Hotel Investment Overview

By Richard Warnick

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This chapter is divided into two sections. The first section is an update and expansion of an article I wrote several years ago that was subsequently converted to a chapter entitled “Investor Lessons” in Hotel Investments: Issues & Perspectives,
The Immutable Laws of Lodging Investment

The Immutable Laws are based on the belief that most economic losses in lodging real estate are self-inflicted. Stated differently, while recessions (especially bad ones like the Great Recession) and unpredictable events (like 9/11 and SARS) contribute in varying degrees to economic loss, the majority of the hardship felt in the lodging sector over the years has been caused by—or at least exacerbated by—questionable investment decisions and/or questionable lending practices. The patterns described in this section are not only clearly observable, but definitively predictive. All of the mistakes related in this section have been repeated multiple times in the past and will continue to be repeated in the future—regardless of admonitions such as those contained in this chapter—for a variety of reasons, including:

- Conscious or subconscious amnesia.
- Turnover among investment decision-makers and lenders, ensuring a continuous crop of the inexperienced and uninitiated.
- Misaligned incentives.
- The it-won’t-happen-to-me syndrome.
- The ever-present “ances” of arrogance and ignorance.

The conditions existing years ago when the original Immutable Laws were conceived are very different from those that exist today and those that will likely exist in the future. Updating these laws for this chapter was a test of their basic premise: their immutability. While some of the accompanying descriptive/explanatory language has been modified to be more current, I’m happy to say that the sixteen original Immutable Laws still stand as originally written. So far, so good. For this publication, I have added four more laws that I hope will also stand the test of time.

Heeding these laws may not prevent financial hardship in the lodging sector, especially in an era where unexpected events like 9/11 can suddenly and radically disrupt normal economic cycles, nor will it completely insulate investors from severe downturns or the onslaught of new supply. Heeding these laws can, however, substantially reduce the likelihood of problems and mitigate adverse impacts if and when they occur.

In no particular order, let’s consider the now twenty Immutable Laws of Lodging Investment.

1. With few exceptions, hotels are not an appropriate asset class for a long-term hold.

Hotels are not an appropriate asset class for a long-term hold because the lodging business: (1) is highly cyclical, (2) has high operating leverage (rapidly eroding profits during cyclical lows), (3) is vulnerable to uncontrollable and unpredictable
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external events (e.g., terrorist attacks, epidemics, oil spills), (4) is vulnerable to periodic (and unavoidable) spikes in supply, and (5) is subject to extreme irrationality by those who control pricing decisions. Hotels also require extensive reinvestment in capital over time in order to remain competitive. So, the highest yields will accrue to industry-savvy cyclical traders. The most recent manifestation of this phenomenon is what is occurring in the energy belt. Like Sinatra sang: “...you’re ridin’ high in April, shot down in May…”

2. Never fall in love with real estate.
It is all too easy for irrationality to quietly creep into decision-making when one becomes too attached to the allure of a particular site, building, concept, or opportunity. Emotional attachment has undone more investors than affairs of the heart have undone politicians. This may be one of the more insidious pitfalls, because it can happen without total awareness and is usually subject to vociferous self-denial. A related concept that was not included in the prior versions of Immutable Laws is: Never fall in love with the hotel industry. It’s easy to do, especially in the luxury and lifestyle segments. Hotels are more fun than office buildings, industrial parks, or apartment complexes. There is a prestige factor. Like a sports franchise, hotels can be sexy to own. Unlike sports franchises, supply is not constrained. Cool, sexy, and prestigious are not necessarily words that mesh well with return on investment.

3. Location is and always will be the most important criterion differentiating real estate—and hotels are no exception.
This law applies at both the macro/destination level (general desirability, airlift, demand base, local economic drivers, labor market, seasonality, etc.) and the micro level (access, visibility, type and quality of surrounding uses, views, barriers to entry, proximity to demand generators and/or attractions, etc.). When markets are at their peak performance, compression will partially level the playing field. But market compression is no substitute for location—a lesson learned episodically when markets go through their inevitable declines.

4. Leave some chips on the table.
No one is smart enough to know precisely when the bottom or the top of a market cycle will occur. Those who catch it at exactly the right time are simply lucky. However, you do not need to be a first mover during cyclical lows to buy at a good price—and there are plenty of signs to indicate when the sector is nearing the top (i.e., still time to exit).

5. Easy construction credit is a leading indicator that the top is approaching.
Because lenders generally rely on the false security of well-established trends, one of the first signs that the market is becoming risky is when lenders deem it to be safe for construction financing. Ironically, that spigot generally opens at about the time it should be closing. When hotel construction financing becomes easy and plentiful, it may not yet be time to run for the exits—but the hairs on the back of your neck should be tingling. (Note: There are services that track hotel development and construction activity and are thus an excellent proxy for actual knowledge of construction lending activity.)
6. If you can’t build a hotel so as to open in the early to mid-part of a growth cycle, you probably shouldn’t build it at all.

The best time to commence new development is in the late stages of a downturn, because land is comparatively cheap, construction costs are at their most competitive, and the hotel will open with the maximum amount of time remaining in the ensuing up-cycle. In most instances, the only guaranteed winners of late-cycle new construction—especially for upscale and luxury full-service hotels and resorts—are (1) developers using other people’s money (“OPM”), (2) brands bent on growth, and (3) the second or third owner (after the first one or two failed). This may be the most difficult of the laws to adhere to, because adherence requires debt financing to be obtained at the time when virtually every construction lender will be loath to provide it. Ironically, it is the best part of the cycle to lend on new construction.

7. Do not equate luck with skill or intellect.

Many lodging industry investors who made money because of cyclical good fortune have gone on to lose it in other deals because they could not distinguish that good fortune from the knowledge/experience necessary to develop and operate this complicated property type.

8. Cap rates should be viewed as a derivative of value rather than a determinant of value.

Viewed in the context of real estate cycles, cap rates are the inverse of what they should be. That is, they are at their lowest when the cycle is near the top, net operating income is peaking, and there is no place to go but down. They are at their highest when the market is at or near the bottom, net operating income is low, and the future holds the most opportunity for growth. (Note: Early cycle buyers often buy at low cap rates. However, at the bottom of the cycle, when net operating incomes are severely depressed, buyers are not pricing assets based on cap rates, but rather on some combination of discount to replacement cost, projected current yields, and overall yields, including reversion. Cap rates for such buyers are still, therefore, derivative values.)

9. There will always be a replacement source of irrational capital.

Every cycle manages to attract a source of capital that will over-value assets as the cycle matures. Indeed, these are the buyers every cyclical investor prays for. The trick is to take advantage of them—not become one of them.

10. Generally speaking, leverage of more than 60–70 percent loan-to-value is a high-risk proposition for hotels.

The degree to which a borrower chooses to lever lodging assets in excess of this level is inversely proportional to: (1) the number of cycles the borrower has experienced, (2) the amount of the borrower’s “own” money in the deal (versus other people’s money), and (3) the borrower’s propensity to reduce risk. Even experienced cyclical investors can be affected by excess leverage because of unpredictable event-related downturns. An extension of this law is that if you are borrowing against the promise of future cash flow—as opposed to in-place demonstrated cash flow—you had better be prepared to provide out of pocket money to cover potential shortfalls or you might be handing the keys to your lender. A second extension of this law is that if you are borrowing against late-cycle (peak) cash
flow, a debt service coverage ratio (DCF) of, say, 1.4, could easily become a .9 DCF or worse when the inevitable down cycle occurs.

Indeed, the only “safe” way to over-leverage (assuming the borrower doesn’t care if the lender ends up owning the asset) is to go all the way. That is, have little or no equity in the deal with non-recourse financing. This is equivalent to getting paid (from current cash flow) for having a put option to a lender. The borrower clips coupons when times are good and hands back the keys when times are bad.

11. **Understand the nature of various industry participants and diligently observe their behavior.**

As Margaret Thatcher so aptly said, “Nothing is more obstinate than a fashionable consensus.” It’s easy to get swept up in excessive exuberance, especially when the entire market seems to be moving in the same direction. But most industry participants are self-serving entities that unwittingly or intentionally stoke the cyclical flames. After all, developers need to develop, managers/brands need to grow, lenders need to lend, brokers need to transact, etc. To borrow from an old saw: *Where there’s a fee, there’s a way.* The actions of entities that benefit from or rely on the up-cycle are the least reliable indicators of cyclical downturns. The entities to pay closest attention to (through their actions) are industry-savvy agnostics—that is, those who are knowledgeable of the business and indifferent to advancing any agenda other than optimizing returns. They most likely have a return-maximizing strategy—and the discipline to stick with it. (Note: This category specifically excludes investment funds that have already raised their capital and need to place it.)

12. **The degree to which asset pricing is rational is inversely proportional to the amount and cost of capital in the system.**

When money is plentiful, competition for assets is high. This is especially true when so much hotel transaction activity is driven by public and private funds raised specifically for acquisitions (money raised must be spent). Heavy competition for assets drives prices up and yields down. In today’s environment (2015/2016), this phenomenon is being exacerbated by international capital flows to safe-harbor locales.

The cost of money is also a significant factor—never more so than in this post–Great Recession cycle where debt is the closest we have ever seen to being free. Consider the illustration in Exhibit 1. To maintain a 12 percent levered equity yield for this hypothetical hotel, the supportable price would need to be roughly $8,000,000 less if interest rates were 7.5 percent instead of 4.5 percent. Arguably, the variance would be even greater, since equity yields would also rise in a higher interest rate environment.

The prospect of interest rates reverting to historical norms (eventually) also adds a layer of risk to the exit strategy. If interest rates remain low for the long term, the bets buyers are making on exit value are rational and support the higher prices being paid today. But what happens if (some would say when) interest rates rise. Prudent underwriting would suggest that exit cap rates should take into account the potential that debt will be more expensive for a new buyer than what it is in this current artificially suppressed interest rate environment.

(Note: There are those who believe that any increase in interest rates will be offset by a corresponding rise in ADR and, thus, EBITDA. This is based on the
belief that interest rates wouldn’t rise if the economy were not in a robust state, thereby supporting ADR increases as well as strong occupancy. This logic is flawed in two ways. First, rising interest rates do not always occur because of or even consistent with economic growth. If you are too young to remember the “stagflation” of the 1970s, look it up so you can understand its perverse consequences. Second, hotel pricing does not necessarily parallel inflation and, in fact, is often completely divorced from the underlying cost of product delivery, especially where there is excess supply. And even under stabile supply conditions, prices are susceptible to the dumbest competitor in the market and/or to the competitor with the lowest cost basis. Room rates reflect competitive market conditions far more than they reflect what it cost to build, maintain, and operate any given property.)

13. The first sign that a down cycle is nearing the end is when the vast majority of industry participants have joined in the funeral dirge.
Looking back on this latest cyclical nadir, for example, it was early in the fourth quarter of 2009 when the third movement of Chopin’s Op. 35 became the background soundtrack for nearly every conversation about the lodging industry. That said, thinly capitalized investors should take heed of Immutable Law 4, because the only entities that can (read should) take advantage of the lowest cyclical pricing are those that can afford to guess wrong.

14. The liquidity of lodging real estate varies widely from market to market.
Liquidity in this sense refers to the ability to convert quickly from a hard asset to cash. Of course, “quickly” is relative, since real estate, by its very nature, is illiquid. Below, I have identified ten market factors that, when combined, have a material and measurable effect on the liquidity of lodging real estate:

- Depth of the buyer pool (i.e., number of investors likely to be interested in the market)
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- A market’s appeal to international investors
- A market’s appeal to institutional capital
- Barriers to entry
- The variability from high to low of historical pricing within the market (obviously, less variability is better)
- Historical recovery time from a market’s prior cyclical lows
- Degree of strategic importance to lodging brands
- Size (the larger the market, the less susceptible it is to the dilutive effects of any given number of new rooms)
- Demand diversity and demonstrated stability
- The degree to which the market depends on the old economy (e.g., traditional manufacturing) versus the new economy (e.g., technology)

The comparative liquidity of markets was particularly acute during the buying cycle that began in 2009. It was a case of the “haves” versus the “have nots.” In the United States, the “have” markets are generally gateway cities on the east and west coasts (especially, New York City [which is in a category of its own], San Francisco, and Miami), and the “have nots,” which to some degree are all the others (especially secondary and tertiary center-of-the-country markets). Of course, as economic cycles progress and pricing in the “have” markets becomes prohibitive, the “have not” markets become increasingly desirable. (Note: this law does not speak to where one might get the highest returns. Rather, it speaks to risk mitigation from the standpoint of where might an investor be able to exit within the narrowest range of time and, all other things being equal, with the least risk of loss.)

15. The liquidity of lodging real estate varies, depending on asset size and type. In addition to market factors, specific asset characteristics affect liquidity. This is generally related to the number of buyers for any given asset. For example, for the foreseeable future, there will be adequate buyers for:

- Top-tier branded select-service assets that have adequate remaining time under the license agreement
- Iconic assets in desirable markets
- Hotels in New York City (notwithstanding the surge in new supply)
- Hotels in desirable markets with high barriers to entry (e.g., San Francisco)
- Hotels that will look sexy on the cover of someone’s annual report or equity offering memorandum

On the other hand, there are generally fewer buyers for:

- Generic resorts
- Small (less than 100 rooms) independent hotels, because they are not suitable for institutional buyers (though a number of REITs are now investing in the “lifestyle” hotel segment)
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- Properties with some form of incurable obsolescence (e.g., exterior corridor mid-tier hotels)
- Management-intensive assets, such as those with an outsize reliance on food and beverage
- Hotels with a questionable branding future (e.g., an Embassy Suites nearing the end of its franchise term)
- Hotels with virtually no branding future (e.g., a thirty-year-old Days Inn)
- Hotels requiring a capital-intensive repositioning (unless the acquisition price justifies the repositioning investment)

16. Beware of “Star Trek” underwriting—boldly projecting that ADRs will go where they have never gone before.

This admonition applies at both the market level (projecting market ADRs well in excess of their inflation-adjusted historical highs) and the single asset level (projecting that a particular asset will achieve ADRs materially in excess of market comparables). This is a corollary to “if you build it, they will come”; that being, “if you build it, they will pay.” A market’s pricing and pricing power are, in fact, highly resistant to change. Therefore, in the absence of material and demonstrable changes in demand characteristics, the most reliable gauge of any given market’s future cyclical ADR performance is its past cyclical ADR performance. Of course, there are exceptions. For instance:

- The rapid run up in rates in San Francisco in 2014 and 2015
- Markets with pent-up/unsatisfied higher-end demand without commensurate higher-end supply (Bentonville, Arkansas, before the introduction of 21C)
- Certain resort destinations where demand can be induced/created by brands like Aman, Four Seasons, and Montage
- Introducing a new generation select-service hotel (e.g., Hilton Garden, Marriott Courtyard) into a market with older/obsolete hotels

(The last three of these examples are not necessarily exceptions to Immutable Law 16, because they do not reflect the performance of true comparables in their respective markets.)

Investors would be wise to remember that gravity exists, both as a force of nature and a force of economics, and the lodging landscape is littered with the bones of those who believed they could ignore that reality.

17. You are more likely to make money on the buy side than you are on the sell side of lodging real estate.

Absent over-leveraging, under-capitalization, or simply bad execution, going-in price generally outweighs other factors affecting returns in lodging real estate, including re-branding, re-positioning, better management, and so on. Being in a hotel at the right basis is also the best hedge against downside market risks. The corollary is that every investor should take comfort in the fact that the only thing worse than losing a deal is winning it at the wrong price. Or, stated differently, the best deal you ever did may be the one you didn’t do.
Readers will no doubt have observed numerous instances where an investor paid an aggressive price for a hotel only to sell it later in a frothy market for an insanely high price. However, this feels more like gambling than an investment strategy. Investors’ propensity to pursue such an approach likely depends on the amount of their own money in the deal (versus OPM) and whether they have experienced a down cycle.

18. **Replacement cost is an unreliable guide to value.**
One of the factors most often used in gauging the value of a hotel asset—especially in down markets or periods of early recovery (when cash flows are not indicative of value)—is how the acquisition price compares to replacement cost. The basic assumption to this valuation methodology is that, at some point in the cycle, construction will recommence and that the asset will be worth at least what it would cost to reproduce it. The problem with this discount-to-replacement-cost theory is that it presumes that a hotel of the type and location being purchased is—or will be at some future date—economically viable at the cost it would take to build it. There are simply too many instances where that is not the case. This is especially true in the luxury tier, where development costs today typically range from $500,000 to $1 million per key (rarely less, and significantly more in some locations and with some product types). How many markets support the RevPARs necessary to justify that kind of investment without some other motive (e.g., the sale of branded residential, “place-making” for a resort community, or urban mixed-use)—benefits that will not generally accrue to a hotel buyer? Another danger in using replacement cost is underestimating the cost of CapEx for older hotels, which can run 8.0 percent to 10.0 percent of gross revenue—even after a renovation.

Replacement cost works best as an indicator of value on non-luxury mainstream hotels (not resorts). For other product types, an attractive discount to replacement cost should be nothing more than a starting point to warrant a closer look.

19. **Industry fundamentals are not a proxy for hotel values.**
One of the more frequent themes relating to hotel values (occurring at almost every industry conference) is, “Where we are in the cycle?” It is often expressed in terms of baseball innings (“What inning are we in?”). In early recovery periods, the question may be framed as follows: “When we will return to prior ‘peak’ performance?” The “fundamentals” generally referred to in these discussions is simply RevPAR (in real versus nominal dollars), because, thanks to STR, it is the most accurate publicly available data and it encompasses millions of hotel rooms.

Such discussions are interesting from the standpoint of cyclical supply and demand, but they can be quite misleading in terms of asset prices. The up-cycle prior to the Great Recession was a poster child for why this is true, because asset prices in 2006 and 2007 were driven by a confluence of favorable lodging fundamentals, low interest rates, high leverage, and plentiful capital. In order for prices to hit those same levels, all of these conditions must be repeated, or some must be strong enough to offset the laggards. Stated differently, there are many factors that influence asset pricing, and they do not always align with what most people consider to be industry fundamentals—even if one focuses on the only industry fundamental that really matters—namely, net operating income.
Barriers to entry are more of a speed bump than a stop sign.

Barriers to entry are highly touted (including by me) as an important investment criterion—but they are often transitory or based on conditions that can be altered. This does not diminish their importance, as they are and always will be a core determinant of successful lodging investment. Investors must realize, however, that not all barriers to entry are created equal; their effectiveness ranges from being merely an inconvenience for new development to giving properties a good head start over new development and to providing a sustainable supply-constrained market.

Barriers to entry are more effective for urban hotels than for resorts, because all individual business travelers and many individual leisure travelers are going to a specific destination for a specific purpose. That is, business travelers who have a meeting in New York City are not going to travel to Chicago instead because the rates are better there or they like a particular hotel there. That condition is not true for the meetings market segment, which accounts for a significant amount of the demand for most resorts. So, having high barriers to entry in a specific resort destination (Destination A) does not prevent someone from developing a competitive property in an alternate resort destination (Destination B) that can compete for groups and vacationers who may like, but are not locked into, Destination A. Take, for instance, the Coachella Valley in Southern California, which includes the desert cities of Palm Springs, Rancho Mirage, Palm Desert, and Indian Wells. Even though there has been a dearth of new supply in that area, the market has proven vulnerable to regional supply additions (e.g., the Southern California coast, Las Vegas, and Phoenix). This external vulnerability is particularly acute for destinations that are disadvantaged in terms of access, especially airlift.

Among barriers to entry, the least reliable is cost, because:

- Some public entity might use tax-free bond financing to build—or subsidize a private developer to build—a hotel in order to generate new transient occupancy taxes, support urban renewal, supply additional rooms for a convention center, etc.; or
- Some enterprising developer—or a brand hell-bent on expansion—might convince an equity capital source and a lender to finance an economically unsupportable deal; or
- Some high-net-worth individual might decide to build a monument to his/her ego irrespective of project economics; or
- A mixed-use component (probably residential) might sufficiently alter the economics of a hotel component to overcome the cost barrier;

... and so on.

Lack of entitlements is a more effective barrier, but the entities controlling entitlements may allow a re-zoning for a variety of reasons, including, but not limited to:

- A desire to generate tax revenue (municipalities love to tax visitors since they do not vote—except with their feet by choosing a different location).
• A change in the tenor of local politics (e.g., election of a new pro-growth city council).
• A successful lawsuit.
• Successful lobbying by a smart, well-capitalized developer.
• Urban redevelopment.

A lack of available land may also seem like an effective barrier. But public land (e.g., an old military base) may be privatized for development, or already developed private land might be converted to a higher and better use if the economics are compelling. The harder it is to find available development sites, the more likely it is that sub-optimized land will be repurposed.

NIMBYs (the “not-in-my-back-yard” crowd) can be a barrier to entry but, generally, only when combined with a required zoning change. Even then, there are countless examples of well-heeled, well-organized local citizenry losing a re-zoning battle to a committed municipality and a well-capitalized developer or land owner.

Ultimately, the most effective barrier to entry is really a combination of most or all of these factors (i.e., you need more than one). And, reflecting back on Immutable Law 3, location is the ultimate hedge against competition, regardless of the ebbs and flows of barriers to entry.

Economic, Demographic, and Industry Macro Trends Shaping Lodging Investment in the Foreseeable Future

At the risk of stating the obvious, the future is hard to predict. And in the lodging sector, it gets harder every day, because:

• The marketplace is complex and increasing in complexity.
• Change happens at a fast pace, and the pace is accelerating.
• The world is more integrated and interdependent—events in distant places can have far-reaching consequences on the lodging sector.
• There are rapid advances in technology and the application of technology, and the pace is accelerating.
• Economic and political volatility is extraordinarily high—“black cygnets” abound, and one or more may become a black swan.

For example: Who would have predicted in 2010 what has occurred with respect to Airbnb, a then two-year-old San Francisco–based startup? True, there was concept precedence (e.g., VRBO). But even if someone saw the potential growth for this concept in the sharing economy, who would have further predicted the size of this latent market or the speed at which it would grow to mainstream credibility? A mere six years from the introduction of Airbnb, the company’s first major round of funding in April of 2014 valued the company at $10 billion. Subsequent rounds (one in June 2015 and another in November 2015) that raised more than $1.5 billion in additional capital pegs the company’s valuation at $25.5 billion. To put this in perspective, as of January 2016, Hilton’s market cap was $17.4
billion, Marriott’s was $15.2 billion, Starwood’s was $10.0 billion, and Hyatt’s was $5.1 billion—and Airbnb does not own, operate, or franchise a single hotel room anywhere on the planet. Even founders Brian Chesky and Joe Gebbia must be pinching themselves to make sure this is not a dream.

A lot of Airbnb’s value is related to its rapid growth and perceived potential for future growth. Still, think for a moment about comparative values. As of January 2016, an eight-year-old Internet distribution channel is worth:

- About 80 percent of the combined value of Hilton and Marriott
- Over two-and-a-half times the largest public hotel REIT (Host) and about the same as the top seven public hotel REITs combined

Beside the value implications, Airbnb is changing the supply and demand equation in a very material way. In New York City, for instance, it is estimated that Airbnb has over 30,000 listings and is believed to be one of the major factors limiting ADR growth in the market.

In spite of this general unpredictability, there are certain “transcendent” macro trends that are and will continue to affect lodging dynamics, and they should definitely be considered in evaluating lodging investments. It is worth noting that, for the most part, these trends are not investment-focused. However, hotel real estate is inextricably linked to the operation of hotels; what affects one will, directly or indirectly, affect the other. Listed below, in no particular order but numbered for ease of reference, are some of the more important of these macro trends. With apologies to international readers, they are decidedly U.S.-centric.

1. Continuing and escalating impacts on hotel investments by brands.
   There are many ways in which brands influence asset pricing. Some of the more significant/prolific ones include the following.
   
   Property Improvement Plans (PIPs) on change of ownership. Every time a branded asset is sold, the buyer is subject to an upgrade to the latest and greatest brand standards. The requirements can be eye-popping. Even when the initial PIP is negotiated down from the brand’s wish list, buyers will likely be subject to future pressure to meet the latest standards. Investors need to obtain benchmarking guidance on typical PIPs at different stages of a product life cycle and factor this element into their acquisition underwriting (and exit strategy). While the buyer of the asset will pay for the PIP, the sales price of the asset will be affected. That is, the purchase price will equal the estimated asset value less the cost to meet brand PIP requirements and other required CapEx.

   Cost escalation via centralized services. Operators (especially brands) have engaged in a gradual and systematic transfer of many services that were once part of their management fee to “centralized services” for which they are separately paid. Because most management agreements require centralized services to be provided “without profit,” the operators providing such services do not mark up the cost of providing them. However, if a branded operator charges an owner “at cost” for something they used to include as part of a basic management fee, and if, as a result of doing so, more of the management fee flows to the brand’s/operator’s bottom line, it is a distinction without a difference. That is, it equates to more money to the operator, less money to the owner.
Brand outsourcing at the owner’s expense. In addition to escalating centralized services costs, brands are outsourcing and relying on third parties for an increasing number of services and are passing these costs on to owners. Examples include commissionable group sales, online travel agency (OTA) “commissions,” sales training, recruitment, purchasing, quality assurance inspections, energy studies, AAA/Forbes training, etc.

Short-term license agreements for purchased versus newly built hotels. If a franchise renewal is only awarded for, say, a ten-year period, what is the plan for the hotel post-expiration? How is exit value affected when there are only three to five years left on the license agreement for a desirable brand? What, for instance, is a thirty-year-old Embassy Suites worth if the license is not renewed on sale?

Same-brand impact issues. The big brands (mostly public companies) must grow. That means, given the opportunity, they will add as many hotels as they can to any given market. “Can” in this context is often determined by impact studies to determine “incremental” impact. That is, assuming the new hotel would enter the market in any event (and thus affect a given existing hotel regardless), how much additional impact would the existing hotel suffer if the new hotel bore the same brand as the existing hotel? A dip in revenue for an existing brand hotel that is recovered over a given time period (often, three years) is considered “acceptable” by most brands. Fees for impact studies are far less than for a traditional market study with financial projections, but the issues are easily as complex. Moreover, outcomes rely heavily on judgment calls—and the independence of third-party consultants conducting such studies is suspect, since they are beholden to the brands to be on an approved list.

Brand proliferation. There are many brands, and they vary wildly in terms of their value to a hotel owner. In the “lifestyle” segment alone, there are now about 100 brands (or wannabe brands).

Impact on a hotel from other brands within the same brand family. With the proliferation of brands within the same corporate entity, a frequent occurrence is for a brand holding company to enter the market with another competitive brand from their portfolio. Rarely does a management contract or franchise license agreement offer protection from such intra-brand cannibalization, even though these brands share all manner of systems, marketing intelligence, customer loyalty programs, and data (including customer data).

The brand attribute arms race. The Great Recession and a tepid recovery put a damper on brand initiatives (capital and operational). However, as the lodging sector strengthened, a steady increase in brand-mandated spending has occurred. Hotel owners should brace themselves, because that will continue into the foreseeable future. Increases in brand-mandated spending relate primarily to three areas:

- Enhanced services, especially to members of the respective guest loyalty programs which are financed by hotel owners (see next prediction).
- Increased CapEx costs as brands attempt to improve their product/image at the expense of hotel owners.
- Increased technology costs as brands try to leapfrog competitors—or play catch up—at the expense of hotel owners. (Please see additional comments under “6. Technology—the good, the bad, and the ugly” below.)
The bottom line is that, regardless of the cause, brands will have an outsized impact on lodging investment for the foreseeable future.

2. Increasing costs of brand loyalty programs.

Dateline January 28, 2025 – Los Angeles
Instant Hospitality News Network (IHNN)

Hilltop Hotels & Resorts announced today at the International Lodging Investment Summit that it will roll out its latest Hilltop Honors program: “We’ll pay you $50 to stay at any of our 47 Hilltop brands—and you’ll get three free rooms at any Hilltop property worldwide.”

Not to be outdone, Marrionette Hotels vowed to match Hilltop’s offer to Marrionette’s 630 million Marrionette Reward members at any of their 62 brands—and include free breakfast.

Hilltop’s and Marrionette’s latest offers appear to have been precipitated by the successful launch of a new program by Hyend Hotels & Resorts: “We’ll Pay Your Transportation Costs to Our Hotel” available to all of their 300 million Gold Visa members.

All three companies have stated they will impose a special assessment to hotel owners to cover the cost of the new programs, since the current 25 percent of total folio charge for each frequent guest stay has been insufficient to cover the escalating cost of their loyalty programs.

The comments of frequent business traveler Juanita Perez exemplify those of most frequent travelers surveyed by IHNN staff for this story. Said Ms. Perez, who carries loyalty cards for seven hotel brands: “As long as they keep paying me, I’ll keep staying at their hotels.”

Though the preceding news release from the year 2025 was written with tongue solidly in cheek, it is not hyperbole to state that the offered benefits of the brands’ guest frequency programs are increasing dramatically as hotel companies try to differentiate undifferentiated products with more benefits in order to “buy” the loyalty of their customers. I can’t predict when the breaking point will be reached, but one thing is increasingly clear. As long as brand “loyalty” can be purchased with someone else’s money, brands have no incentive to take their foot off the throttle.

One must also wonder about the long-term effectiveness of these programs, as OTAs and other intermediaries ramp up their own loyalty programs totally independent of any brand other than their own.

3. Continued escalation in the cost of guest acquisition.
The lodging industry has fought hard—to little or no effect—to reclaim pricing control over rooms inventory from OTAs. In 2007, 85 percent of all online bookings came directly from hotel brand websites (referred to generically as “brand.com”), with OTAs providing the remaining 15 percent. During the first half of 2015—the latest data available for this chapter—the allocation had shifted to 64 percent from brand.com and 36 percent from OTAs. To make matters worse, individual hotels and hotel companies have become more and more reliant on third-party intermediaries for group business as well, at a substantial incremental cost. It is common practice today to have local, regional, and national hotel sales teams dedicated to third-party group intermediaries—i.e., sellers focused on selling to sellers. The
industry’s latest crack cocaine is Cvent, which currently offers relatively efficient access to meeting planners through sophisticated electronic RFP methodology. Do not be surprised if Cvent tries to shift to a merchant model based on a percentage of booked business sometime in the not-too-distant future.

Notwithstanding this massive shift in how business is sourced, owners still have to pay full brand marketing and group sales fees even if the brand is incidental to the purchase decision. This leaves only one party on the wrong side of rising customer acquisition costs: hotel owners. The industry’s top expert on this topic, Cindy Estis Green, CEO of Kalibri Labs, has done significant research on the issue of third-party intermediary costs. Through its research, Kalibri Labs estimates that the U.S. hotel industry paid $14 billion in commissions and transaction fees in 2015, largely to the global distribution systems, travel agencies, and OTAs (not including most group commissions), and that number will continue to grow as more and more transactions are touched by more and more intermediaries. Preliminary numbers from the 2016 update of this Kalibri Labs report show that hotels’ total customer acquisition costs are estimated to be between 15 to 25 percent of total guest-paid revenue. Another notable statistic from Kalibri Labs: commission costs in the U.S. market grew at twice the rate of revenue growth from 2011–2015.

All this is occurring against a backdrop of a new generation of middlemen bellying up to the trough with smartphone apps aimed at aggregating pricing data or simply becoming another fee-for-service purchase channel for consumers. Unless you are a hotel owner, these are great business models in that they get to price and sell inventory that they do not have to build, service, or maintain.

Adding insult to injury, the introduction of so many intermediaries into the booking equation means that there is a declining percentage of customers with whom hotels (and hotel companies) have a direct relationship.

Good strides have been made on the OTA front to correct this shrinking revenue problem, with certain big brands negotiating lower commissions, restrictions on last room availability, etc. Brands have also restricted or eliminated loyalty program points for business booked through OTAs. And consumers are finding that a room booked through an OTA is not afforded the same privileges and flexibility as a room booked directly. Many brands are introducing aggressive communication campaigns outlining the benefits to consumers of booking directly. Even the Federal Trade Commission, using data and examples compiled by the American Hotel & Lodging Association (AH&LA), has posted warnings to consumers about the high risk of booking through third parties. More work is being done by a group of owners and brands to level the playing field through AH&LA’s Consumer Innovation Forum, which will be visible in the market later in 2016 and early 2017. Still, the concern is that there may not be enough fingers to plug all the revenue-leaking holes in the dike—and until the tide turns, hotel owners will continue to bear the brunt of revenue leakage.

4. Brand.com to the rescue—or not.
As noted above, a major effort has been underway by the major brands to take back lost ground from the OTAs by directing customers to their proprietary websites. Considering that OTAs have an effective “commission” rate of 15 percent to
25 percent, depending on each brand’s negotiating strength/ability, owners have been rooting for the brands. What is not known to most owners (because it is obscured and difficult to assess) is that the cost of customer acquisition through the brands is now approaching the lower end of the OTA range (as high as 13 percent, according to in-house research performed by a large, highly sophisticated owner of many hotels across multiple brands).

5. The disruptors will get disrupted.
This topic brings to mind the 1969 movie classic, *Butch Cassidy and the Sundance Kid*, in which a pair of outlaws (Butch and Sundance) futilely attempt to escape a relentless posse that continues to find their trail. After a string of unsuccessful attempts to lose the posse, Butch says to Sundance: “I couldn’t do that. Could you do that? Why can they do it? Who are those guys?” And thereafter, in growing frustration, he repeatedly asks Sundance, “Who are those guys?”

Now, the OTAs, companies that have devoured so much of the industry’s revenue, profits, and wealth, are about to themselves be eaten. The posse in this case is Google (and perhaps Amazon). With enormous financial resources, first-in-line consumer contact, and a frightening amount of individual demographic and behavioral data, these behemoths will likely make Expedia and Priceline far less relevant in the coming ten years—notwithstanding the OTAs’ efforts to morph and adapt through innovation and acquisitions of travel-related technology companies. Before popping the champagne cork, however, brands and hotel owners alike should note that it is only a matter of time before they also become part of the meal.

6. Technology—the good, the bad, and the ugly.
The hotel business has been woefully behind the curve in terms of developing or adopting technology. That is now changing so rapidly that the industry is going to be suffering from whiplash for the next decade. Here’s a brief look at the coming technological changes—the good, the bad, and the ugly.

*The Good.* Technology is benefitting many aspects of the industry, including customer access, customer relations, marketing, revenue management, mobile check-in/keyless entry, service management, employee accountability, labor productivity, inventory management, real-time market intelligence, purchasing, data collection/management, and on and on. It seems that at least weekly there is a new application, system, or platform that promises material benefits to hotels. The emerging trend of hosted and cloud-based technology also affords the opportunity to deploy new systems without the need for costly on-site hardware, programming, and maintenance. Cloud computing has the added benefit of rapid deployment and inexpensive updates/upgrades. And while most consumer-facing applications are parasitic in terms of revenue, there are a few notable exceptions. For example, Nor1 is a technology that both improves hotel revenue and increases guest satisfaction by upselling underutilized premium rooms. Another recent example is HotelsByDay, which allows consumers to purchase hotel rooms for discreet periods of time during the day when rooms would otherwise sit idle (the equivalent of increasing inventory turnover in retail, or a chain like McDonald’s adding breakfast to capitalize on an otherwise idle time period).
The Bad. Of course, new technologies are not free, and their adoption is generally not voluntary for hotels that are part of a brand. The rapid introduction of technology has become another competitive weapon in the fight for market share by the brands as they increasingly try to cater to the rising wave of tech-savvy consumers. Naturally, these costs are paid for directly or indirectly by hotel owners.

The Ugly. There are a number of scary aspects of technology that will affect the industry in profound ways in the foreseeable future. The ones I believe will be most impactful are listed below:

- **Pricing transparency.** Technology has introduced unprecedented pricing transparency and knowledge into the marketplace, providing consumers with virtually instantaneous and continuous knowledge of offered prices for rooms (and other services) on a real-time basis. These new technologies enable consumers to exploit the weaknesses in the industry’s flawed pricing structure. Commoditization is bad for hotel ownership—and brands. Consider TripBAM, for instance. This clever tool gives consumers (both individuals and corporate travel departments) the ability to (1) book a room at a hotel of their choice far into the future, (2) identify other hotels in that destination that they would consider if their pricing was competitive, and then (3) allow TripBAM to automatically track pricing offers for that set of hotels on all electronic channels and automatically cancel their reservation and rebook it at a new hotel—or at the same hotel—any time a better price for the room is identified. The process is repeated over and over, all the way up to the date of arrival. Another relatively new rate-inhibiting technology is Rocketrip, which allows firms to reduce travel costs by providing a way for employees to share in the savings they generate by staying in less expensive hotels, flying during off hours, etc.

- **Third-party apps.** Advances in technology continue to allow new forms of intermediation, which is great for the consumer, but profit-eroding for the owners of the physical assets being intermediated. The introduction of third-party apps in the lodging space has become the latest disruptor to contend with, ultimately costing owners a lot of money. Historically, the introduction of new technologies by third parties was constrained by expensive research, development, and marketing costs. In today’s world, it is much easier and far less expensive to develop, market, and distribute new platforms.

- **Technology obsolescence.** The shelf life or time between rollout and obsolescence of a given technology can be shorter than the expected amortization of its cost. While hosted and cloud-based solutions help mitigate this risk to owners, not all systems and applications are going to stand the test of time. Even those which seem “future proof” can become unexpectedly obsolete due to a market-disrupting advance or an unanticipated change in the way business is transacted. And there’s no available source to tell us where the next world-changing innovation is coming from. Moreover, not all of the technologies being marketed will survive. Investing in a cool new technology may seem like a good idea, but not if it fails to get sufficient market traction before the venture capital funding runs out.
• **Airbnb.** This technology-driven platform is no longer just an option for adventurous leisure travelers and those willing to take risks in exchange for favorable pricing. More and more, it has edged into the mainstream, in spite of its drawbacks for the core travel marketplace (e.g., safety, sanitation, absence of services, inconsistency, the oddities of check-in, etc.). There are speed bumps, including regulatory agencies, homeowner associations, taxing authorities, AH&LA—but this “shadow inventory” is here to stay and it’s growing. It is already having a serious impact on rate growth in certain major markets like New York City.

• **System integration.** The number of desired/needed/available systems is increasing, as is the number of vendors offering technology-driven solutions. System-to-system communication is a big issue—solvable, but at a price.

• **Brand proprietary systems.** Many brands are obsessed with developing and owning their own technology platforms (keyless entry, for instance). While it is understandable for a brand to want to have a system that no one else has, brands have not had a great track record of developing and operating leading-edge technology. Brand-owned legacy systems that do not run on an open platform also exacerbate the integration issue described in the point above.

• **Questionable brand pass-through costs.** Brand research and development expenditures are amortized by including those costs in centralized expenses and are, therefore, generally paid for by hotel owners. This may be justifiable in theory, but the investment pain is not shared by the brands. With few exceptions (e.g., Omni Hotels & Resorts), brands do not own much real estate. Those that still do are quickly divesting in pursuit of the so-called “asset light” capital strategy (largely a consequence of their public ownership—Wall Street does not like real estate on the balance sheet of the hotel brands). This situation is exacerbated by the issue in the point above.

• **Maintenance.** The cost of maintaining the various technology platforms can be quite high. These costs can also be difficult to measure/monitor, as they come in many forms: brand centralized services, vendor charges, IT consulting, software updates, and in-house payroll.

7. **Evolving demographic influences.**
There are at least three clear demographic trends that are affecting the lodging sector:

• While still influential, Baby Boomers are declining as a portion of active travelers. There were about seventy-six million births in the United States from 1946 to 1964, the nineteen-year period called the “Baby Boom.” Of those seventy-six million boomers, nearly eleven million had died by 2012, leaving about sixty-five million survivors. When immigrants are included, the Baby Boomer number is still over seventy-six million. Every day, roughly 6,000 Baby Boomers turn sixty-five. Having retired or surpassed their peak earning years, their travel spending will both change (less business, more leisure) and decline over the next decade.
The combined population of GenXers and Millennials (164 million) dwarfs the Baby Boomers. These consumers have different purchase criteria and spending habits than their predecessors.

In addition to this shift in age demographics, the U.S. population has begun a transition from predominantly English-speaking Caucasians to predominantly non-Caucasians (66 percent Caucasian in 2009 to an estimated 46 percent in 2043). In the not-too-distant future, English may actually no longer be the first language of the majority of U.S. inhabitants. Even today, roughly fifty million Americans speak a language other than English in their homes.

8. Post–Baby Boomer travelers will continue to change the lodging landscape in profound ways.
As just mentioned, post–Baby Boom consumers are meaningfully different from their predecessors—at least so far. Their demands, desires, and behaviors are driving changes in hotel design, functionality, and even brand. Witness, for instance, the rush to so-called “lifestyle” product introductions across the industry, including by the big brands. At the time this chapter was written, there were about 100 lifestyle brands operating nationally or regionally in the United States, the majority of which were introduced to the market in the past five years.

The following are four significant ways that post–Baby Boomer consumers are different from Baby Boomers:

- Notwithstanding some notable exceptions (e.g., the iPhone), post–Baby Boomer consumers do not exhibit brand loyalty, at least in a traditional sense.
- Largely as a result of advances in technology and the post–Baby Boomers’ natural embrace of it, the preferred purchase methods of post–Baby Boomer consumers differ radically from that of Baby Boomers.
- Post–Baby Boomers’ method of product validation—that is, how they hear about products, whose opinions they trust, and from where those opinions emanate—also differ materially from Boomers (e.g., social media).
- Post–Baby Boomers distrust traditional advertising more than their predecessor generations. One possible reason is found in the following quote attributed to Shane Smith, founder of Vice Media: “Young people today have been marketed to since they were newborns, because cartoons are made to sell cereal. So, as a consequence, they have the most sophisticated B.S. detectors of all time.” Whatever the reason, this distrust has serious implications in terms of how sellers communicate to this buyer pool.

9. Female travelers will continue to increase as a percentage of all business travelers.
According to a 2014 study by Judi Brownell, Ph.D., a professor at Cornell University in the Management and Organizational Behavior Program, women are the fastest-growing component of the business traveler market segment in the United States, and they already account for nearly half of all business travelers. Their needs and desires are different from those of male travelers, with implications that extend to hotel design, operating modalities, and marketing. Quite aside from the increasing importance of women to the business traveler market, Marybeth Bond,
the creator of “The Gutsy Traveler” website and author of eleven travel books, asserts that 80 percent of all travel decisions are made by women.

10. Emerging demand sources.
According to the U.S. Travel Association, there are more than a billion potential travelers from Asia that will soon become lodging consumers outside their home country. Initially, their impact will be felt mostly in gateway markets. This surge in new travelers can have very positive impacts on owners and operators who understand their expectations in terms of physical plant, product offerings (F&B, amenities, etc.), and service (cultural sensitivity, translation services, and so on). Travel visas have been an impediment to this potential demand pool, but the United States is finally addressing this issue in the largest Asian market, mainland China. Growing internationalization does, however, increase vulnerability to currency fluctuations and international terrorism.

11. Continuing escalation in labor costs.
Notwithstanding advances in technology that improve measurement, accountability, and productivity, labor costs will continue to rise as a result of several inexorable factors:

- **Government intervention.** Government intervention takes many forms:
  - The Affordable Health Care Act is a costly burden on labor-intensive businesses like hotels and will materially and adversely impact operating costs.
  - Minimum wage increases (national, state, and local).
  - Living wage requirements imposed by a growing number of municipalities.
  - Mandated paid time off.
  - The Department of Labor’s proposed amendments to the Fair Labor Standards Act (FLSA), which will dramatically increase the minimum salary required for employees to qualify for FLSA white-collar exemptions and substantially increase the minimum compensation required for employees to qualify for the Highly Compensated Employee exemption (from $23,660 in 2015 to $50,440 plus COLA adjustments in 2016 and beyond).
  - Changes at the NLRB that favor organized labor (see next point).

- **Organized labor.** Unions have placed a giant bull’s-eye on the hotel industry. And why not? This labor-intensive business is geographically locked in place. That is, unlike most manufacturers, hotel owners cannot move their assets to right-to-work locales. Hotels are and will remain vulnerable to unions and the politicians who court them. This unholy alliance between unions and politicians is especially prevalent in situations where municipalities facilitate hotel development, either through subsidies or direct ownership. As for the impact on the bottom line, ask anyone who owns/operates a hotel in San Francisco or New York City what happens when hotel unions control wages, benefits, and
work rules. Even in less virulent locales, the adverse impact of unionization on a hotel's bottom line is significant.

- **Failed immigration reform.** The (misplaced) burden of immigration enforcement is a hidden cost on businesses that rely heavily on unskilled labor. It also depresses the labor pool for housekeeping, stewarding, and similar entry-level positions.

12. **Increased government regulation (e.g., ADA).**

Every business in the United States is affected by increasing regulation. A recent and notable example for the lodging industry was the pool lift regulation that increased the cost and litigation risk for every U.S. hotel with a swimming pool. While sensitivity to the disabled is a laudable objective, use of these unsightly and expensive devices has been astonishingly low. It is a virtual certainty that the next pool lift debacle is being cooked up in some government office right now.

Note: The aforementioned escalating cost factors bring to mind a very interesting (and disturbing) structural aspect of the lodging industry; namely, that increased costs cannot easily be passed on to the consumer in terms of higher prices. That is, like any business whose product inventory is fixed and highly perishable, prices of hotel rooms are market-based, not cost-based. Thus, pricing power is vulnerable to the dumbest or most desperate competitor in the market.

13. **Increasing business complexity.**

The goal of revenue management is to sell the right product to the right customer at the right time and for the right length of time at the right price with the least intermediated cost (net versus gross revenue). This is no small task, given the multitude of distribution channels, intermediaries, and technologies at play—and the speed and frequency at which changes in strategy need to occur. The human brain is incapable of managing a process this complicated. Even most automated revenue management systems fall short, including the ones used by the big brands.

Rapid advances in technology are not likely to abate, and new challenges will accompany those advancements. Take, for instance, how quickly Mobile Travel Chat (also known as Mobile Travel Concierge) broke into the market. Already boasting nearly a dozen entrants (e.g., HYPER, Lola, ETA, HelloGbye, GoHeroGo, Hello Scout), MTCs use artificial intelligence to personalize travel bookings for users by learning user preferences and remembering them to make suggestions for the next booking. They are creating a new form of commission-based OTA expected to be highly popular, especially with Millennials.

As a result of its increasing complexity and a recognition of just how important it has become, revenue management has evolved from:

- A part-time pursuit by existing hotel personnel holding other positions, to...
- Full-time clerical positions with little training and no corporate regional/support, to...
- Full-time clerical positions with strong regional/corporate support, to...
- Full-time revenue management professionals (often part of the hotel executive committee) plus corporate/regional support.
Yet, revenue management as a discipline is still sorely lacking at most hotels, especially at the strategic versus tactical level. For the foreseeable future, hotels are going to be playing catch up—or perhaps just holding on for dear life.

14. Reduced consumer spending power over the long term.
There is reason to believe that post–Baby Boomer generations in the United States will have declining purchasing power. The following are five factors that could cause such a decline, each of which has been raised publicly by various experts:

- **Declines in the lifetime earnings of younger generations.** Educational lapses and international competition are at the core of this problem, and even an optimist would have to conclude that it will take some time to turn this trend around. A number of recent studies have shown that the joblessness and/or underemployment experienced by many college graduates during the last seven years created a permanent decline in their future earning potential.

- **The shrinking middle class.** The shrinking middle class means reduced consumer spending power, which can’t fail to have an impact on travel expenditures.

- **Entitlement burden.** The declining number of workers in the U.S. labor pool are earning less and paying more for a growing entitlement burden. When Social Security was introduced, the average U.S. male lived to the ripe old age of fifty. Not only has that increased to roughly seventy-nine (and women on average live even longer), but our aging population now believes that replacement of every conceivable body part is a matter of right. This is further exacerbated by extraordinary end-of-life care. According to a study by The Dartmouth Institute for Health Policy & Clinical Practice, the average Medicare cost of end-of-life care (the last six months) is $50,000. High medical bills for Medicare patients’ final year of life now account for about a quarter of the program’s total spending. All of this will be compounded by our national obesity crisis and the health care system’s unaccountability, exacerbated by the Affordable Care Act.

- **Personal debt.** This factor is driven in particular by student loans.

- **National debt.** This ticking time bomb clouding our collective future brings to mind a line oft-stated by Wimpy the Moocher, a character in Popeye cartoons: “I’ll gladly pay you Tuesday for a hamburger today.” So it is with the national debt—consume today, pay tomorrow. But tomorrow must eventually arrive, and the tax dollars used to pay principal and interest on the national debt are not going to be spent on a vacation at the beach.

15. Collapse of traditional hotel product market segmentation.
Meaningful differentiation between limited-service/select-service/focused-service hotels and full-service hotels (excluding luxury) is disappearing, and this blurring of the lines will have serious implications with regard to the competitive nature of markets. Compare, for example, the early generation Marriott Courtyard or Hilton Garden Inn to their current offerings, and compare these newer offerings to full-service hotels (within the same brand family or otherwise). Or compare a current generation Hampton Inn with, say, any mid- to upscale full-service hotel built
within the last ten years (e.g., a Holiday Inn). Except for meeting space and F&B, there is very little distinction.

There are numerous implications attending this collapse, not least of which is a brand’s ability to oversaturate a market with products within the same brand family that are not covered by area of protection (AOP) clauses. Another example of how this blurring is impacting markets (or will impact markets in the future) is reflected in how the industry thinks about new supply. Part of the industry’s euphoria over the past few years has been based on the fact that the supply pipeline is so small by historical standards. But the following are seven reasons owners of existing non-luxury full-service hotels should be concerned about new supply:

- The time to finance and develop the typical limited/select/focused-service hotel is far shorter than the time to entitle, finance, and construct the typical full-service hotel.
- The threat to existing hotel inventory is exacerbated by the age and condition of those existing full-service hotels.
- The product quality of the new generation of limited/select/focused-service products is much closer to the quality of full-service hotels than they were historically—and thus, more directly competitive.
- Increasingly, individual business and leisure travelers (i.e., non-group travelers) are not interested in or willing to pay for those components of a full-service hotel that define it as full-service (a restaurant and meeting space). This tradeoff is occurring despite the very narrow ADR gap that often exists between full-service and limited/select/focused-service hotels.
- Increasingly, limited/select/focused-service hotels have some type of food offering, further diminishing one of the historic differentiators.
- As every traveler knows, brand loyalty programs do not distinguish between sub-brands in the same family. If, for instance, there are six Marriott brands in any given market, travelers can get their Marriott Rewards at any one of them.
- Brands are on a tear in terms of portfolio growth and will jump at any opportunity to squeeze new hotels into markets (both new brands and existing ones).

Naturally, there are supply-constrained segments/areas—like destination resorts and markets with real barriers to entry (e.g., San Francisco). But the fact that there are few full-service hotels currently under construction should be cold comfort to owners of existing assets.

16. Year-round education and sports programs will have an impact on traditional family vacations.

The advent of a longer school year and unsynchronized schedules between different grades/schools will continue to challenge hotels that rely heavily on summer vacation travel. This is further exacerbated by sports programs that used to be seasonally focused but are now becoming year-round activities to elevate competitive performance.
17. The disparities between markets will increase.
Recall Immutable Law 14 regarding variations in liquidity. Notwithstanding the positive impact of compression on market by market performance, there will be continuing disparity between markets. Two of the most important characteristics that will drive this market disparity are: (1) appeal to international travelers and (2) the influence of the “new economy.”

Whether it be cruise lines, vacation ownership properties, glamping, or any of a number of residential rental options (e.g., Airbnb, VRBO, FLIPKEY, Romorama, etc.), leisure travelers have a wide array of alternatives to traditional hotel rooms. Leakage is also occurring in the individual business traveler segment with a broadening appeal/acceptance of Airbnb and a rise in serviced apartments (especially with the consolidation occurring in that niche). As evidenced by the Stratospheric Rise of Hospitality Alternatives breakout panel session at the 2015 International Hotel Investment Forum in Berlin, this is not just a U.S. phenomenon. These hospitality interlopers have pretty much covered all the bases in terms of habitable real estate. And don’t rule out the “virtual” vacation. With today’s younger consumers living substantial parts of their lives within the confines of a 2” by 4” video display, it’s not hard to imagine a not-so-distant future where these consumers enjoy a raft trip through the Grand Canyon or an elevator ride up the Eiffel Tower through a virtual reality device instead of a trip.

19. Brands will continue to propagate.
The growth in the number of brands in the past five years has been breathtaking, especially in the lifestyle segment. This is likely to continue because:

- Most of the large brands are public companies. Their share price depends in part on growth. There are only so many Brand X hotels that can fit into any given market, so brands have two choices: (1) move into international markets and/or (2) launch a new brand that has virtually unfettered expansion capabilities for the first ten to fifteen years of its existence.
- The big umbrella brands must continue to introduce products that have more appeal to the post–Baby Boomer traveler than do their legacy brands.

20. Eventual inflation.
According to Laurence J. Peter, “An economist is an expert who will know tomorrow why the things he predicted yesterday didn’t happen today.” I am not an economist, but, in spite of the continuing weak U.S. recovery, lots of excess labor capacity, and leaders who are loath to make necessary but politically unpopular decisions, it’s hard to imagine a scenario where the mountain of currency pumped into the system in the past several years, coupled with our collective inability to live within our means, does not lead to higher inflation somewhere in the not-too-distant future. Happily, inflation has historically proven to be good for the lodging industry, except when it is coupled with excess supply.

21. Interest rate increases.
Out of fear for the adverse impact on a precarious economic recovery (and, perhaps, the impact on the government’s ability to service its own debt), the Federal
Reserve’s Open Market Committee has maintained near-zero interest rates since December of 2008. This is not sustainable, and, notwithstanding powerful inertial forces, rates will eventually go up. This will have profound impacts on hotel real estate. Please refer to Immutable Law 12 for details.

22. **Continued hotel company consolidation.**
There is a high probability that industry consolidation will continue to occur. From the perspective of the acquirer, the acquired, or the merged entity, the objectives are fairly obvious and include all or some combination of the following:

- Reductions in overhead and other efficiencies
- Increased negotiating power with vendors and intermediaries (e.g., OTAs)
- Greater global distribution
- Increased market share or “shelf space”
- Increased ability to grow in markets currently saturated with a holding company’s other branded products
- Increased consumer reach and name recognition
- Increased membership in brand loyalty programs
- Increased ability to access expensive and ever-changing technological innovation
- Greater capital access

Regardless of the motives, the implications for hotel owners of these new Frankenbrands is not very appealing, to say the least:

- Less competition among brands for deals during acquisition and development (i.e., higher fees, higher reimbursables, and worse contract terms).
- More cannibalization in any given market (potentially offset in part by a greater pool of customers loyal to that brand).
- Reduced differentiation/competitiveness between similar hotels, with different owners operating under different brands within the same brand family. Think Marriott’s *Sales Force One* representing Ritz-Carlton, Bulgari, St. Regis, Luxury Collection, JW Marriott, Westin, W, Edition, Le Méridien, Autograph, Marriott, Sheraton, Tribute, Four Points, and Delta—*all in the same market*! Then include all of their limited-service brands and overlay regional revenue management. Top this off with whatever rotation protocols the parent company employs for nonbrand-specific inquiries to their central reservation system and/or website searches.

When you consider the above factors, along with a shift in consumer psychographics and technology-enhanced market access, is it any wonder that more and more owners (even institutional ones) are considering independent/unaffiliated/non-branded options?
1. “Economic loss,” as used here, means both an actual loss of income/value, but also a failure to fully capture income/value even though no actual loss has occurred.

2. Top seven publicly traded lodging REITs as of January 2016: HST, HPT, APLE, LHO, RLJ, SHO, PEB.