy his creditors and to fund new purchases. Hilton then bought control of the Sir Francis Drake in San Franscisco, the Town House in Los Angeles, the Stevens in Chicago, and the Roosevelt and Plaza in New York.

Ernest Henderson founded what was to become the Sheraton hotel chain in 1937 with the purchase of the Stonehaven Hotel in Springfield, Massachusetts. By 1941, his company had acquired four hotels and Henderson was well on his way toward building one of the nation's largest lodging chains.

Large, sophisticated hotel companies, such as Hilton and Sheraton, were able to overcome the fears of bankers and other lenders who were wary of independent developers and hotel investments in general. By taking advantage of low selling prices, the strong hotel companies were able to continue their expansion.

Representatives of the hotel industry warned investors during the depression years not to value hotels based on their present income streams, which were, of course, very low. They stressed rather that hotels should be valued on the expectation of future earnings, which would turn around. Trade writers, looking back at previous recessionary times, optimistically forecast three years of darkness before the industry would recover. However, the depression years were different because of the overbuilding that had preceded them.

[5] World War II Era

The hotel industry did not begin to recover until the early 1940s, after both the general economy improved and the hotel room supply had been significantly reduced by closures. With the onset of World War II, the industry experienced an increase in lodging demand that surpassed even the booming 1920s. As a result of the war, the country was on the move; servicemen traveled home on leave, civilians relocated near defense plants, and commercial travelers swelled in number to meet the huge need for goods and services. Despite the large increase in demand, supply remained constant because construction materials and labor were devoted to the war effort. Financing was generally unavailable for new construction because lenders and investors were still wary after experiencing the downswing of the depression. In some areas, hotel room supply was actually significantly reduced when the armed forces required that hotels such as the Hotel Stevens in Chicago and the Greenbrier in White Sulphur Springs, Virginia be converted to housing for troops. The combination of excessive demand and constant or diminishing supply created occupancy levels over 90 percent and unmatched profits.

The labor and material shortages made it difficult to maintain high service standards during this time, but guests waiting hours in hotel lobbies for accommodations had no alternatives. In fact, at one point New York City hotels had to limit the stay of guests to three days.

[6] Postwar Development

The years immediately following World War II did not see a construction boom such as the one that followed the First World War, in large part because hotel lenders were concerned about the risk of repeating the financial disaster of the 1930s. Though averse to lending on new hotel projects, mortage lenders did grant refinancing to existing hotels. Having developed successful track records during the 1930s and 1940s, the larger hotel chains (specifically Sheraton and Hilton) were looked on favorably by lenders and received assistance during the 1950s in expanding their chains, both by acquiring existing properties and, to some extent, by building new hotels in key cities. Hilton purchased the Statler chain of 10 hotels in 1954 for $111 million from Statler's widow, and Sheraton expanded in 1956 by acquiring 22 hotels from Eugene Eppley.

The 1950s were marked by the development and growth of motel chains. With their beginnings in the tourist courts of the 1930s, motels in the early years were usually 20–50 unit, family-run operations in which a small investment (such as a retirement nest egg) was made and family members contributed all of the labor. The war activity of the 1940s caused tourist court business to decline because there was little free time for vacation travel and gasoline and food were rationed. It was not until after the war that the situation improved for this segment of the industry.

Travel had become an accepted part of American life during the war. Travel came to be seen as recreational, and the new-found pastime was fueled by the increasing use of the automobile and the expanding economy, which provided many families with more disposable income. It was easy and inexpensive to take a family vacation by driving and staying at motor courts, where the car could be parked by the guestroom door. In addition to vacation travelers, the motel market included business travelers (especially salespersons, middle-mangers, and small business owners) and per diem government employees.

The first motels were distinctly different from hotels of the same period in terms of size, construction costs, land values, and management requirements. They were also distinctive in the benefits they offered—convenient highway locations, ample free parking, and low rates.

[a] Emergence of Chains and Franchises

While motels began to flourish throughout the U.S., their potential guests had no idea what service and quality levels to expect when pulling off the highway. Standards were at best unpredictable and frequently disappointing. Recognizing an opportunity when traveling with his own family, Kemmons Wilson started a new era in the lodging industry in 1952 by founding Holiday Inns, one of the earliest motel chains. Holiday Inns offered its guests a modern motel with standardized service and a recognizable name at a moderate price. The growth of the Holiday Inn chain from Kemmons Wilson's original four motels in and near Memphis, Tennessee in the early 1950s to over 100 motels nationally by 1960 was driven by the sale of franchises to investors who then operated the properties as their own businesses. The first Holiday Inn franchise was sold in Clarksdale, Mississippi for $500 and a flat fee of $0.05 per occupied room. In return, the franchisee received the Holiday Inn name, architectural plans, and national advertising. In 1964, when Holiday Inns launched its Holidex I reservation system, a major benefit was added to the franchise package and Kemmons Wilson was overwhelmed with franchise applications.

[b] Expansion of Supply

On a nationwide basis, motel room supply increased from 600,000 to 1.5 million rooms during the 1950s. Three major factors contributed significantly to this increase. The first was the passing of the Interstate Highway Act in 1956, which defined the future growth of interstate highways and allowed planning for roadside motel sites throughout the nation. The second was a change in income tax laws in 1954 that permitted real property owners to use an accelerated depreciation method. This led to a period of readily available cash from ''tax-based'' hotel deals in which syndicators offered investors participation in hotels that benefited from the large depreciation and interest expense that offset income in the early years of the investments. The drawback to this type of investing was that in order to keep up the high depreciation and interest deductions, new properties had to be added continuously to an investor's portfolio, which led on occasion to poor investment choices. The third factor was the use of franchising as an expansion tool for motel and hotel chains.

[7] Changes in the Marketplace in the 1960s

Hotel owners were at first reluctant to accept the fact that they were competing with motels for the same market. However, steady declines in their own occupancy rates as motel rooms came on the market, coupled with the fact that motel occupancy levels remained stable, told them differently. Nationwide occupancy, performing in the upper-70 percent range during the early 1950s, dropped to the mid-60 percent range by 1960, and fell further to low-60 percent figures overall by 1962 as more motel rooms came on the market. In order to compete for the same market as hotels, motels began to offer more amenities and to develop properties in metropolitan loca-

tions. Hotels, in turn, started to offer parking facilities and lowered their room rates in order to stay competitive. The distinction between hotels and motels continued to diminish and resulted in a hybrid lodging facility known as the motor hotel, which combined the services and facilities of a hotel with the convenience of a motel.

Marketing achieved recognition as a profession during the 1950s and 1960s, and "market segmentation" gained acceptance as an industry precept. As a result, the market for lodging accommodations was no longer thought of as one homogenous mass. Marketers began to research and understand their customers more clearly, to define specific segments with varying characteristics, and to focus on the segments more effectively by carefully selecting the services, amenities, and prices that were offered.

The late 1950s and early 1960s saw the rise of several new lodging chains in addition to Holiday Inn that relied on innovative marketing strategies for their initial success. Ramada Inns, Howard Johnson Inns, Marriott, Hyatt, and Radisson all successfully won significant market shares in their early years through inventive, aggressive marketing.

International activity on the part of U.S. hotel companies became common during the decade of the 1960s. Pan American Airways' subsidiary, Inter-Continental Hotels Corporation, which had begun in the late 1940s with the opening of the Inter-Continental in Belem, Brazil, continued to develop hotels in Latin America. Hilton Hotels, which had been operating the Caribe Hilton in Puerto Rico since the late 1940s, established their Hilton International division, and began expanding their operations in Europe and South America.

A move toward vertical integration within the airline and lodging industry also occurred during the 1960s as several large airlines acquired or merged with hotel companies. In 1967, Hilton International Corporation (by then a separate company from Hilton Hotels) was purchased by Trans World Airlines. UAL, Inc. purchased the Western International hotel chain, which is now known as Westin Hotels. Another example of the union of lodging and transportation companies was Holiday Inns' acquisition of the Continental-Trailways bus lines and the Delta Steamship Lines in the late 1960s.

The convention and meeting market became a focus of interest during the 1960s as hotel chains sought new opportunities for growth. The New York Hilton, which opened in 1963, was designed and built specifically to cater to the growing convention market, which favored major cities as destinations.

[8] Expansion and Contraction in the 1970s

The large hotel companies that were formed in the 1950s and 1960s matured in the 1970s, becoming more professional and more sophisticated in their management systems. The disciplines of hotel operations, finance, accounting, and marketing were developed into a science. Emphasis was placed on making operations more efficient, monitoring operating statements, and comparing financial ratios to prior years and national averages. University degree training in hotel administration became common for management personnel.

The concept of "market segmentation," which gained respect in the 1960s, became the guiding force behind the growth of many of the major chains throughout the 1970s and into the present. As market segments became better defined and hotel companies selected the segments their hotels could best target, the appropriate sales skills for the chosen segment also improved.

During the late 1960s and early 1970s, hotel companies actively expanded through franchising. In a franchise agreement, the hotel owner pays an initial franchise fee plus monthly royalty fees for the use of a hotel chain's name, logo, reservation system, national advertising, operation and training manuals and, in some cases, centralized accounting systems.

The late 1970s and early 1980s saw a trend by hotel chains toward selling ownership of their hotels to investment groups and taking back management contracts to operate the properties, thereby freeing capital for further expansion while still retaining a high degree of control. (See Chapter 16 for further discussion of the role of management contracts in the industry.) Professional hotel management companies proliferated as it became apparent that the industry was moving in this direction.

Aggressive expansion of hotel chains and the creation of budget motels during the late 1960s and 1970s caused the start of a construction boom and overbuilding cycle reminiscent of the 1920s. While many factors contributed to this period of expansion, the ready availability of capital, in several forms, may be seen as one of the driving factors.

High-leverage finance organizations known as real estate investment trusts (REITs) were created to allow small investors to participate in real estate mortgages and equities. They were greeted with a great deal of enthusiasm and as a result provided an enormous amount of funds for hotel financing during the early 1970s. The concept was just as eagerly accepted by Wall Street and funds became available for investment that had not existed before. Many lenders became so overwhelmed with new money that their underwriting qualification procedures broke down, resulting in a number of marginal and speculative developments being approved.

Franchising itself was an indirect source of new capital for hotel companies because the franchisee's investment could, essentially, be used to finance corporate growth. In some cases, franchises were sold and hotel properties developed in markets that were not strong enough to support them. On one intersection in Selma, North Carolina, eight nationally franchised properties were built, though demand existed for one at best. The combination of readily available financing and aggressive hotel chains eager to sell franchises resulted in overbuilding and the development of a number of undercapitalized properties managed by inexperienced owners in poor locations.

The frenzied growth in hotel supply in the early 1970s led to a crisis for the lodging industry. High inflation caused construction costs and interest rates to escalate. In addition, the oil embargo in 1974 and the resulting energy crisis drastically reduced travel. The recession that followed curtailed even further business trips, conferences, and conventions. The marginal properties built during the boom earlier in the decade could not survive this downturn and as a result were taken back in foreclosure by the lending institutions that had financed them. The lenders then either established workout departments headed by experienced hoteliers or engaged professional management companies to assume operational responsibility for the properties, the primary objective being to improve profits so that the hotels could be sold at satisfactory prices. Over the short term, very few properties were able to meet this objective, however, and lenders frequently had to either take substantial all-cash write-downs or provide purchase-money financing with extremely favorable terms. Over the long term, many of these hotels recovered during the early 1980s and became successful lodging facilities.

By the late 1970s, a rough equilibrium between lodging supply and demand was reached because of the scarcity of capital, the downturn in new construction, the retirement of older lodging facilities from the market, and the closure of unprofitable

hotels developed during the construction boom. High occupancy rates were once again recorded.

[9] Overbuilding and Recovery in the 1980s

In the early 1980s, the prime rate was at a record high, with the result that construction financing became too costly and many projects were rendered infeasible. In addition, lenders were still wary of hotel investment after the downturn of the mid-1970s and were thus resistant to extending credit. Hotel supply did not increase during this time, so hotel occupancy continued to remain at high levels.

After 1983, interest rates dropped as a result of declining inflation and falling energy prices, and hotel development resurged. As had been the case in the early 1970s, the ready availability of capital contributed to a period of excessive hotel construction. At this time, however, it was the entry of savings and loan (S&L) institutions into the commercial lending market that provided new capital for hotel development. In many ways, the overall scenario was the same as it was in the 1970s: So much capital became available for real estate transactions that review processes broke down and many marginal and speculative investments were approved.

Another major contributing force to overbuilding in the first half of the 1980s was the favorable treatment offered by U.S. income tax regulations. Many real estate syndications were structured using ''tax-based'' real estate deals for investors, which took advantage of rules that allowed losses from one investment to offset other types of income from different investments. In addition, a favorable capital gains tax rate enhanced the value of real estate investments. These ''non-economic'' deals (i.e., generally non–cash flow generating) provided equity capital that would not have otherwise existed. In addition, in anticipation of the changes in the tax laws, a large number of hotel construction deals that might well have been delayed until market conditions were more favorable were pushed through before midnight on December 31, 1985. Because of the considerable lead time needed to plan and build a hotel, this led to an extended period of overbuilding and a glut of hotel rooms coming on the market at the same time.

The industry recovery that has taken place in recent years is similar to that which occurred after the period of overbuilding in the mid-1970s: Lenders holding distressed properties have contracted professional management companies to turn around their hotels and avoid losses; most lenders are now extremely wary of making new hotel loans; and demand in many markets is beginning to catch up to supply. As a result, occupancy rates appear to be on the way to recovery.

Although overall new construction has slowed, hotel chains have still been active in development as ''product segmentation'' became the watch word of the 1980s. In the 1960s and 1970s, the concept of market segmentation and its emphasis on the demand side of the lodging equation affected every aspect of the industry. Marketers began to research and understand the buying public more clearly, to define specific segments by their varying characteristics, and to target the segments more effectively by offering the services, amenities, and prices that the public was seeking. The 1980s saw this concept taken one step further to product segmentation, when hotel products began to be designed specifically for targeted market segments. The trend in services and amenities over the last 30 years has been to deliver what is appropriate to each market segment and product type, based on market demand and price. For luxury and first-class hotels, where high room rates are charged and guests expect high quality, services and amenities have been increased and expanded. Con-

cierge levels have been added, guestrooms have been lavishly furnished, and guestroom amenities such as toiletries, robes, towels, and personal care equipment have been added and upgraded. Conversely, services and amenities in economy-level properties have tended to be reduced or eliminated in order to reduce or maintain low room rates, which are the most important factor to this segment.

A new market segment was defined and addressed during the 1980s. Known as the extended-stay market, it comprises guests who need accommodations for a period of time greater than the typical guest's one to three days, for such reasons as business training, temporary assignment, or relocation. Demand for these needs has previously been met chiefly by short-term lease apartments.

The all-suite hotel is a product that also became active during the 1980s, as several hotel chains brought their all-suite designs to the market. The guest accommodations in these facilities usually includes a living area as well as a sleeping area, a room layout that is favored by many guests.

There has also been a revival of bed and breakfast inns and country inns since the 1980s as a significant number of vacationers have sought quaint, older-style accommodations.

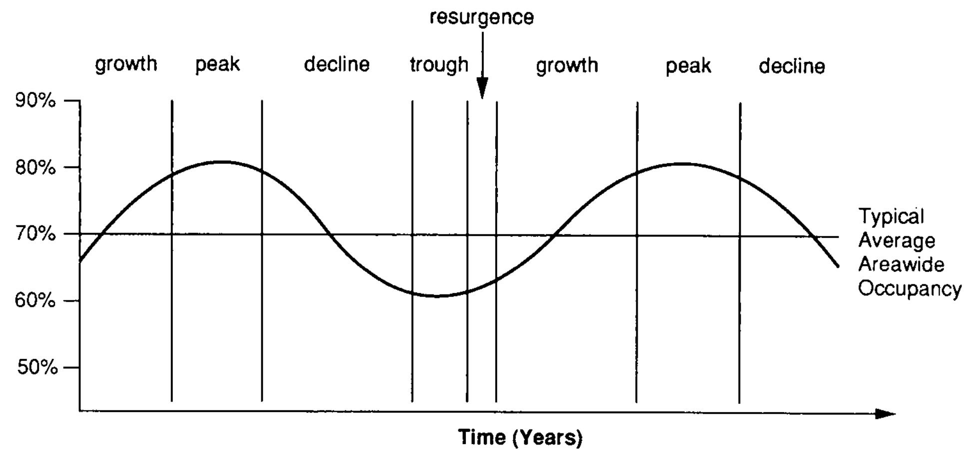
On a national basis, lodging demand gained strength in the second half of the 1980s (as had not been the case after the energy crisis and recession in the mid-1970s) and major influences continue to appear healthy. Trends of increased leisure time and the changing structure of the American family have contributed to both growth in travel and overnight lodging stays, although not at the rates seen in the 1940s and 1950s. The population as a whole is aging, which means more Americans are in the higher age brackets known for greater disposable income, more free time, and a propensity to use both for travel. Predictions by industry experts have been made for a 20-year period of slow to moderate growth for the lodging industry in the United States.

2.02 INDUSTRY DYNAMICS

The evolution of the hotel industry is driven by the interaction of the demand for lodging accommodations and the supply of hotel rooms. At its equilibrium point, the demand and supply in a market area are exactly equal. Every guest needing a room is accommodated and every room is filled. However, since demand changes daily and room supply cannot be added to or removed from the market nightly, it is more realistic to define the equilibrium level in terms of the level of occupancy at which, all else being equal, the supply of rooms would remain constant. Although this equilibrium level does not frequently occur, it is useful to recognize that there may be typical area-wide conditions characteristic of each market where supply and demand and all the forces affecting them are in balance. Being able to recognize this stabilized level helps hotel investors determine where in the hotel industry cycle a particular market is situated.

The hotel supply and demand relationship in a given area does not, of course, exist without outside influence. It is both directly and indirectly affected by the interaction of many factors that tend to shift the balance and contribute to upward and downward swings of the cycle. Factors affecting demand include the general state of the national economy, the economic vitality of the specific market, and changing travel patterns. Factors that affect supply include the availability of capital and government policies and programs.

FIGURE 2.1
Typical Hotel Industry Cycle



This section examines the forces responsible for change in the lodging industry. Where possible, the actual experience of the hotel industry in the United States is used to illustrate these factors.

[1] Industry Cycle

Most industries experience periodic cycles that reflect changes in the economic forces that affect a specific type of business. Movement in the hotel cycle is typically measured by changes in occupancy levels in a specific area or in the nation as a whole. The typical cycle that the hotel industry follows has a pattern of five characteristic phases (see Figure 2.1). Each phase is marked by specific conditions in the local marketplace.

In the growth phase, hotel occupancy rates increase, as do average room rates (usually over and above the rate of inflation). Individual properties, therefore, generate increasingly strong cash flows. This phase is also marked by the availability of capital at feasible rates for hotel development. In addition, debt sources are actively interested in lending on hotel properties. Overall, the market value of hotel properties increases.

During the peak phase, hotel occupancy and room rates remain strong and cash flows from operations maintain a high level. Both equity and debt funds are readily available and hotel market values, while still on the rise, tend to grow at a slower rate as they move toward a stabilized peak level.

The decline phase marks the beginning of a decrease in the overall occupancy level. Average room rates may increase, but only in step with inflation, and the interaction of these factors will mean either stable or slowly decreasing cash flow from operations. Equity investors generally sense higher risks in hotel investment during this phase and may increase their return requirements. The combination of decreasing cash flows and higher return rates causes the market value of hotels to decrease.

During the trough phase, hotel occupancy, room rates, and cash flow from operations reach their lowest levels. Average room rates may drop because of the need for competitive pricing. In response to the perceived high risk, equity investors may raise their return requirements still further. Debt financing for proposed hotels may be nearly impossible to find, and refinancing dollars almost as hard to locate. Hotel market values continue to decrease and eventually bottom out.

The resurgent phase is characterized by the rebounding of hotel occupancy, room rates, and cash flow from operations. As the market begins to show signs of recovery, equity sources begin to lower their return requirements. Hotel lenders, however, may still be wary and debt financing may still be hard to obtain.

[2] Economic Life of Individual Properties

A key element in the economic life of a hotel is the length of time over which improvements to the property contribute to its value. As hotel improvements age, they may suffer physical, functional, and external obsolescence, causing income productivity to decline. The economic life of a hotel can vary considerably, and the risk factor associated with an unknown economic life must always be evaluated by hotel investors before developing or purchasing a lodging facility.

Physical deterioration is evidenced by wear and tear, decay, or structural defects in a building, such as cracking in the building foundation. The physical deterioration of a hotel can be minimized by ongoing maintenance and remedied by periodic extensive renovations and so does not typically influence the economic life of a hotel.

Functional obsolescence may be caused by a deficiency in the size, style, or mechanical equipment of a building. For example, after the advent of the elevator in 1852, hotels higher than three stories that did not have elevators quickly became functionally obsolete. Other examples of functional obsolescence include hotels with exterior corridors rather than interior hallways, outdoor pools rather than enclosed facilities, and ballrooms rather than conference facilities. Sometimes the cost of redesigning and replacing the outmoded elements is not economically justified, and the property gradually becomes less competitive. However, correcting functional obsolescence in a hotel property is frequently possible and does not necessarily reduce economic life.

External obsolescence is caused by negative outside influences over which the hotel operator and investor have no control. Examples include a declining neighborhood, adverse changes in the local economy, overbuilding, and new highway or travel patterns. External obsolescence can radically affect the economic viability of lodging facilities and immediately diminish bottom line profits.

In 1978, the Internal Revenue Service conducted a study that showed that hotels and motels have the following average economic lives:

	Life (in years)	*Standard deviation*
Hotels	40.91	20.63
Motels	31.00	6.87

Source: The Appraiser, *June 1978*

The large standard deviation found in this survey indicates that a hotel may have a useful life as short as 20 years or as long as 60 years. This variable element contributes greatly to the risk of hotel investments.

A shorter economic life means an income flow of shorter duration and the possibility that a property may only reach a lower stabilized net income level, thus necessitating more market recapture. In analyzing the project, investors may use higher mortgage constants and may require higher equity dividends and yields.

[3] Demand Trends

Various broad factors contribute to shifts in hotel demand. In some cases, these factors can work to decrease demand. As discussed previously, the stock market crash of 1929 and the subsequent depression directly reduced demand for lodging accommodations. The economy contracted, disposable income was reduced, and both commercial and leisure travel dropped significantly. The oil embargo of 1974 and subsequent recession also sent lodging demand plummeting for many of the same reasons. Conversely, wartime activity generated extensive lodging demand in the United States because of the tremendous increases in travel created by troop movements and the relocation of workers to essential industries. During World War II, the nationwide occupancy rate reached an historic high of 94 percent.

Changes in the local economy specific to the market area of a hotel also directly affect lodging demand. Population shifts (e.g., from the Northeast to the Sunbelt) have reduced market growth rates, especially if they are followed by movement of commercial activity. Changes in the health of the individual industries that make up the local economy also affect lodging demand. For example, the "oil patch" markets, which include much of Texas, Oklahoma, Louisiana, Colorado, and Wyoming, have been dramatically affected by reductions in the price of oil in the mid-1980s. In general, developers now look for market areas with diversified economies in order to mitigate the risk of changes in individual industries.

Changing travel patterns have been a major factor affecting developments in lodging demand throughout the history of the industry. As discussed earlier, lodging facilities were often opened in response to new innovations in transportation. As each new innovation was introduced, the industry adapted to meet the needs of a new sort of traveler. Those lodging facilities that could not adapt, such as a motel located away from the route of a new interstate highway, often suffered a precipitous drop in demand and a dramatic shortening of their economic lives.

[4] Supply Trends

The hotel supply cycle generally follows the same course as the overall industry cycle. Changes in building activity are sometimes a result of changes in occupancy level, while in other cases they may precede and be the reason for the occupancy shift. The actual circumstances usually depend on contributing factors such as increased demand from newly accommodated markets or a surge in building that is fueled by readily available funds.

[a] Effects of Increased Supply

Hotel development usually occurs when the need for a greater supply of hotel rooms becomes apparent, either by overly high occupancy rates achieved by existing hotels or by customer dissatisfaction with the available hotels.

There have been many instances, however, when the need was apparent but development did not occur. Other factors, such as the lack of materials for construction or the lack of available and cost-justified financing, inhibited new hotel development. During World War II, occupancies ran in the 90 percent range, but no construction took place because materials were rationed and labor was unavailable because of wartime activity. In the late 1970s and early 1980s, occupancy levels were high but the cost of capital prohibited new construction.

[b] Development Without Demand

Hotel development also occurs occasionally when demand for additional rooms does not exist, simply because it is sometimes difficult to accurately quantify and project hotel demand over extended periods. Even when existing demand is properly quantified, the interaction of other factors may cause future demand levels to change. For example, new supply may be added to the market in the time it takes to develop a particular hotel. The decision to build may make economic sense for an individual hotel or chain but not to the overall market. A new hotel may be expected to capture demand from older properties, effectively shortening their economic lives. In some cases, a chain may build a hotel in a particular market in order to have its name or "flag" represented. In order to keep up a predetermined level of growth or to reach a critical mass, a hotel chain may lower its development requirements and allow marginal properties to be built. Hotels may also be introduced into a market as loss leaders in order to attract other development. This occurs presently when hotels are built in mixed-use developments in order to generate interest in the project. Finally, hotels may sometimes be erected to bring economic revitalization or civic pride to an area.

The decision to build may even be justified by individual profit motives. For example, personnel working for franchisors, developers, and hotel lenders may receive compensation dependent on the number of deals closed. Incentives may exist for such people to go forward with marginal projects, especially if they expect to change positions and will not be held accountable for the subsequent poor performance of the projects. All of these motivations for pushing through marginal deals should cause potential investors to be very careful to make sure that the project they are examining is economically sound for their own interests.

[c] Availability of Capital

One of the most prevalent reasons for hotel development is that "the money was there." This factor contributed significantly to periods of overbuilding in the 1920s, 1970s, and 1980s. In each case, a new source of investment funds (respectively, real estate bonds, REITs, and S&L loans) attracted large amounts of money that was utilized for the construction of new hotels.

[d] Government Intervention

Government actions and policies have affected hotel development throughout its history. For example, in colonial times Massachusetts required its towns to build inns for travelers.

The government may intervene in the hotel market by providing funds that would otherwise not be available. On the federal level, the Urban Development

Action Grant (UDAG) program of the U.S. Department of Housing and Urban Development has provided funds for hotel projects as well as other types of development. Local city and state governments also provide funds in the same manner. In the case of a downtown metropolitan area that is trying to revitalize by building, for example, a convention center and hotel, the standard industry sources of funds may not be available because of the current lack of demand in that area and the high risk of the project. Monies provided by the government in this situation contribute to the hotel market directly, by the addition to room supply, and indirectly, by funding the convention center, which, if successful, will generate lodging demand that would not otherwise have existed.

Local governments may provide outright bonuses or inducements, in the form of tax incentives, for development they would like to see take place. In 1927 the city of Waco, Texas gave Conrad Hilton a bonus of $50,000 as inducement to build a hotel in that town. Government agencies may offer favorable leases for government-owned property, effectively providing funds and incentive for development. Government agencies may also effect hotel development by helping with the assemblage of parcels.

Changes in tax law have had profound effects on the lodging industry. In 1954, such changes enabled hotels to use an accelerated method of depreciation, thus increasing the depreciation expense in the properties' early years and lowering their tax liabilities. Anticipation of the Tax Reform Act of 1986 generated a rush of hotel development at the end of 1985 that might otherwise have been delayed until market conditions improved.

[5] Financing Trends

[a] Development Costs

Hotel development costs include the costs of land, labor, construction materials, furniture, fixtures, and equipment, financing, professional fees, and preopening expenses. The cost of each of these goods and services operates on a separate market cycle, which may be dependent on the general economy, the availability of raw materials, and alternate or more profitable uses. Table 2.1 lists the results of eight surveys taken between 1976 and 1988 regarding development costs.

As illustrated in the table, construction costs between 1986 and 1987 rose at a 1–2 percent rate, one of the slowest increases in recent years. This modest rise compares to the rapid 7–8 percent escalation in prices that took place between 1983 and 1984. Several factors contributed to the more recent favorable trend in construction costs. Inflation decreased significantly between 1986 and 1987, resulting in lower material costs and wage expenses. At the same time, interest rates declined 300 to 400 basis points, making the cost of construction financing much less expensive. However, as was the case in the 1930s, relatively low construction costs in the late 1980s have been coupled with limited opportunities for developers to take advantage of this condition. Not only is new construction difficult to justify in already overbuilt markets, but lenders who have had their fill of hotel investments (and who may be holding distressed properties themselves) are reluctant to initiate new hotel mortgage loans.

Table 2.1 also shows that preopening expenses have increased over this period as hotel management companies have put increased emphasis on establishing adequate preopening budgets in order to have sufficient funds for marketing and training

TABLE 2.1
Hotel Development Costs (in dollars per available room)

	Improvements	Furniture, fixtures and equipment	Land	Preopening	Operating capital	Total
1976						
Luxury	32,000– 55,000	5,000–10,000	4,000–12,000	1,000–2,000	1,000–1,500	43,000– 80,500
Standard	20,000– 32,000	3,000– 6,000	2,500– 7,000	750–1,500	750–1,000	27,000– 47,500
Economy	8,000– 15,000	2,000– 4,000	1,000– 3,500	500–1,000	500– 750	12,000– 24,250
1979						
Luxury	36,000– 65,000	8,000–15,000	5,000–20,000	1,500–3,000	1,500–2,000	52,000–105,000
Standard	25,000– 36,000	5,000–10,000	3,000–11,000	1,000–2,000	1,000–1,500	35,000– 60,500
Economy	10,000– 20,000	3,000– 5,000	1,500– 6,000	750–1,000	750–1,000	15,750– 33,000
1981						
Luxury	45,000– 80,000	10,000–20,000	8,000–22,000	2,000–3,500	2,000–2,500	67,000–128,000
Standard	25,000– 40,000	7,000–13,000	4,000–12,000	1,200–2,500	1,200–2,000	38,400– 70,000
Economy	13,000– 25,000	4,000– 7,000	2,000– 7,000	700–1,200	900–1,200	20,600– 41,400
1983						
Luxury	55,000–100,000	12,500–20,000	10,000–24,000	2,300–4,000	2,000–2,800	81,800–151,000
Standard	35,000– 50,000	9,000–15,000	5,000–13,000	1,400–3,000	1,300–2,200	51,700– 83,200
Economy	18,000– 32,000	5,000– 8,000	3,000– 8,000	800–1,500	900–1,300	27,700– 50,800
1984						
Luxury	58,000–110,000	13,000–21,000	10,500–25,500	2,500–4,200	2,000–2,900	86,000–163,600
Standard	37,000– 55,000	9,000–16,000	5,300–14,000	1,500–3,100	1,300–2,300	54,100– 90,400
Economy	19,000– 35,000	5,000– 8,500	3,200– 9,000	900–1,600	900–1,400	29,000– 55,800
1985						
Luxury	60,000–115,000	13,400–30,000	11,000–26,500	3,000–5,000	2,100–3,000	89,500–179,500
Standard	38,000– 57,000	9,500–16,500	5,500–14,700	1,900–3,600	1,400–2,400	56,300– 94,200
Economy	20,000– 36,000	5,000– 8,800	3,300– 9,500	1,000–1,700	1,000–1,400	30,300– 57,400
1986						
Luxury	62,000–120,000	13,700–30,600	11,500–27,800	3,100–5,200	2,200–3,100	92,500–186,700
Standard	39,000– 60,000	9,700–16,800	5,800–15,400	2,000–3,800	1,500–2,500	58,000– 98,500
Economy	21,000– 37,000	5,100– 9,000	3,500–10,000	1,000–1,800	1,000–1,500	31,600– 59,300
1987						
Luxury	63,000–122,000	13,800–30,900	11,900–28,600	3,300–5,500	2,300–3,200	94,300–190,200
Standard	40,000– 61,000	9,800–17,000	6,000–15,900	2,100–3,900	1,500–2,600	59,400–100,400
Economy	21,000– 39,000	5,200– 9,100	3,600–10,200	1,100–1,800	1,100–1,500	32,000– 61,600
1988						
Luxury	65,000–125,000	14,000–31,000	11,900–28,600	3,300–5,500	2,300–3,200	96,500–193,300
Standard	41,000– 63,000	10,000–17,100	6,000–15,900	2,100–3,900	1,500–2,600	60,600–102,500
Economy	22,000– 40,000	5,200– 9,200	3,600–10,200	1,100–1,800	1,100–1,500	33,000– 62,700

during the initial start-up period. The current competitive environment makes this strategy essential to financial survival.

[b] Amenity Creep

A phenomenon associated with the growth of hotel development costs is ''amenity creep.'' This process begins when a new lodging product is introduced with a basic package of amenities. As the lodging product matures, it is upgraded with additional amenities, such as swimming pools, restaurants, meeting rooms, and health clubs. These changes are justified under the premise of keeping up with the competition. Inevitably, the room rate is increased to cover the cost of the new amenities package. As this process occurs over time, lodging chains that started as budget level properties begin to ''creep'' into higher priced markets, and a gap develops at the economy end of the scale.

The process of amenity creep is illustrated by the case of the motor hotel. As discussed previously, the 1930s saw the establishment of motels as an inexpensive alternative to hotels. As the motels developed, a new lodging product, the motor hotel, gradually emerged as a hybrid of these two types of lodging facilities. Like motels, motor hotels provided an informal atmosphere that catered to motorists, with free parking and, in some cases, drive-up check-ins. However, in the manner of hotels, motor hotels also offered more amenities and a higher level of service and charged a higher price than most motels of the time. As motels upgraded themselves to become motor hotels, an opening was created for new motels.

The phenomenon of amenity creep can also be seen in the data contained in Table 2.1. In the data for 1988 economy hotel construction costs, the low end of total project cost is $32,000 per room. However, hotel developers can actually build a no-frills budget motel that would be attractive to a sizable portion of the economy travel market for $18,000–$22,000 per room. This opportunity at the low end of the economic scale is the direct result of amenity creep.

[c] Methods of Financing

Over the past 60 years, the use of leasing arrangements (both land and total property leases), hotel management contracts, franchising, and depreciation methods have all had significant effects on hotel financing. Banks and other lending institutions have become more or less involved in the hotel industry depending on overall economic conditions of the time and their perceptions of the risk and return of hotel activity. Mirroring the hotel industry cycle, lenders have a higher degree of confidence making hotel loans when the cycle is in its growth and peak stages, and show a hesitancy to make loans during the downturn and trough phases. Lenders generally lag behind the rest of the lodging industry in renewing their activity after a downturn because they remain wary of the conditions.

[i] Franchises. Beginning in the 1950s, motel chains such as Holiday Inns used the concept of franchising as a technique for financing their growth. Rather than developing motel properties with their own funds, these lodging firms sold a standardized franchise product and package to investors who then developed and operated the properties as their own businesses.

As franchising proliferated, however, drawbacks such as lack of control by the franchisor became apparent. By the 1960s, and continuing through the 1980s, hotel and motel chains moved toward the increased use of management contracts. This arrangement allows hotel chains to expand the number of properties bearing their name without using their own capital to fund their growth while still retaining a high degree of control over the property. Depending on the management agreement negotiated between the hotel chain and the hotel owner, this arrangement may also put the chain in a position of lower risk than would be the case if it owned the property.

[ii] Public Corporations. In 1946, stocks from both Sheraton (United States Realty–Sheraton Corporation) and Hilton (Hilton Hotels Corporation) were listed for the first time on the New York Stock Exchange and traded on the open market. Raising equity by selling stock is a strategy that has been actively used since the mid-

1960s, and it continues to be seen as a viable means of generating capital for growth by hotel and restaurant chains.

[iii] **Leasing.** The use of total property leases was common in the early part of the 20th century, but since the 1950s the general practice has tended toward leasing of only the land. The leasing of a hotel's furniture, fixtures, and equipment (FF&E) has also been used as a source of capital in the early stages of hotel development. When capital is short and the developers feel that the hotel will generate enough income to cover F,F&E as a fixed expense, they may negotiate a lease arrangement in order to get the hotel open.

[iv] **Leverage.** Although the use of leverage in hotel financing structures is not unique to this century, it has become an important component of modern deal structures. As discussed earlier in this chapter, an over-dependence on leverage in the 1920s brought about the failure of a number of hotels during the Great Depression because their high debt service could not be supported. For a long while after the experiences of those crisis years, lenders, when they did make hotel loans, would not allow the debt level to exceed more than 50 percent of fair market value. Larger chains were, however, able to borrow up to 60 to 70 percent of fair market value by using the entire hotel chain as collateral. Current industry patterns indicate that 75 percent of fair market value is now standard for most hotel loans.

[v] **Syndications.** Syndications, which are usually thought of in terms of "tax-driven deals," became a common form of hotel financing in the 1950s when a change in the income tax laws allowed real property owners to use an accelerated method of depreciation. Hotels benefited from this method because of large depreciation and interest expenses that offset income in the early years of the investments. Syndications soon became known for tax-sheltered investments that provided tax losses to be used against tax liability generated by other income-producing investments. Tax-based syndications were common until the Tax Reform Act of 1986 eliminated many of their benefits.

[vi] **Innovative Techniques.** During the history of the hotel industry, a number of innovative and imaginative techniques have been used to raise money to finance hotel investments. As discussed earlier, the REIT and the savings and loan industry played important roles in hotel development in the 1970s and 1980s.

Throughout the 1980s, the Wall Street community played an increasingly important role in hotel financing as innovative financing techniques were introduced and accepted by investors. Master limited partnerships (MLPs) have been used by many hotel companies to dispose of their real estate assets while maintaining operating control of the hotels through management agreements. A large number of MLPs are traded publicly, and investors have found that they provide more liquidity than the usual kinds of hotel investments.

Of late, large financing deals have been structured by the Wall Street investment houses that include the pooling of hotel properties to reduce risk. Generally, several lenders participate in this sort of cross-collateralized transaction, which usually includes a number of hotels (anywhere from 5 to 75 properties) chosen for their diversity in terms of geographic location, condition, and target market.

Wall Street investment houses have also been successful in marketing hotel deals to foreign investors, who were one of the most active sources of hotel money in the latter half of the 1980s. Owing to the decline of the dollar in world markets, foreign investors, many of whom are Japanese, have found profitable investment opportunities in the United States. During this period, foreign investors acquired many hotel properties, including Omni Hotels, Intercontinental Hotels, Westin Hotels, and Ramada Inns.