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What Happens To Occupancy and Average Rate In A Slowing Economy?

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May 2005

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This is the $64,000-dollar question facing the hospitality industry today. And, as you might imagine, we spend a lot of time and energy focusing on this issue at HVS International. This article will consider the forces that influence occupancy and average rate, in an effort to identify probable trends in these industry indicators over the next few years.

Occupancy is influenced by two factors: supply and demand. Of these two, supply has historically been, by far, the most influential. Over the past three decades, a majority of the decreases in occupancy have occurred when the rate of supply growth has outpaced the rate of demand growth. Data compiled by Smith Travel Research and HVS International indicates that, on a national basis, occupancy has decreased in 17 of the past 30 years. In only six of these years did demand actually decline. In the other 11 years, the decrease in occupancy was caused by a supply growth that was in excess of demand growth.

At this point in time, the supply side of the equation is relatively straightforward. The data compiled by the principal sources covering the hospitality industry all agree: the rate of supply growth is decelerating, and has fallen dramatically from the peak recorded in 1998. Further, this decrease is relatively consistent in all sectors, from limited-service, to full service, to extended-stay properties. As always, this trend is influenced first and foremost by the availability of financing. And, as money for new development is getting harder and harder to come by, the development pipeline will continue to diminish. With the current widespread concerns about the performance of the industry as a whole, and particularly the fear of softening demand levels, construction financing will likely continue to be a challenge. As a result, on a national level, supply is likely to remain under control for the near to mid-term. However, many individual markets are still facing supply increases, as the projects now under construction or in the current pipeline are completed. In these markets, supply will continue to be a factor in occupancy trends for the next several years.

Demand is not so easily addressed. History has demonstrated that demand only decreases in times of severe stress. A period of prolonged economic malaise, followed by a brief recession that was characterized by high inflation and interest rates, caused demand to decrease in the first four years of the 1980s, which proved to be the only extended period of demand declines in the 30-year survey. The two other decreases occurred during recessionary periods that extended over several years. However, demand actually declined in only one year during each of these recessions, when a specific factor exacerbated the economic downturn. In 1974, it was the combination of a recession and an energy crisis that consisted of severe gasoline shortages and sharply higher prices. In 1991, it was a national recession combined with a war.

So what can we expect of demand in the next few years? There is no question that the economy is slowing, and that the lodging industry is vulnerable in the current economic climate. Travel and entertainment expenses are often viewed as more discretionary – and more easily curtailed – than other business expenses. Fewer and shorter business trips, greater scrutiny of travel expenses, and limitations on the number of meetings held as well as the number of attendees are common cost-control strategies that directly affect the lodging industry.

The parallels between the 1974 downturn and the current energy situation are also notable, and cause for concern. Rising energy costs put further pressure on corporate profits, necessitating expense controls. The fact that higher fuel costs are likely to cause an increase in airline fares and automobile costs will only intensify the focus on controlling business travel expense – and could potentially affect the leisure and convention segments as well.

It seems almost certain that lodging demand will be affected by these forces; in fact, data for the first quarter of 2000 reflects the beginning of this trend. Demand trends in individual markets will be directly influenced by the character of the industries that support those markets. We are already seeing declining demand in markets areas where the recent demand growth has been driven by high-tech industries.

However, it does not automatically follow that a *decrease* in demand is inevitable. Demand doesn't just grow or decline, it also moves – from market to market, and from hotel to hotel. Meetings once held in a more distant, more expensive market may relocate to a more affordable local alternative. Business travelers whose expense accounts once ran to a full-service hotel may seek out less expensive – and often equally suitable – alternatives among the "focused-service" lodging sector. And so on. In these circumstances, one property's decrease is another's growth.

Which brings us to average rate. Average rate is often treated as a secondary element in industry overviews and forecasts. Reports focus on occupancy and RevPAR, with average rate an ingredient in the RevPAR equation, but rarely given much attention in its own right. This is flawed thinking, as average rate was the single most influential factor driving the extraordinary financial success achieved by the lodging industry over the past five years. In many respects, it is also the industry's most vulnerable point as the economy slows. Failure to fully consider the factors influencing average rate can result in misleading forecasts and disappointing results.

On a national basis, average rate has outpaced inflation (as measured by the CPI) in 17 of the past 28 years. In fact, average rate growth has been less than 3% only three times during this period, and has never been negative. There is no absolute correlation between occupancy and average rate, although it can be said that average rate increased at a pace below the inflation rate in each year that demand decreased. And, as a rule, stronger rate growth has occurred during periods of strong occupancy. From this historical perspective, it would appear that, on a national basis, the worst-case scenario is that average rate growth will not keep pace with inflation.

On an individual property and market basis, the prognosis is more complex. Average rate is not just about the price of a hotel room. It is equally about market mix, discount availability, and a host of other factors. For hotel managers, the battle cry of the last decade was *Yield Management!* Through sophisticated computer models and highly trained sales, reservation, and front desk staff, most hotels were able to maximize the average rate achieved on a given night, week, month, and year.

How did they do this? Certainly, price increases were an important element. But, at the same time, the mix of business accepted by the hotel was also considered. In markets where demand from individual business travelers was burgeoning on weeknights, savvy hotel

managers cut back on the number of rooms committed to the group segment of the market. As these groups generally commanded a somewhat discounted average rate, the net effect of this strategy was an increase in average rate. Groups that still wanted to meet midweek were brought in at the corporate rate. A price increase? Perhaps, from the perspective of the group itself. But from the perspective of the hotel, it was a result of the overall rate strategy.

Similar strategies were employed within the commercial segment. Prior to the boom period in the latter half of the 1990s, most hotels offered a “preferred” corporate rate to those companies that generated a minimum number of room nights per month or per year. As demand from individual business travelers increased steadily, the need for this base of business diminished. Hotels essentially purged their preferred customer lists. Those companies that were not meeting a (now substantially higher) threshold of demand lost their preferred status, and were offered the standard corporate rate instead. Those companies that met the threshold requirement saw their rates increase significantly from historic levels.

With their own profit levels strong and growing, the companies themselves were not overly sensitive to the loss of their preferred status and the consequent increase in the rate they paid. Those that did object, and relocated their business to another property, were quickly replaced by other demand sources. The net result was that the hotel was still operating at or near capacity on most weeknights throughout the year. And, average rate was a lot higher.

Similar strategies were employed in the leisure segment, and were particularly successful in popular destination resorts. In this segment, the number of rooms committed to tour operators and discounted packages were decreased, making way for individual leisure travelers who typically paid higher rates. The shift away from dependence on the more discounted business supported average rate growth for these properties as well.

So, what will the future hold? With softening occupancies and shifting demand patterns, hotels cannot expect to sustain the average rate growth achieved in the past five years. As individual companies focus on opportunities to save on travel expenses, they will be more aggressive in pursuit of discounted corporate rates. Faced with softening demand from the individual business traveler segment, hotels may well respond by increasing the availability of “preferred” corporate rates. The number of room nights required to qualify for such an account may decrease, making the opportunity more widely available. Similarly, the larger companies may succeed in obtaining a greater discount off of the standard corporate rate. And groups that were shunned by a hotel last year will find a much warmer reception in the new economic environment. Thus, even with no change in the prices associated with these segments, average rate could decline.

What about the price side of the equation? It is a regrettable truth about the hospitality industry that price is often the first marketing tool considered by managers faced with softening occupancy patterns. If hoteliers can avoid the temptation to decrease prices, and focus instead on continuing to employ the yield management strategies that have served the industry so well in the recent past, the impact of the current economic cycle on average rate growth can be minimized. While yield management will not be as obviously successful in a softening economy, it is nevertheless an extremely appropriate tool for these economic times.