

# CHAPTER 2

## History of the Lodging Industry

¶ 2.01	Colonial Times to World War II . . . . .	2-2	¶ 2.04	Late 1970s: Recovery and Calm . . . . .	2-8
	[1] Inns, Rooming Houses, and Grand Hotels . . . . .	2-2		[1] Maturation of Systems and Procedures . . . . .	2-9
	[2] Birth of the Modern-Era Hotel . . . . .	2-2		[2] Chain Expansion Through Asset Sales . . . . .	2-9
	[a] The First Significant Commercial Hotel . . . . .	2-2	¶ 2.05	The 1980s . . . . .	2-9
	[b] Luxury Hotels in the Early 1900s . . . . .	2-2		[1] Non-Economic Real Estate Transactions . . . . .	2-10
	[3] Overdevelopment in the 1920s . . . . .	2-3		[2] The Savings and Loan Debacle . . . . .	2-10
	[4] Depression Years . . . . .	2-3		[3] Development of Product Segmentation . . . . .	2-10
	[a] Acquisition Opportunities for Ready Capital Sources . . . . .	2-3		[4] Extended-Stay and Suite Concepts . . . . .	2-11
	[b] The First Major Hotel Chains . . . . .	2-4		[5] Supply and Demand Imbalance . . . . .	2-11
	[c] Early Valuation Theory . . . . .	2-4		[6] Lodging Industry Stock Performance . . . . .	2-11
	[5] Economic Recovery in the Early 1940s; World War II . . . . .	2-4	¶ 2.06	The 1990s: Significant Events . . . . .	2-11
¶ 2.02	Post-World War II Era: Controlled Growth and Chain Expansion . . . . .	2-5		[1] Nonperforming Loans . . . . .	2-11
	[1] Motels . . . . .	2-5	EXHIBIT 2-1	Hotel Loan Performance . . . . .	2-12
	[2] The Late 1950s and Early 1960s . . . . .	2-6		[2] Gradual Improvement . . . . .	2-12
	[a] International Expansion Activities . . . . .	2-6		[3] Rebirth of the REIT . . . . .	2-12
	[b] Marketing Advantages Through Related Activities . . . . .	2-6		[4] Alternative Financing Sources . . . . .	2-13
	[c] Evolution of the Convention Hotel . . . . .	2-6		[5] The Hot Market: Increased Occupancies, Profitability, and Values . . . . .	2-13
	[d] Start of Franchise Development . . . . .	2-7		[6] Demand Outpaces Supply . . . . .	2-14
	[e] Product Diversification and Segmentation . . . . .	2-7		[7] The Markets, the Buyers, and the Sellers . . . . .	2-14
¶ 2.03	Early 1970s: Construction Boom, Energy Crisis, and Downward Spiral . . . . .	2-7		[8] Future Trends . . . . .	2-15
	[1] The Bubble Burst . . . . .	2-7	EXHIBIT 2-2	Lodging Industry Profitability 1982-1997 . . . . .	2-15
	[2] The Involuntary Owners . . . . .	2-8	EXHIBIT 2-3	Occupancy, Demand, and Supply Growth From Prior Year . . . . .	2-16
	[3] Historical Perspective on Hotel Values . . . . .	2-8	EXHIBIT 2-4	Occupancy, Demand and Supply Growth From Prior Year . . . . .	2-17

## ¶ 2.01 **COLONIAL TIMES TO WORLD WAR II**

---

### [1] **Inns, Rooming Houses, and Grand Hotels**

---

The first lodging facilities developed in the United States were coaching inns and taverns. Patterned after English inns, these facilities were situated primarily in sea-port towns and along coaching routes. As the new colonies developed and the country expanded westward, lodging facilities with higher degrees of opulence were established. Influenced by their European counterparts, they closely resembled the hotel as we know it today and were located in resort and urban settings.

The growth of the U.S. railroad system led to an increased demand for overnight accommodations for rail travelers. Numerous small rooming houses were built near train stations to accommodate transient guests. Quite spartan, these facilities generally had much lower standards of service and cleanliness than the luxury hotel properties found in the cities and resort areas. Travelers in most situations had a choice between high-quality downtown hotels and inexpensive accommodations in railroad rooming houses. For many travelers, unable to afford first-class accommodations, the railroad rooming houses were the only viable option for overnight accommodations.

### [2] **Birth of the Modern-Era Hotel**

---

At the turn of the century, the United States experienced an economic expansion that, in conjunction with improvements in transportation and lower travel costs, opened up travel to the middle class, thereby creating a new and rapidly expanding market for hotel accommodations. The economic expansion also brought about increased commercial activity and ever-larger numbers of business travelers. However, neither the hotels at the upper end of the market nor those at the lower end satisfied the needs of business travelers.

#### [a] **The First Significant Commercial Hotel**

In response to expanding commercial market demand, Ellsworth M. Statler in 1908 opened the Buffalo Statler in Buffalo, New York—the first modern era hotel meant to accommodate the needs of the commercial guest. 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.

#### [b] **Luxury Hotels in the Early 1900s**

During the early 1900s, an aggressive expansion in hotel construction took place in the United States as large luxury hotels (e.g., the Plaza, built in New York City in 1907) were constructed in major cities, and the commercial hotel segment continued to emerge. This expansion slowed during World War I, but when the nation's involvement in that war concluded in 1918, there was a tremendous resurgence in hotel development, which lasted until the early 1920s.

### **[3] Overdevelopment in the 1920s**

After the war, the middle class continued to prosper, and investment capital for hotel development projects was generated. 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 contribute development capital as they listened to hotel promoters. Many times the developer's arguments for investment were predicated not on economic feasibility but on civic pride, improving a neighborhood, or the personal prestige associated with investing in new hotel development projects. In some cases, local merchants were promised business from the hotel when it opened in exchange for an investment in the project. In these "community-financed" hotel projects, real estate bonds for first and second mortgages were sold to local residents to stimulate business for the hotels from the local community. In many situations, the financing structures that were created involved extremely high leverage accompanied by a commensurately high degree of risk.

Despite these conditions, however, investors were convinced of the viability of hotel development projects. Investment capital was readily available, and numerous hotel development projects were financed, resulting in a boom in hotel construction throughout the decade.

By the mid-1920s, *Hotel Management* (a trade publication that later became the current *Hotel and Motel Management*) began to print articles by industry spokespersons warning against "over-hoteling" and urging professional hoteliers to reveal to the public the "real facts" about their hotel's occupancy level and financial condition to offset the larger-than-life stories that had contributed to the overbuilding. To illustrate the extent of the overbuilding problems, a nationwide survey was conducted in 1928 and 1929 by an objective body, the Engineering-Economics Foundation. This post-graduate college in Boston quantified hotel room supply, guest demand, occupancy levels, rates, and hotel failures between 1919 and 1928. They found that nationwide hotel occupancy had drastically declined from a high of 85.5 percent in 1920 to 67.6 percent in 1928. A staggering decrease of 17.9 occupancy points equated to a 21 percent decline in hotel rooms sold.

Room rates remained generally constant from 1921 to 1928, but the Foundation determined that the additional services offered to guests during this period considerably reduced the profitability of hotel operations. Hotel failures averaged a stunning 15 percent annually between 1924 and 1928.

### **[4] Depression Years**

The true financial condition of the hotel industry became quickly apparent immediately following the stock market crash of 1929. Hotel rate wars became common, leading one industry spokesman to suggest mergers of hotels within cities to stabilize rapidly falling prices. However, even low rates could not stimulate demand.

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, more than 80 percent of the hotels in the nation were in foreclosure or in some form of liquidation. Many properties closed entirely, never to reopen.

#### **[a] Acquisition Opportunities for Ready Capital Sources**

As is generally the case in real estate cycles, a major opportunity arose from the collapse of the hotel industry for investors who had available cash. These investors

were able to acquire distressed hotels with minimal cash outlays and reasonable financing. It was during this period that some of the most well-known hotel chains were born.

### **[b] The First Major Hotel Chains**

Conrad Hilton entered the lodging industry in 1919 with the purchase of the 40-room Mobley Hotel in Cisco, Texas. During the 1920s, Hilton 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 tremendously. Despite aggressively cutting costs (e.g., by removing guestroom telephones and shutting off entire floors), he was able to retain control of only five hotels in his chain. By 1935, however, profits from oil leases he had purchased provided Hilton with sufficient capital to satisfy his creditors and to fund additional hotel acquisitions. Hilton purchased managing control of the Sir Francis Drake in San Francisco, the Town House in Los Angeles, the Stevens in Chicago, and the Roosevelt and Plaza Hotels in New York.

Another substantial hotel chain was developed during the same period. Ernest Henderson founded what was to become the Sheraton hotel chain in 1937 with the initial purchase of the Stonehaven Hotel in Springfield, Massachusetts. By 1941, his developing hotel 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 development companies, such as Hilton and Sheraton, were successful in persuading skeptical bankers and other investors to invest in their hotel organizations. By taking advantage of the extremely depressed hotel real estate market, the strong, well-capitalized hotel companies were able to continue to aggressively expand their hotel portfolios by acquiring hotel properties at depressed prices.

### **[c] Early Valuation Theory**

Financial analysts who monitored the hotel industry advised investors during the depression years not to value hotels on the basis of their present income streams, which were extremely depressed. They stressed rather that hotels should be valued on the expectation of future earnings, which were expected to rebound as the economy recovered.

Basing their conclusions on the pattern of the previous recession, hotel industry writers and analysts optimistically forecast three years of depressed sales and subsequent earnings before the industry would fully recover. This theory did not hold true because it did not take into account the tremendous overbuilding that preceded the depression; in addition, the economy did not fully recover until the early 1940s.

## **[5] Economic Recovery in the Early 1940s; World War II**

Hotel occupancy levels recovered shortly after 1940 as the general economy of the United States improved. Room supply had been diminished by the closing of many hotels during the depression. With the onset of World War II, the industry experienced a tremendous 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 the commercial market segment increased

dramatically as all industrial activity related to the war effort was heightened. Despite the large increase in demand, supply remained constant because construction materials and labor were focused on the war effort. Additionally, financing was generally unavailable for new construction because lenders and investors still had a fresh memory of the devastation in the real estate industry caused by the last economic downturn.

In some markets throughout the country, hotel room supply was significantly affected when such hotels as the Stevens in Chicago and the Greenbrier in White Sulphur Springs, Virginia were converted to housing for troops. The combination of increased demand and constant room supply resulted in tremendous increases in hotel occupancy rates. Occupancy levels exceeded 90 percent throughout the country—translating into one of the most profitable economic cycles the industry has experienced.

During this period of extremely high demand and limited supply, labor and material shortages significantly compromised the service levels of most hotels, in many cases forcing guests to wait for hours in hotel lobbies for accommodations. The situation became so untenable during this period in the New York City market that hotels were forced to limit the length of stay to three days for all guests.

## ¶ 2.02 **POST-WORLD WAR II ERA: CONTROLLED GROWTH AND CHAIN EXPANSION**

---

In the years immediately following World War II, a construction boom equaling that of the period immediately after the first World War failed to occur, primarily because hotel lenders were concerned about a repeat of the financial disaster of the 1930s. Averse to providing development capital to new hotel developers and new construction projects, lenders did, however, provide acquisition capital and limited development capital to proven industry performers to allow them to continue the expansion of their hotel chains. 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. The Hilton hotel company purchased the Statler chain of 10 hotels in 1954 for \$111 million from Statler's widow, and the Sheraton organization continued its expansion plans by acquiring 22 hotels from Eugene Eppey in 1956.

### [1] **Motels**

---

During the 1950s, continued growth of higher-end hotel chains was matched by the expansion at the lower end of the market of the family-operated tourist courts, developed initially in the 1930s. With their beginnings in these tourist courts, motels in the early years were usually 20- to 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. Although during World War II the occupancies of most of the larger hotel properties increased dramatically, the business of the smaller tourist courts declined because people had neither the time nor the money to vacation. Additionally, gasoline and food supplies were rationed, and leisure travel was not popular. It was not until after the war that the situation improved for this segment of the lodging industry.

After the war, travel in the United States became increasingly popular, stimulated by an improving economy that provided increased disposable income and by improvements in automobile travel. Traveling by automobile was simple and relatively inexpensive. The motel market expanded to include business travelers (especially salespeople, middle managers, and small business owners) in addition to vacationers, as well as employees traveling on government-related assignments.

The first motels were distinctly different from the larger hotels of the same period in terms of size, construction costs, land values, and management requirements. They provided lodging accommodations at convenient highway locations; they were much smaller and provided fewer amenities, but charged lower rates than the typical urban hotel facilities of the era.

## **[2] The Late 1950s and Early 1960s**

During the late 1950s and early 1960s, several new lodging chains had their beginnings. Holiday Inns, Ramada Inns, Howard Johnson Inns, Marriott, Hyatt, and Radisson all successfully won significant market share in their market segments through aggressive and inventive sales and marketing practices and techniques.

### **[a] International Expansion Activities**

International expansion activity by several U.S. hotel companies became prevalent during the 1960s. Pan American Airways' subsidiary, Inter-Continental Hotels Corp., which had initially been founded 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 its Hilton International division and began expanding operations in Europe and South America.

### **[b] Marketing Advantages Through Related Activities**

A significant move toward vertical integration within the airline and lodging industries 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.

### **[c] Evolution of the Convention Hotel**

The convention and meeting market became a focus of interest during the 1960s as hotel chains sought new opportunities for growth and increased revenues. A prime example of this type of expansion was the development of the The New York Hilton, which opened in 1963. Designed and built specifically to cater to the growing convention market, this type of facility was established in large cities that provided numerous tourist attractions to bolster attendance at conventions and meeting events. In addition, holding major events in large cities provided attendees with easy and relatively inexpensive travel options.

**[d] Start of Franchise Development**

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.

**[e] Product Diversification and Segmentation**

Spurred by competition and the oversupply of rooms, companies diversified their product types and plunged into new market segments. The lines of price value and service demarcation become cloudy with the push into diversified business lines. More mature segments (e.g., full-service hotels) began experiencing competition from limited-service properties, suite properties, and extended-stay facilities. Companies learned that brand recognition can stretch across several price points, affording ready acceptance to new brands and products. This segmentation fueled much new development and provided a means of absorbing older properties whose location and age made them less competitive than the newer ones. This specialization attracted new capital, and the limited scope of services and lower variable costs reduced development costs and provided higher operating margins.

As franchise growth proliferated, however, drawbacks such as lack of control by the franchiser became apparent. To gain further control of the management of the brand, the hotel companies aggressively pursued management contracts in addition to franchise agreements.

**¶ 2.03 EARLY 1970s: CONSTRUCTION BOOM, ENERGY CRISIS, AND DOWNWARD SPIRAL**

---

In the early 1970s, as a result of a healthy global and domestic economy and an expanding U.S. interstate highway system, travel in the United States was flourishing. Hotel supply and demand were at an imbalance, with hotel rooms satisfying only two-thirds of the pace of demand growth. As a result, hotel occupancies climbed to 65 percent in 1974. Higher occupancies and increased room rates coupled with obtainable hotel financing accelerated hotel development activity. At the same time, many hotel franchise companies were aggressively expanding to increase their national exposure.

Also, during this era REITs (Real Estate Investment Trusts) were formed, allowing small investors to participate in real estate mortgages and equities.

**[1] The Bubble Burst**

As a result of favorable demand and available development capital, numerous hotels entered the marketplace in 1974, just as the U.S. economy began to soften as a result of the OPEC oil embargo, which began in 1973. The embargo dramatically increased energy prices and decreased consumer confidence, leading to a decrease in business and leisure travel. Annual hotel occupancy declined to 62.3 percent from occupancy levels approaching 70 percent earlier in the decade. In 1975, room demand increased by only 0.7 percent, further exacerbating the oversupply situation.

Many lenders and developers believed, wrongly, that a national franchise

would virtually guarantee a successful and profitable operation. The bubble burst on the lodging industry when inflation caused construction and interest rates to radically escalate. Additionally, the 1974 energy crisis drastically reduced travel, and the accompanying recession curtailed business trips, conferences, and conventions.

## **[2] The Involuntary Owners**

Operators of undercapitalized properties quickly became delinquent with their financial obligations, and in numerous situations, lenders were forced to foreclose to protect their financial interest in the projects. To address their problems as involuntary hotel owners, lenders developed and organized work-out departments generally headed by experienced hotel personnel, or they engaged professional hotel management companies to assume the operational responsibilities for the foreclosed-upon assets.

These involuntary owners, in most cases, were seeking to dispose of these assets quickly to remove nonperforming loans from their books and to reduce their prices substantially to attract all-cash buyers. Lenders who were willing to hold their hotel assets and employ professional management to reposition and improve the properties' operation were generally able to recoup their original investment in three to five years, once the industry began to recover. However, even lenders who held their assets until economic conditions improved were typically forced to provide favorable financing to dispose of these assets at acceptable prices.

## **[3] Historical Perspective on Hotel Values**

Interestingly, the history of real estate development and economic cycles indicates that during periods of economic decline, the values of hotel assets do not generally decline as radically as their income declines. Sellers of hotel assets and lenders of hotel assets during periods of economic problems were often unwilling to sell at substantially reduced prices. Their objective was to wait out the downward cycle and dispose of their assets when the market began to recover.

## **¶ 2.04 LATE 1970s: RECOVERY AND CALM**

The late 1970s was a period of relative calm for the lodging industry. Because most lenders were recovering from the financial wounds inflicted by the 1975 recession, they had little interest in making hotel mortgages. New construction was restrained, and consisted primarily of additions to existing hotel properties and the development of some larger hotels oriented toward the commercial and convention markets. The rebirth of center-city hotels was a direct result of fuel shortages and the availability of government financing for inner-city redevelopment projects. Highway-oriented properties, on the other hand, were adversely affected by escalating gasoline prices and decreased automobile travel. These lodging facilities lost some of their appeal among investors and hotel companies.

Decreased building activity, the normal retirement of older hotels from the market, and an improving economy created a favorable supply-and-demand relationship and record-high occupancy levels from 1979 to 1980. Average room rates increased



rapidly as operators took advantage of excess demand to recoup earlier losses and keep up with inflation.

### [1] Maturation of Systems and Procedures

Hotel companies that were formed in the 1950s and 1960s matured in the 1970s, becoming more professional and more sophisticated in their management systems and techniques. The disciplines of hotel operations, finance, accounting, and marketing improved during this era, and a great deal of emphasis was placed on making operations more efficient. This was accomplished by the consistent monitoring and measurement of sales and marketing activities and daily operational procedures. Additionally, the practice of comparing individual hotel performance with industry averages was expanded during this era. As the hospitality industry continued to expand and develop, many colleges and universities expanded their hotel and restaurant related curriculums, graduating an increasing supply of talented and well-educated hotel and restaurant personnel.

### [2] Chain Expansion Through Asset Sales

To maximize cash flow and minimize financial risk, in the late 1970s and early 1980s hotel chains began to sell ownership of their hotels to investment groups while retaining ongoing management of the facilities. This practice generated capital—used to foster further acquisition and development activities—through fee management agreements with the new owners of the assets. Because the chains were maintaining and managing the properties on a daily basis, they were able to maintain their established standards. (See Chapter 16 for further discussion of the role of management contracts in the industry.)

## ¶ 2.05 THE 1980s

After the decline in hotel development during the late 1970s, the environment seemed conducive to a period of renewed expansion. However, the Federal Reserve tightened the money supply in the early 1980s, sending the prime interest rate up to double-digit levels, and most of the projects that were in the preliminary stages but lacked suitable financing were put on hold. In 1983, the national inflation rate began to come under control, and inflationary pressures were reduced. These events resulted in a decline in interest rates, and tremendous amounts of capital became available for real estate development and investment. Hotel developers who had been out of the market since the mid-1970s rushed to initiate new projects. These developers were aided by the following major real estate development incentives:

- Improved demand resulting in higher occupancy rates;
- Escalating room rates;
- Readily available debt and equity financing; and
- Extremely favorable income tax benefits designed to stimulate the national economy out of the recession of the early 1980s.

A steady flow of new hotel properties entered the market during the 1980s, and as a result, the aggregate United States occupancy level declined every year between 1980 and 1987. Many hotels could not operate profitably under a scenario of declining occupancies, and stagnant room rates and another round of hotel foreclosures ensued.

### **[1] Non-Economic Real Estate Transactions**

As mentioned previously, during the 1980–1987 period many real estate syndications were structured using “tax-based” real estate transactions for investors able to take full advantage of taxation rules that permitted losses from one investment to offset other types of income. Additionally, a favorable capital gains tax rate enhanced the value of real estate investments. These “non-economic” real estate transactions (i.e., those not designed to generate cash flow) provided equity capital that would not have otherwise been available to develop these hotel projects. Also, in anticipation of pending changes in the tax codes governing such transactions, hotel construction projects that should have been postponed until market conditions improved were concluded prior to midnight, December 31, 1985.

Because of the extensive lead time needed to complete the entire development process, this led to a period of overbuilding and a glut of hotel rooms coming on the market at the same time. Additionally, since there was little incentive to justify a transaction’s economics (i.e., cash flow and reversionary benefits), a number of syndicators overpaid for hotel properties, took out exorbitant transaction fees, and placed unreasonable amounts of debt on the assets.

### **[2] The Savings and Loan Debacle**

By the end of the 1980s, the depth of the savings and loan crisis was evident and the industry became fully aware of the serious problems it faced—too late to reverse the oversupply of rooms developed throughout the decade. Between 1985 and 1990, a staggering 556,000 new hotel rooms were added to the U.S. hotel supply.

### **[3] Development of Product Segmentation**

Although overall new construction slowed, hotel chains had still been active in development as “product segmentation” became the watchword of the 1980s. During 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. In the 1980s, this concept was 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 during the past thirty years has been to deliver what is appropriate to each market segment and product type, on the basis of 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. Concierge 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 of prime importance in this market segment.

#### **[4] Extended-Stay and Suite Concepts**

A new market segment was defined and addressed during the 1980s. Known as the extended-stay market, it comprised guests who needed 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 had previously been met chiefly by short-term lease apartments, but the rapidly growing extended-stay market represented one of the fastest growing segments the industry has witnessed since its beginning.

All-suite hotels also proliferated during this era and several major hotel chains began to aggressively expand in this arena. The unique feature of a hotel room's having separate sleeping and living areas was extremely popular in the commercial market segment as well as the leisure segment—allowing parents to be in the same general area as their children but providing two separate sleeping areas.

#### **[5] Supply and Demand Imbalance**

On a national level, lodging demand gained strength during the second half of the 1980s, but the market was awash with excess rooms. Once pressed to meet soaring demand, the industry was now buffeted by listless occupancy, tight pricing, and margin pressure. Hotel chains, which had eagerly capitalized on booming demand, were now locked into an intense battle for market share.

#### **[6] Lodging Industry Stock Performance**

The publicly traded stock of the major hotel companies performed as well as the broader markets in 1988 but traded at the lower range of historical trading ranges. Operating trends confirmed the industry's overheated expansion, and although occupancy levels remained at 65 percent in 1988, the industry continued to operate well below its historical peaks. The excess room supply impeded upward price movement (increases were held to around 3 percent—below the Consumer Price Index (CPI)).

### **¶ 2.06 THE 1990s: SIGNIFICANT EVENTS**

The national economy entered another recession in 1990, which along with overbuilding and the negative effects of the Persian Gulf War in 1991 caused the national hotel occupancy rate to bottom out at 60.8 percent in 1992. In some markets, hotel occupancies fell as low as 35 percent.

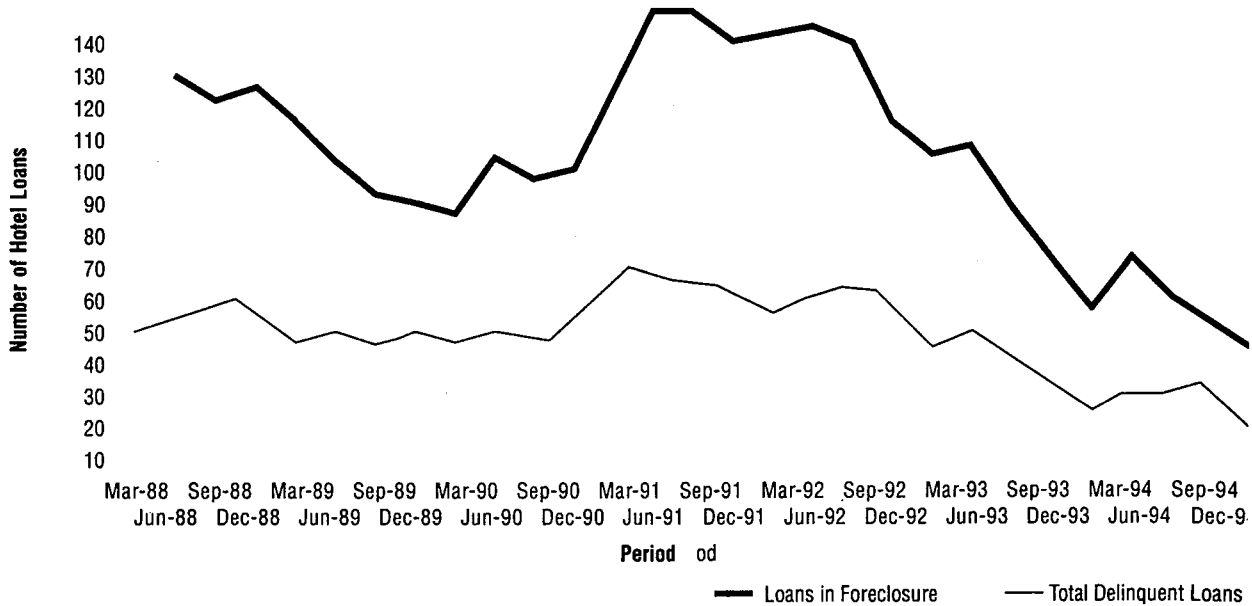
#### **[1] Nonperforming Loans**

The number of nonperforming loans reached record levels, and the majority of lenders moved to a workout mode of operation in order to foreclose and restructure

their hotel investments. Many of the savings and loans were taken over by the federal government, and their hotel assets were sold at auction. Exhibit 2-1 illustrates hotel loan performance as reported by the American Council of Life Insurance. The number of hotels in foreclosure peaked in 1991 as loan restructuring was an attractive alternative to foreclosure. During this period, the number of restructured loans almost doubled from previous levels.

**Exhibit 2-1 Hotel Loan Performance**

Source: American Council of Life Insurance



**[2] Gradual Improvement**

The industry began to improve around 1992. The national average occupancy was 61.7 percent, a 2.6 percent increase over 1991 performance levels and the largest increase in more than ten years. This was the result of a 4 percent surge in demand coupled with a 1.3 percent rise in supply. All regions of the country except for the West Coast experienced this improvement, with hotels in the New England, South Atlantic, and East North Central regions showing above-average increases.

By 1993, new hotel construction had declined significantly. Lenders, trying to get out from under problematic hotel portfolios, curtailed all real estate lending and would not even consider funding a hotel development project. The tax benefits associated with hotels had been reduced significantly, and passive investors left the hospitality market entirely.

**[3] Rebirth of the REIT**

In 1993, Real Estate Investment Trusts (REITs) again emerged as an alternative financing source for hotel acquisition and development. The first successful hotel REIT offering of the 1990s occurred in August, 1993, with the initial public offering of RFS Hotel Investors, Inc. Since the initial offering, numerous additional of-

ferings have been completed. Hotel income does not qualify as income from real estate under REIT operating restrictions, which stipulate that a REIT must derive at least 75 percent of its gross income from rents and mortgage interest. Therefore, hotel operating income must be converted to lease income through a more complete REIT structure whereby the REIT owns the hotel properties and leases them to a third-party operating entity.

A great deal of activity continued in the REIT market until the fall of 1994, when the increase in interest rates and the perception of oversupply of offerings and pending structural problems brought the hotel REIT market to a virtual halt. Yields on existing REITs fell and numerous offerings in the planning stages were put on hold or canceled.

The Hotel Real Estate Investment Trust (REIT) was reinvented in late 1990's to serve the management-intensive hotel business. Especially popular were the few so called paired shared REIT's that were able to take advantage of a loophole in the tax law and raise capital very quickly and cheaply to acquire hotel companies. The two most famous Paired-Shared REIT's were Starwood and Patriot Hotels. The hotel market soon turned into a sellers market when the REITs exploded on the scene, buying up so much hotel property that they started a bidding war for hotel real estate in late 1997 and early 1998. Then in the fall of 1998, a credit crunch hit the real estate market and REITs, which had paid a premium for hotel properties started to find their stock values declining rapidly. REIT stocks were left at one-half of their 52-week highs. In addition, Congress passed legislation that severely restricted future activity of paired-shared REITs and thus many of them have converted or are in the process of converting to Regular C corporations.

#### **[4] Alternative Financing Sources**

Another source of capital was introduced in 1994-REMICs (Real Estate Mortgage Investment Conduits). Initially, mortgage conduits were offered through national home mortgage programs Fannie Mae and Freddie Mac. In these cases, the government is involved to provide an incentive fostering homeownership. The government is not involved in facilitating hotel lending but otherwise the process is in many ways similar. The process starts with the investment bank making a loan to a borrower. When the investment bank amasses a large enough portfolio of loans, it then packages the loans for sale to investors in the secondary market. The loan portfolio is split into distinct subgroups called tranches, with loans of various risks offering commensurate interest rates of return. It is this intention to sell the loans to subsequent investors that leads to the unique feature of REMIC loans. Ratings are provided by firms such as Standard and Poors or Fitch. These rating agencies have historically taken a very conservative approach to hotel transactions, and hotel loans earmarked for a conduit require conservative underwriting. The advantage of these financing vehicles is that loan terms are up to 23 years, which eliminates the rollover risk borrowers face with balloon loans. Additionally, the loans are nonrecourse and are assumable.

#### **[5] The Hot Market: Increased Occupancies, Profitability, and Values**

As occupancy rates continued to improve, resulting in rapidly rising hotel values, acquisition activity continued to increase. There was a feeling in the investment community, however, that the market for acquisitions was becoming overheated, and

investors were becoming cautious in order to avoid the first-loss position that the equity players take. New construction of full-service hotel projects continued to be rare, but several developers indicated they were preparing to develop several projects. The only significant addition to supply was in the limited-service market segment.

The pace of hotel sales transactions quickened throughout 1994 and increasingly involved full-service hotels. Many of these properties were owned by insurance companies that are penalized heavily under risk-based capital rules. Both, U.S. hotel operators and foreign buyers displayed healthy appetites. Marriott purchased several full-service hotels from a large insurance company, and Starwood Capital and Goldman Sachs Whitehall fund purchased the upscale Westin hotel chain.

Impressive value increases were a result of vastly improved occupancies and average rates, large amounts of capital in the marketplace, and no significant new supply in sight. The full-service sector offered the best buy for investors.

The impressive recovery of the lodging industry continued, and 1995 was a banner year, posting \$7.6 billion in pretax profits spurred by increased occupancies, room-rate gains, and operating efficiencies. 1995 represented the third consecutive profitable year for the lodging industry since it bottomed out in the economic recession of the early 1990s. Financial performance improved substantially as demand for lodging accommodations rose over the past several years while only a limited number of new hotels entered the market.

## **[6] Demand Outpaces Supply**

In 1995, driven by the expanding economy, total U.S. lodging demand increased at a 3.1 percent compounded average growth rate. Between 1991 and 1995, total aggregate hotel supply increased by only 1.4 percent. Average U.S. occupancy increased to 66.3 percent in 1995—the highest level in twelve years. With improved occupancy levels, hotel owners were able to increase room rates and the average daily room rate in the United States increased by 4.8 percent in 1995—following a 3.8 percent increase in 1994—the first year in which room rates have grown faster than inflation since 1986.

## **[7] The Markets, the Buyers, and the Sellers**

The top five markets for new construction were the Dallas, 8174 rooms; Atlanta, 7435 rooms; Phoenix, 7335 rooms; Orlando, 6824 rooms; and Chicago, 5059 rooms. Additionally, the top five contenders for most rooms added to a hotel market segment in 1997 were Hampton Inn, 12826 rooms added; Holiday Inn Express, 8536 rooms added; Courtyard by Marriott, 7791 rooms added; Comfort Inns 6728 rooms added; and La Quinta, 6654 rooms added.

Significant sales activity and price increases resulted from this improved profitability and value. The life companies who in the past had been sellers became active buyers. Wall Street looked favorably on the industry and continued to supply debt and equity components for the acquisition of hotel products.

The products that were offered for sale in 1997 were supplied by portfolios of subperforming and nonperforming loans, foreign financial institutions, U.S. banks, and private sellers.

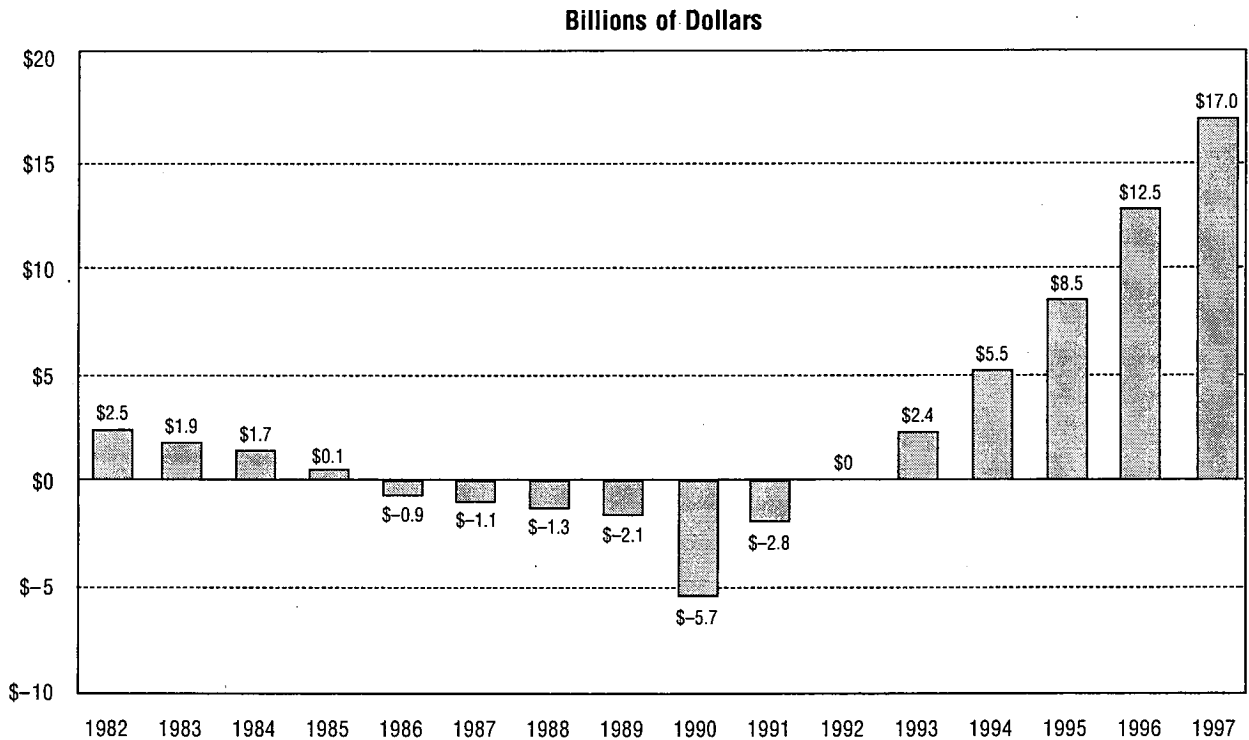
**[8] Future Trends**

The supply of new hotel rooms is expected to increase slowly during the next several years. Lenders (not necessarily traditional banks and insurance companies, but credit companies and Wall Street securities firms) are beginning to make hotel loans based on very conservative lending criteria. This activity is commencing with the refinancing of existing properties, and the consensus is that hotel lenders will eventually become interested in financing new construction projects in selected markets. This change will occur when occupancies and room rates recover sufficiently to justify new projects that will substantiate the costs of development and construction. Additions to supply are expected to peak in 1998.

With the credit crunch in late 1998 along with the collapse of the CMBS market, the hotel industry is more difficult to predict how the industry will fare. Hotel valuation has retreated somewhat from their highs and financing is becoming more difficult to obtain. Cash has once again taken over as the preferred method of buying. The near term future of the hotel industry is tied to how well the economy performs. As is shown in Exhibit 2-2, the industry has had record earnings since bottoming out in the early 1990s.

**Exhibit 2-2 Lodging Industry Profitability 1982-1997**

Sources: Smith Travel Research



Hotel demand is expected to continue to increase if the U.S. economy improves. A peak in demand growth was projected to occur in 1996. Occupancies are projected to peak in 1997, returning to the highest level since 1979. Thereafter, occupancy is expected to decline slightly in the years ahead but occupancies are still healthy enough for hotels to boost hotel rates between 5 and 6 percent. This will increase overall RevPar, even in face of falling occupancies (see Exhibits 2-3 and 2-4).

**Exhibit 2-3 Lodging Outlook Survey for the Year Ending December, 1998**

Sources: Smith Travel Research

Top 25 Markets	Occupancy Percent			Average Room Rate			Room Revenue	Rooms Available	Rooms Sold
	1998	1997	% Chg	1998	1997	% Chg	% Chg	% Chg	% Chg
Anaheim-Santa Ana, CA	65.1	67.5	-3.6%	79.48	75.37	5.5%	2.3	0.6	(3.0)
Atlanta, GA	64.9	63.3	2.5%	78.02	76.48	2.0%	10.5	5.7	8.3
Boston, MA	72.9	74.2	-1.8%	127.05	117.1	8.5%	10.0	3.3	1.4
Chicago, IL	71.1	71.6	-0.7%	109.57	101.55	7.9%	11.5	4.2	3.4
Dallas, TX	66	66.3	-0.5%	82.56	78.99	4.5%	11.9	7.6	7.1
Denver, CO	69.3	70.8	-2.1%	78.15	76.06	2.7%	11.8	11.1	8.8
Detroit, MI	66.1	66.2	-0.2%	74.33	70.34	5.7%	10.0	4.3	4.1
Houston, TX	63.5	63.8	-0.5%	74.38	70.92	4.9%	14.3	9.5	8.9
Los Angeles - Long Beach, CA	69.3	68.7	0.9%	88.59	82	8.0%	10.3	1.3	2.1
Miami - Hialeah, FL	70.3	71.6	-1.8%	101.77	94.77	7.4%	7.5	1.8	0.1
Minneapolis - St. Paul, MN	68.9	68.5	0.6%	79.06	76.36	3.5%	12.8	8.3	8.9
Nashville, TN	62.7	66.8	-6.1%	74.72	73.06	2.3%	0.1	4.2	(2.1)
New Orleans, LA	68.3	69.3	-1.4%	108.78	104.64	4.0%	8.3	5.7	4.2
New York, NY	81.3	80.3	1.2%	180.01	165.01	9.1%	10.9	0.5	1.6
Norfolk - Virginia Beach, VA	59.3	57.3	3.5%	66.7	64.67	3.1%	7.7	0.8	4.4
Oahu Island, HI	72.3	77.2	-6.3%	112.88	113.28	-0.4%	(6.7)	-	(6.4)
Orlando, FL	74.7	79	-5.4%	84.64	79.81	6.1%	3.8	3.4	(2.1)
Philadelphia, PA-NJ	68.8	70.4	-2.3%	96.46	90.26	6.9%	9.2	4.5	2.1
Phoenix, AZ	64.7	69.1	-6.4%	99.14	98.63	0.5%	4.7	11.2	4.2
San Diego, CA	72.7	71.4	1.8%	97.72	86.26	13.3%	16.2	0.6	2.5
San Francisco, CA	78.7	79.8	-1.4%	128.82	117.74	9.4%	7.9	(0.1)	(1.4)
Seattle, WA	71.5	72.2	-1.0%	94.57	89.59	5.6%	11.1	6.3	5.3
St. Louis, MO-IL	62.2	62.9	-1.1%	69.37	68.81	0.8%	4.6	5.0	3.7
Tampa - St. Petersburg, FL	64	65.3	-2.0%	77.68	73.35	5.9%	9.5	5.5	3.4
Washington DC, MD-VA	70.4	70.6	-0.3%	105.05	100.11	4.9%	7.0	2.3	2.0

Occupancy is calculated by dividing the room night demand by the supply. During the historical period, supply increased at rates ranging from 0.7% in 1982 to 6.0% in 1974. Demand declined each year from 1980 until 1983 and also in 1974, but increased in all other years. In 1979, demand growth peaked at 5.3%. Changes in supply and demand had a varied impact on occupancy. In addition to declining when demand fell, occupancy also dropped when the increase in demand was smaller than the increase in supply.

Also, the data presented in Exhibit 2-4 can be related to historical economic trends. The early 1970s marked the beginning of a hotel building boom reminiscent of the 1920s. Many factors contributed to this expansion, but the two main elements were readily available financing and aggressive chains that were eager to sell franchises.

There will be fewer unencumbered turnaround assets offering high returns because many assets have already been repositioned and are stabilized. There will be limited additions to supply in the foreseeable future.



**Exhibit 2-4 Occupancy, Demand, and Supply Growth From Prior Year**

Sources: Bear, Stearns & Co. Inc.; Coopers & Lybrand L.L.P.; Smith Travel Research.

