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Revenue Management

Key Considerations for Hotel Investors During Due Diligence

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Whether underwriting an investment for a distressed hotel, conversion opportunity or a traditional transaction, assumptions surrounding revenue (and profit) potential will serve as the key drivers validating price and investment returns. Naturally, market conditions and historical high/low performance benchmarks are reasonable indicators of the strength and resiliency of a given market. However, investment returns are not predicated on market strength alone, but rather the value-add financial performance achieved through improving a hotel's position and subsequent performance within a market. In short, every good deal has an investment story which must be uncovered to determine future upside. Double digit investment returns are not typically achieved through riding the tide, but rather require experience in identifying the potential of an asset which is not currently being achieved. So, how do investors identify opportunities and separate the value-add deals from the coupon clippers? Increasingly, investors are relying on an examination of revenue management practices and results to provide insight on performance upside. The following provide some key areas for investors to consider during acquisition due diligence to identify opportunities in revenue management, as well as project overall asset value upside.

Revenue Management Resources & Structure

Understanding how the revenue management function is delivered at a hotel provides insight as to the resources currently in place and whether there is room for improvement. Is the hotel managed by a brand, 3rd-party professional management company or owner-managed? How is the revenue management role staffed? Is it a cluster manager, dedicated position on property, tag-team effort by the General Manager and Director of Sales? Does the team rely on any outsourced revenue management services? Many brands have developed customized systems and add-on services in the area of revenue management. Does the hotel take advantage of any such programs? Is there a dedicated revenue manager at the property, and if so, what is their scope? Are they integrated with the sales team, setting strategies and active on the executive committee or is their role limited to adjusting rates? While the jury is still out on exactly what the best practice is for revenue oversight, specifically on-property vs. off-property revenue management, understanding how the function is handled will at least provide investors the context by which all other information can be evaluated, as well as compared against the ultimate plan for the hotel, should it be acquired. Understanding the current structure will also provide a basis for expense assumptions in this area, which may yield savings or require additional expenditures to properly oversee the function depending on the intended strategy. The primary objective here is to determine a baseline for how focused the team has been historically on revenue management and generally where the asset falls along the continuum.

Business Plan

Having determined how revenue management is handled, a good next step is a review of a hotel's Business Plan (also referred to as an Operating Plan or Sales & Marketing Plan). This document will provide insight as to what revenue management strategies are in place, or in some instances, not, and the effectiveness of these efforts. Does the plan address pricing strategies by segment? Are seasonal selling strategies in place? Are distribution costs (profit by source of reservation) considered? Are group room targets and ceilings in place? Although the strategy ultimately employed under new ownership may vary from what was practiced historically, the existence or absence of a comprehensive approach will suggest how much room for improvement exists.

Competitive Index

Another barometer by which revenue opportunities can be identified is hotel performance relative to a competitive set, referred to as a property's index. Whether measuring occupancy, ADR or RevPAR, the index provides a sense for the existing strategy and effectiveness in competing for market share. A few words of caution to investors when analyzing competitive information. First, the relative performance of a hotel is only as good as the competitive set by which it is being measured and must be considered and reviewed for comparability. Second, review this data less for the absolute numbers and more so to identify trends. Does the subject hotel demonstrate a consistent strategy or do results fluctuate wildly, suggesting a reactive vs. a more deliberate strategy? Consider new hotels that may have come into the market. How did the hotel and overall set perform and how many months did it take to absorb the new supply? Look at the subject hotel's performance and try to identify trends or patterns which will help focus on areas that may be opportunities or potential limitations to future growth. For instance, a property may be performing at or above the market occupancy. This should prompt a series of questions which should be at the forefront of due diligence. Is it the brand? Is it the location? Is it the pricing? Perhaps rate is much lower than the competitive set average. What is holding the ADR back? Is it segmentation, pricing strategy or the property's physical condition? Understanding trends in hotel and market performance can spark key questions during the due diligence phase and can provide a road map for exploring opportunities for additional upside.

Segmentation

In developing assumptions about future average daily rate (ADR) growth potential, an examination of historical ADR absent an understanding of business segmentation is a stab in the dark, at best. Reviewing the contribution and rate by business segment is the first step to determining opportunities for rate and profit growth. Evaluate the level of diversification within demand segments (corporate, leisure, group, contract) and demand sources (corporations, attractions, etc.). Is the hotel heavily reliant on only a handful of accounts (one major corporation or a several companies varied by industry?) or are there multiple sources of demand? Consider the contribution from the brand, especially if a conversion is being contemplated. What will the impact be on rate and occupancy if changing brands? Consider the impact if another hotel opened within the same brand family. Consider the reliance on third-party channels and discounted business. As the market continues to grow, there should be an opportunity to wean off lower-rate business and shift to higher-rated retail demand. Will the hotel be properly positioned able to capture this business? Is the subject market heavily dependent on government per diem or other business segments that are more rate-fixed than others? Is there an opportunity to grow group business? If so, the increase in this segment may ultimately serve to reduce the ADR but increase profits due to food and beverage and other revenue contribution. Shifts in segmentation can have a significant impact on ADR and need to be considered when projecting future rates with any degree of confidence. The goal is to identify opportunities that will shape the development of a strategy for the future; however, to do so, investors need to carefully examine and understand the composition of the business being accommodated today.

Forecasting & Booking Pace

Accurately projecting demand is critical to developing a pricing strategy that serves to maximize rate and profit potential. Understanding what systems are in place may allude to the level of sophistication and analytics behind forecasting practices. A review of a sampling of transient and group booking pace reports can uncover valuable insight on current practices. Look for booking and pricing patterns for potential opportunities. For instance, wild fluctuations in occupancy within a week may suggest that minimum length of stay and other strategies to smooth out demand patterns over a given period are not being utilized (i.e. an occupancy opportunity). Another finding may be an instance of selling out too far in advance, which may indicate that pricing is too low or not being adjusted in accordance with increases in demand (i.e. a rate opportunity). While these reports contain volumes of data, being able to isolate one or two key findings will provide additional support toward future opportunities for revenue improvement.

Price Value

Determining the existing price/value of a potential acquisition can be very subjective, but should be considered during due diligence. Guest feedback gleaned from Guest Satisfaction Surveys and even user generated content sites (i.e. TripAdvisor) can be valuable indications of the price/value perception. Again, consider the occupancy and ADR index…does the hotel "buy" occupancy by undercutting the market rate? How does the property compare from a physical condition and services and amenities standpoint to the other hotels in the market? How does the subject hotel price relative to the competitive set? It is amazing how much one can learn from investigating and comparing hotel rates within a market and this information is easily accessed online. While there are a number of factors that can influence price variations between hotels, such as a large group in-house, renovations, etc., reviewing a sampling of published rates across different time periods can provide insight on how dynamic a hotel may be in its pricing and whether they are considering events or high demand periods in their rate strategy.

Property Renovation/PIP: In many instances, investors are purchasing assets that are due for major capital upgrades or at minimum a brand-required PIP (Product Improvement Plan). Investors must consider the existing condition of the asset and determine what is the rate upside that might be achieved? A close examination of the rate potential in the market, as well as its relative condition to other competitors will validate assumptions surrounding "as renovated" rate potential. If all of the competing hotels have already completed upgrades and the subject hotel is performing below market, then growth may be limited to a reasonable range of the market average. If many of the properties have not yet been improved, a renovated hotel may be able to differentiate itself as the market rate leader, as well as suggest future market growth as other properties invest, serving to elevate product offerings throughout the market.

New Supply

While new supply is an external factor, investors need to anticipate and underwrite the potential impact that new entrants will have on the market and the subject hotel. Every effort should be made to research proposed and planned projects, the timing of opening, location, size and brand. Absent the knowledge of any specific projects, an assessment of the general ease of market entry and land availability should be evaluated and factored into assumptions. Examining what brands are not currently represented may also provide a sense for the future supply landscape and related risks.

While the industry has made great strides in revenue management, there still exists a wide range of practices and degree of sophistication employed today. There remains a real opportunity to enhance performance through revenue management practices at many properties across the US, which, when uncovered, can yield incremental value and investment returns.

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