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Global Economic Changes Mean Volatile Year For Hotels

Law360, New York (January 11, 2016, 12:55 PM ET) -- This past year has presented a number of challenges for the hotel industry in the United States. The strength of the U.S. dollar, global economic changes (particularly in China), falling oil prices and over-saturation of the hotel market have all negatively impacted profitability for the hotel industry. However, the severity of the impact generally depends on whether the hotel in question is located in a gateway or secondary market, and this year's slower-than-predicted growth in the hotel industry shows just how volatile and dependent on global economic changes the industry has become.

Gateway markets like New York, Los Angeles, Chicago, San Francisco and Miami have been more negatively affected by the strong U.S. dollar and increasing supply, while secondary markets such as Charlotte, Houston, Louisville and Denver have been more negatively impacted by decreases in the amount of business conventions as well as declining oil prices. Although many "experts" predicted that both the primary and secondary hotel markets would have a robust 2015, a number of unexpected changes posed unforeseen challenges to the industry that will likely continue to play out into 2016.

By way of example, Jones Lang LaSalle Inc. (JLL) predicted in January 2015 that there would be strong growth in the United States hotel market "driven by healthy demand fundamentals and low new supply" and that low supply would lead to an accelerating revenue per available room (RevPAR) domestically. Similarly, in its 2015 Travel, Hospitality & Leisure Industry Outlook, Deloitte predicted that the amount of money spent by visitors would increase roughly 4 percent in 2015, due to an improving global economy and "increasing income levels in emerging markets." JLL was able to accurately predict that "recent global forces," like lower oil prices and the strong U.S. dollar would "stand to influence the movement of goods, capital and travelers" and pose a challenge to the industry. While some factors such as management and reputation remain constant, hotels must frequently adjust to changing markets, both foreign and domestic.

Specific Causes of Slowing Growth

Increased Supply From New Sources

With a massive increase in the supply of hotel and alternative lodging accommodations as a result of newly constructed hotels, expansions occurring at existing hotels and new lodging options (e.g., Airbnb), the hotel industry has struggled to remain as competitive as it once was. Industry consulting company PKF Hospitality predicted in March 2015 that occupancy rates would remain above those in previous years and continue to increase, meaning increased supply would not create a problem in and of itself. However, it is not yet clear if demand kept pace with the newly added supply.

Aside from increased supply within the traditional hotel sector, there has been a massive increase in supply due to Airbnb's entrance into the marketplace in 2008. Airbnb’s extremely large number of accommodations are competitive in both price and type with the hotel market, which has led to decreased occupancy at traditional hotels. Since Airbnb’s entrance into the market, it has hosted over 40 million guests in more than 34,000 cities, in more than 190 countries.[1] According to Starwood Hotels & Resorts Worldwide Inc. CEO Adam Aron, the hotel market in New York City (Airbnb’s largest market) suffered a decrease in the average daily rate (ADR) paid by international guests, even though the number of international visitors reportedly increased. However, Starwood and other hotel chains seem reluctant to cite Airbnb as the reason for the decrease in rates and occupancy and instead point to supply growth generally, in addition to the strong dollar, as primary reasons for the decrease.

Airbnb’s impact is most often felt during large events like the Super Bowl, Grammy Awards and political conventions (events that would traditionally cause hotel prices in these markets to increase exponentially during these events). For example, during the Pope’s visit to New York City in September, The Wall Street Journal reported that Airbnb had roughly 20,000 active listings, which “increased the city’s lodging supply by about 17 percent.” Other cities like Philadelphia, Louisville (home of the Kentucky Derby), San Diego (home of Comic-Con International) and Palm Springs (home of the Coachella Music Festival) have been similarly impacted by Airbnb’s success. In the past, the hotel market in these cities charged their highest rates during these events but with Airbnb’s entrance into the marketplace, the pricing has become more competitive.

Despite the research suggesting the hotel industry’s unmistakable competition with Airbnb, many hotel operators and owners try to disprove such findings. In fact, hotel owners have repeatedly attempted to assure their investors and the media that “average daily rates, occupancy levels and revenue are near all-time highs, despite Airbnb’s emergence.”[2] One study shows that although Airbnb affects the number of “compression nights” (nights in which hotels charge peak prices because of near-full or full occupancy), the frequency of those “compression nights” has not decreased drastically since Airbnb entered the marketplace and only accounted for roughly 2-3 percent of revenue for hotels. Others believe that Airbnb has not impacted the hotel industry because its listings attract a different type of guest — one that usually stays longer and is more price conscious. Additionally, because Airbnb listings are typically located outside of traditional hotel districts, they can be less appealing and less competitive to traditional hotel guests.[3] Further, Airbnb still faces certain obstacles as it works through various regulatory challenges throughout the country. While these protestations by hotel owners may hold some truth, the undisputed fact is Airbnb had success in 2015 and continues to target more travelers, including business professionals, which could further increase competition.

Interest Rates Squeeze Construction Loans

As hotel supply has increased, hotels have been pressured to renovate and modernize their structural and nonstructural components along with their services, as they attempt to “find the right combination of personalization, design, ambience and technology to build lasting loyalty with the millennial customer.”[4] According to The New York Times, research shows that both the gateway and secondary markets have been adversely impacted to some degree by rising interest rates that have made “hotel construction and renovation too expensive.”

While hotel owners and operators naturally try to complete construction and renovations as quickly as possible, they often struggle to renovate without exceeding their budget while still maintaining (or increasing) standards and satisfying their customers. This challenging process includes not only making the initial decision to renovate but also deciding when and at what cost to renovate.

Strong U.S. Dollar Affects Gateway Cities More

The strength of the U.S. dollar, combined with a weakening global economy, has been cited most often as having the greatest effect on the industry. As gateway cities rely heavily on visits from tourists from other countries, many analysts predicted that gateway cities would suffer, though visitor numbers and demand may have actually increased in 2015. New York City is especially dependent on foreign tourists, who accounted for roughly 22 percent of all its visitors in 2014. Normally, an increase in demand and occupancy would result in an increase in the ADR, but the ADR was expected to remain flat in 2015 due to the strength of the U.S. dollar and a desire by hotel operators to maintain high occupancy levels by decreasing (or not increasing) their rates.

To date, it's unclear if during the high travel season in New York City (spring and summer) hotel operators experienced any negative results other than their inability to raise prices. However, executives from Starwood, among others, have indicated that the strong U.S. dollar is the "primary reason they've failed to thrive in the New York City market."[5] Meanwhile, the secondary markets have not been affected as much by the strong U.S. dollar, which is most likely due to secondary market's reliance on domestic tourists and business travelers.

Decrease in Oil Prices Hits Secondary Markets

One reason falling oil prices have negatively impacted the secondary hotel markets far more than the gateway hotel markets is because gateway markets are generally located far from oil and energy producers, limiting those markets' exposure to decreasing prices.

As oil prices continue to fall, oil and energy companies with offices and production facilities in the secondary markets are slowing expansion, and as business further declines, meetings and conventions in these markets are being reduced and/or eliminated, which further drives down occupancy at local hotels. While decreasing oil prices generally lead to increased travel by the domestic population as a whole, this increase does not fully offset the decrease in business related travel.[6] Despite the decrease in the number of business conventions, secondary market hotels have pivoted by focusing on sporting events, concerts and social conventions. So while hotels in the "Energy Corridor" in Houston for example could have been experiencing weaker demand, they have managed to avoid doing so by growing beyond their traditional revenue streams. However, not all cities have been able to avoid the downturn resulting from the falling oil prices.

Looking Forward

It remains unclear how local market changes will impact the hotel industry going forward. However, the hospitality and tourism industry has certainly felt the effect of China's downturn, Greece's debt issue and other global economic changes. Some analysts hypothesized that investors have sold off their shares in the industry as a result of the global economic turmoil of 2015. Studies by Market Realist, an investment analysis company, illustrate that although leisure travel and tourism actually increased in the United States in 2015, business travel decreased.

Notwithstanding the hurdles facing the hotel industry, foreign investment in this sector continues to increase. While investors have largely focused on the gateway markets (New York City in particular), studies have shown that foreign investors, in particular those from China and the Middle East, have increased their investments in the greater U.S. hotel industry, given the market's stability and history of “high levels of performance.”[7] Foreign investors have also turned their attention to gateway cities on the West Coast, such as San Francisco and Los Angeles, due to the substantial new supply in New York. In February 2015, Bloomberg Business reported that supply in New York City was predicted to increase by 13,182 rooms this year, with 14,091 additional hotel rooms in the planning stages. Overall, the roughly 21 percent increase in hotel rooms in New York City over the past five years and more dramatic increases in RevPAR in West Coast cities has led foreign investors to reconsider their investments since many of these investors believe this increased supply will likely result in lower returns on their East Coast investments.[8] In general, there has been “a surge in deals for U.S. hotels” driven in part by Chinese investors seeking investment abroad, and Chinese investors were predicted to invest approximately $5 billion in 2015 on global hotel purchases.[9] Although Marriott International ultimately presented the winning bid for the Starwood Hotels chain, there was initially a great deal of speculation that one of several Chinese companies would be the highest bidder, especially given Chinese investors’ recent investment patterns and appetites for solid returns.

Additionally, medium-sized companies, global investment groups and sovereign wealth funds have all increased their investments in real estate, particularly in hotels. Although there are concerns that foreign investments in the hotel sector could decrease as a result of the risk of lower returns, hotel industry advisers believe this will not cause investors to decrease their investments.

Because the hotel industry is impacted by so many global economic factors, it often experiences more volatility than other industries. In particular, 2015 presented significant challenges to the hotel industry, although the industry as a whole has remained successful and seems likely to continue to draw on innovation, competition and foreign investments to retain its strength.

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