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A Different Kind of Pain & Gain for Hotel Investors During this Cycle

by John "Jack" B. Corgel

As a real estate professor during the 1990s, I unavoidably made occasional references back to events in the 1980s in support of lessons about commercial real estate market performance in response to macroeconomic events. Despite the power of these lessons, I never failed to notice the student sighs, rolling of eyes, and under-the-breath remarks, such as "Oh no, he isn't going to talk about the 1980s again, is he?" In 2001, it isn't only the yellow-note professors who are thinking about the 1980s. Many real estate owners, lenders, and analysts are doing serious looks back to the last business cycle for guidance in calibrating their real estate market forecasting models.

Having traded-in my teaching credentials for a stimulating life in hotel consulting, I now vicariously feel the pain of hotel market participants as they brace for the financial impact of the current general economic downturn. For those in hotel real estate, swings in the economy usually create more good fortune and, in turn, more pain than for those who concentrate on other property types.

As the possibility of a recession hovers, an initial reaction is to seek insight from studying outcomes of previous recessions.[1] Unfortunately, the 1980s mark the beginning of time for availability of reliable real estate and hotel industry data with which to perform these analyses. Therefore, over-weighted outcomes from the last recession (*i.e.*, July 1990 through March 1991) may become the only guide available for making predictions about how things will work out this year and beyond. Forecasting hotel real estate market movements based on behaviors during the last two decades, however, is a BIG mistake—the following paragraphs tell why!

HOTEL MARKET DISTORTIONS

The performance of hotel markets during the 1980s was unique and in violation of the economic principles that govern these markets. The most direct evidence of this period-specific behavior comes from the fact that hotel occupancy rates noticeably and persistently declined during the decade while the supply of hotel rooms sky rocketed.[2] *Exhibit 1* contains information on hotel market indicators from the database of thousands of hotels that my firm manages. The average hotel occupancy rate in the U.S. began the decade in 1980 at 73.5 percent and ended at 65.2 percent. In direct contradiction with how supply should have behaved in response to falling occupancy, the number of available hotel rooms increased every year of the 1980s and ended up 48 percent higher in 1990 than in 1980. In addition, real average daily room rates by 1993 ($57.69) about equaled the 1983 ($59.99) level. And by 1994, astute investors were able to pay a mere 30 to 40 cents of replacement cost dollar for quality, full-service hotel assets.[3]

While not all economists agree on causes and effects, persuasive arguments have been put forward to support the position that the market distortions of the last two decades resulted from economic agents acting rationally in response to incentives

Exhibit 1

Hotel Market Indicators, 1980-1999

Year	Rooms Occupied- % Change	Rooms Available- % Change	PERCENTAGE POINT DIFFERENCE DEMAND OVER SUPPLY	Occupancy %	ADR	Real ADR	% Change	RevPAR	Real RevPAR	% Change
1980	-2.0%	1.6%	-3.6%	73.5%	46.63	56.59		34.25	41.57	
1981	-0.5%	2.6%	-3.1%	71.3%	51.95	57.15	1.0%	37.05	40.76	-1.9%
1982	-0.9%	2.2%	-3.2%	69.1%	55.38	57.39	0.4%	38.27	39.66	-2.7%
1983	1.3%	2.7%	-1.5%	68.1%	57.76	57.99	1.1%	39.36	39.52	-0.4%
1984	6.9%	3.5%	3.3%	70.3%	59.78	57.54	-0.8%	42.00	40.42	2.3%
1985	-1.6%	4.8%	-6.4%	66.0%	64.09	59.56	3.5%	42.32	39.33	-2.7%
1986	2.0%	5.3%	-3.4%	63.9%	68.12	62.16	4.4%	43.55	39.73	1.0%
1987	11.0%	9.9%	1.0%	64.5%	71.73	63.15	1.6%	46.27	40.73	2.5%
1988	4.1%	3.5%	0.6%	64.9%	74.75	63.18	0.1%	48.50	41.00	0.7%
1989	4.3%	3.4%	1.0%	65.5%	77.44	62.45	-1.2%	50.75	40.93	-0.2%
Decade Average	2.4%	4.0%	-1.5%	67.7%	62.76	59.72	1.1%	42.23	40.37	-0.2%
1990	2.0%	2.5%	-0.5%	65.2%	80.84	61.85	-1.0%	52.72	40.34	-1.4%
1991	-0.7%	0.7%	-1.4%	64.3%	80.44	59.06	-4.5%	51.72	37.97	-5.9%
1992	2.8%	0.5%	2.3%	65.8%	82.21	58.60	-0.8%	54.13	38.58	1.6%
1993	2.8%	0.3%	2.4%	67.4%	83.36	57.69	-1.5%	56.20	38.89	0.8%
1994	4.1%	0.6%	3.4%	69.7%	86.44	58.33	1.1%	60.26	40.66	4.5%
1995	4.1%	1.6%	2.5%	71.4%	90.51	59.39	1.8%	64.61	42.40	4.3%
1996	3.0%	1.7%	1.3%	72.3%	97.48	62.13	4.6%	70.49	44.93	6.0%
1997	2.1%	1.9%	0.3%	72.5%	104.98	65.41	5.3%	76.15	47.44	5.6%
1998	1.5%	3.0%	-1.6%	71.4%	112.23	68.85	5.3%	80.10	49.14	3.6%
1999	0.9%	2.5%	-1.6%	70.3%	115.93	69.59	1.1%	81.50	48.92	-0.4%
Decade Average	2.3%	1.5%	0.7%	69.0%	93.44	62.09	1.1%	64.79	42.93	1.9%

Source: Hospitality Research Group of PKF Consulting

created by bad tax law and ill-advised financial institution deregulation.[4] While the exact causes are not yet clear, Congress did not set up the current economic downturn and associated hotel market responses. Throughout most of the 1990s, ADRs, available rooms, and occupied rooms behaved in ways that make it easy for professors to explain (*Exhibit 1*). The winners, losers, and the dimensions of gains and losses also should be predictable.

From the rubble of the hotel real estate disaster of the 1980s, huge winners and losers (principally the U.S. taxpayer) emerged. When the rubble is finally cleared from the current downturn we should find the following corpses:

1. Owners of older (*i.e.*, 25+ year old) hotels, some of which have unpopular designs (*e.g.*, exterior corridors).
2. Mezzanine lenders who extended financing late in the cycle.

Obsolescence and greed are central to identifying the losers following any normal economic downturn.

Room nights are a visible component of the household and business budgets across the U.S. When incomes change, budget allocations to hotel room nights change. Hotel owners and managers would rejoice if hotel business activity always increased by more than incomes increase and declined by lesser percentages than incomes decline. Unfortunately, these relationships tend to be symmetrical. No matter how hard industry executives pray, room nights will not economically behave like necessities, such as food, permanent shelter, and even television cable service. When budget cuts must occur, hotel room nights will appear on the floor well before items deemed essential for running households and businesses.

In now what appears to be a L-shaped or U-shaped downturn rather than a V-shaped economic event, certain hotels will suffer. The industry, however, has a large profit cushion entering this downturn; supply growth has moderated in recent quarters; and some degree of 'service creep' in the upper end of the market could be reversed. The likelihood of winners emerging from this downturn is slim. No reasonable quality hotel product will be for sale this time at 40 cents on the replacement cost dollar. REI

NOTES

1. See, for example, Morgan Stanley Dean Witter, *What Happens to RevPAR in a Recession?* Equity Research – Lodging, March 19, 2001.
2. Patrick J. Corcoran, "Explaining the Commercial real Estate Market," *Journal of Portfolio Management*, Spring 1987, pp. 15-21, presents evidence of the same perverse outcome for other property types.
3. See John B. Corgel, "Capital Flow to Lodging Real Estate," *Real Estate Finance*, Winter 1996, pp. 13-19 for estimates.
4. See Corcoran, *op. cit.* and Patrick H. Henderschott and Edward Kane, "U.S Office Market Values During the Past Decade: How Distorted Have Appraisals Been?," *Real Estate Economics* 23, No.2, 1995, pp.101-117.

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