HVS

Total Spend Can Be Your Friend

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I have always thought that stock traders would make great hotel revenue managers. They are highly competitive people, they understand optionality and risk, but most importantly, they know that when market volatility is large, the price of a financial instrument contains little or no information. Traders would have known instinctively what the pandemic should have taught hoteliers: asset valuations highly dependent on the average daily rate (ADR) contain risk; therefore, revenue diversification is not only desirable, but necessary. Unfortunately, the salary discrepancy between Wall Street trader and hotel revenue manager is still generously in favor of the trader; perhaps hoteliers can find the next generation of revenue managers at their local farmer's market.

When confronted with something new, most people look for what they already know. So, when industry experts tried to forecast the recovery from the COVID-19 pandemic, they looked at the recovery from the Great Financial Crisis (GFC) of 2008. The industry consensus, influenced by data from the years following the GFC, was that the average daily rate would take longer to return to pre-crisis level than occupancy would. The more rates dropped, the longer it would take for them to recover. "Whatever you do, don't drop rates, even if there's little demand in the market" was the conventional wisdom; this was easy to agree with if you were not making capital calls to cover operating losses. However, average rates recovered faster than expected, and forecasts were hurriedly revised.

Everyone in the hotel industry should have known that price inflation was coming. Historically, shortages in supply have been followed by a glut. If hotel revenue managers had had a background in trading, they would have applied the supply-side logic to the demand side. An overabundance of demand was coming after mandatory restrictions in travel and socializing were lifted. To their credit, revenue managers have taken advantage of the increased demand and effectively raised average daily rates in markets throughout the U.S. Most revenue managers know to push rate whenever the opportunity arises and usually only push occupancy when all is lost. They are taught not to be the first hotel in the market to fill up.

Traders also understand that risk is inherent financial life; therefore, if the valuation of your asset, in this case hotel real estate, depends on above-market average daily rates, the inability to consistently command a high average rate will diminish returns, and a second option to achieve returns should be at hand. Many private equity firms doing buy-side due diligence try to understand the downside to a business before undertaking any further analysis. Asset managers have always looked for ways to reposition spaces within a hotel for a greater return on investment (even going so low as to turn banquet bathrooms into private dining space), but the experience of the COVID-19 pandemic should force us to consider how ancillary revenues can make up for losses in average rate.

Summary

Revenue managers should think like options traders. The COVID-19 pandemic and subsequent recovery taught hotel operators that average daily rates can be extremely volatile. Revenue-management strategies focused on total guest spend can help mitigate the risk involved in achieving RevPAR share through a high ADR. Management companies need to incorporate techniques and practices to evaluate all possible revenue-generating strategies.

Comments

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Yield Management Involves More Than Price

Hotels sell perishable goods, just like airlines, the one industry hotel executives are always complaining hotels do not emulate enough. Each perishable good has an associated cost; some of the cost is variable, and some is fixed. If a hotel can sell the good at a higher price and maintain the same cost structure, the profit margin increases, as much of the price increase flows directly to the bottom line. The price of an airline seat fluctuates, while the cost of a checked bag does not. The price of a hotel room fluctuates, while the price of parking, food and beverage in the restaurant, and goods in the gift shop do not. Yield management typically does not apply to ancillary revenues because of the fear of losing the primary transaction (airline seat or hotel room purchase). For example, when public dining was restricted during the pandemic, prices in the gift shop did not increase. Wouldn't the guest willing to spend $400 per night on a summer weekend not notice an increase in the price of coffee at the hotel café? When hotel management companies create yearly budgets, the focus is on raising ADR, and rarely is consideration given to increasing ancillary spending—better to play it safe.

I often deal with investors undertaking their first hospitality investment. Most first-time hospitality real estate investors understand average rate and operating margin, but they do not understand the complexity of hotel revenue streams. In their experience, multiple operating businesses under the same roof complement each other, but each business has a unique revenue strategy. Resorts, full-service hotels, and conference center hotels have multiple operating businesses under the same roof that supplement each other. Hotel real estate investors are always excited about average daily rate because it increases the valuations. For example, if a hotel manager can increase the asset's ADR by 10%, the expenses will likely be less than 30% of the additional revenue. It is often difficult to explain to hotel investors that the cost of an additional occupied room is not the year-to-date rooms department expense per occupied room, such as $30 or $40. It is much less than that, and it tends to go down as the manager sells more rooms because the variable costs are typically much lower than the fixed costs. Investors must be taught the concept of marginal cost and diminishing marginal costs.

Total Revenue Per Occupied Room Produces Stable Returns

Hotel managers should strongly consider strategies that increase the total spend per guest and the total revenue per available room. At the very least, in certain scenarios and market segments, greater pricing volatility is required to gain more occupancy, more total spend, and potentially more RevPAR share. An occupancy-focused revenue strategy would not incur prohibitive additional costs. Resort fee revenue would likely cover the marginal costs of selling additional room nights and would contribute to the fixed costs of operating the hotel. It is also likely that additional room nights would increase both the F&B outlets' cover counts and total revenue per occupied room. The reasonable cost structures and labor scheduling practices indicate marginal costs to scale would decline with additional room nights. Finally, the conventional wisdom in the industry post-Global Financial Crisis was that the more ADR decreased, the longer it would take to recapture previous levels; however, nationwide ADR performance since 2020 suggests average rates can recover much faster than previously assumed. Therefore, an occupancy-focused strategy in the short term would not affect longer-term ADR forecasts. Stabilization could still be achieved in year three or four.

Lifestyle and boutique hotels may find it difficult to incorporate a total spend philosophy because of their smaller footprint. They might not have multiple F&B outlets, or they might have too few keys to make the most effective use of the philosophy. They could establish a charge like a resort fee, although "resort fee" would be a misnomer for a lifestyle hotel. Some luxury hotels call their usage fees "amenity fees" or "facilities fees." Lifestyle and boutique hotels might want to consider calling it an "experience fee" instead. The "experience fee" prices could be seasonal, depending on the amenities included (free bike rentals, for instance).

What Hotel Management Companies Should Do

Hotel management companies should consider tweaking their forecasting procedures so that revenue managers offer two options when presenting the monthly forecast to the general manager. One option should be an ADR strategy, and the other option should be an occupancy-based strategy. Whether the management companies use computer software or an Excel spreadsheet for forecasting, the gross operating profit and gross operating profit margin for each respective strategy should be easy to calculate. If this procedure is practiced over time and analyzed for accuracy, managers will have a better idea which strategy will yield better margins and higher RevPAR. Analyzing the forecast for accuracy is important because, as I've discussed, if an occupancy-based strategy provides results near or better than an ADR strategy and is also more likely to be achieved (based on the forecast accuracy), then the occupancy-based strategy reduces risk. Quarterly forecasts are usually dictated by booking pace, and revenue managers usually assume the booking pace will continue. Few revenue managers plan for alternative scenarios.

I have heard plenty of management companies discuss operational efficiencies and cost controls, but I have never heard a management company say it benchmarks variable costs or even tracks the variable costs of its hotel portfolio. If the variable, or marginal, cost is not tracked, there can be no discussion of the point where the marginal cost of an additional hotel room equals the marginal revenue of that room. The marginal cost is unlikely to ever equal the marginal revenue of selling an additional room, but if the market dictates a seasonal or temporary rate ceiling, an occupancy-based strategy will be necessary, and variable costs will need to be benchmarked and controlled.

It can be hard for operators and owners to let go of the desire to achieve more than market share in ADR. However, every market's ADR fluctuates, especially when measured in real terms. The good times never last, so revenue managers must always be ready to adapt and consider whether the ADR-driven strategy is the most effective strategy for their hotel.

About Matt C. Panosh

Matthew Panosh is a Vice President, primarily responsible for advisory and asset management services on behalf of HVS's clients. This includes performing financial and revenue analysis, investor reporting, and budget negotiation for a range of hotel types and sizes with a track record of building equity for ownership. He is also involved in a broad range of consulting assignments with the Asset Management and Advisory division. Prior to joining HVS in 2019, Matt held various positions at hotels in operations, revenue management, and accounting. His experience covers a wide range of asset classes, from a start-up boutique lifestyle brand to a Four Diamond resort. He holds a B.A. from the University of Wisconsin-Madison and Certificate in Hotel Real Estate Investments and Asset Management from Cornell University's School of Hotel Administration. Contact Matt at (401) 625-5015 or .