CHMWarnick

HOTEL ASSET MANAGERS + BUSINESS ADVISORS

2018 Budget Season: Insights for Hotel Owners

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As a follow-up to a recent series of articles covering the annual budgeting process (authored by Rich Warnick, managing director/co-chairman of CHMWarnick, and published by Hotel News Now), the asset management team at CHMWarnick has prepared the following guidance for hotel owners to consider during the 2018 budget season.

Contrary to what some may believe, the role of the asset manager during the annual budgeting process is not to be argumentative and combative with the operator, but rather:

- ✓ Share best practices;
- ✓ Thoughtfully and constructively, challenge thinking
- ✓ Interject strategic direction; and,
- ✓ Align management and ownership objectives.

CHMWarnick will actively participate in the budgeting process on behalf of ownership groups of more than 65 hotels with 28,000+ guestrooms this year. We are pleased to share some key issues and resulting strategies that we plan to employ, as we embark on our 2018 budgeting efforts.

What we know about 2018:

- **Slow and steady** on most counts…forecasting growth, for most KPIs, albeit at a decelerated pace. Challenge will continue to be keeping expense increases at a rate lower than projected income increases.
- **Prognosticators are in alignment,** with projections for occupancy, ADR and RevPAR growth, more or less in lockstep, as compared to wider spreads in the outlook for years past. But, every market is unique and we can't paint the whole Country with the same paintbrush
- **Occupancy** is generally at peak and has leveled off in most markets; Although, market-to-market the story differs, each with its own supply story requiring individualized knowledge and attention, and may differ vastly from Nationally-based forecasts (Nation projections = flat to 0.2% decrease).
- **ADR** is still projected to grow on a National basis, but at a decelerated rate, averaging 2% annually; Industry still wrestling with inability to achieve more meaningful ADR growth at peak occupancy levels (National ADR projections = 2.2% to 2.5% increase).

- **RevPAR** is projected to continue to grow (fueled by ADR). National average increase is forecasted in the 2.0% to 2.4% range. Key in 2018 will be increasing "Net" RevPAR, after commissions, yielding higher profit from revenue growth. *Caution, National averages are just that…RevPAR has already or will soon be turning negative in some markets!*
- **Expense growth** has, and continues, to outpace revenue growth and may even exceed it in 2018; Leading drivers are labor (living wage initiatives, basic wage/benefits) and cost of customer acquisition. Management teams will have to work much harder to achieve profit growth, even in light of increased revenues.
- **GOP** on a per available room basis is reported by CBRE to have increased on average 7.9% between 2009 and 2016; Forecast for year-end 2017 and 2018 is 3.4% and 2.5%, respectively.
- **Revenue management** continues to grow in importance. After the GM, the Revenue Manager is arguably the single most important position in a hotel today; yet, skill and experience at the property level varies wildly. While a case can be made for sharing a Revenue Manager among two or more hotels (e.g., can afford a higher skill level, owners need to look skeptically at how such position "complexing" will affect their own hotel.
- **Leisure** has, and continues to be, a major force in the lodging industry's growth and success. This has manifested in stronger than historical weekend demand in many markets. Continue to look for opportunities here.
- **Group** rate growth still healthy, albeit there are some signs of slowing demand; Shortened booking window and increased intermediary costs are a continuing reality.
- **Corporate** demand remains stable, with U.S. consumer and corporate market on solid footing; Hotels pursuing volume account rate increases of 3% to 6% for 2018, as evidenced by RFP season results within our own asset managed portfolio.
- **Government per diem** rates are a mixed bag, with markets such as Washington, DC, scheduled to experience the highest per diem rates historically, while GSA has decreased rates for other markets.
- **Supply growth** is forecasted to be equal to, or slightly exceed, demand growth in 2018, a notable shift not seen since the last recession; 2018 will see the addition of eight new hotels with over 50,000 SF of meeting space, which has not happened in over a decade.
- **Brand initiatives** continue to focus on enhancing guest loyalty, lowering guest acquisition costs and generally improved control over booking. In 2017, many brands introduced loyalty rates on brand sites that were lower than those available through OTAs; many re-negotiated and were successful in lowering OTA commissions, while others forged new, and significant international business partnerships (Marriott/Alibaba Group). Most brands also adopted a 48-hour (or higher) cancellation policy, to reduce last minute cancellations/rate trade downs. Some brands are testing "urban" resort fees. We remain optimistic about many of these brand initiatives, but encourage owners to track and measure results in 2018, and watch out for increases in brand charges that may off-set positive impact.
- **Brand breeding** has not slowed. The world's 10 largest hotel companies combined have more than 115 brands, roughly one-third of which didn't exist a decade ago. New brand creation in recent years has been mostly be centered on lifestyle hotels (many millennial-focused) and

"soft-brand" extensions of the major players (Tapestry by Hilton, Autograph by Marriott, Hilton's Curio Collection, Hyatt's Unbound Collection, Choice Hotels' Ascend Collection, Wyndham's Trademark Collection, among others). There are no signs of brand proliferation slowing down.

- **Capital requirements will intensify** as hotels generally age, and brands implement new standards to maintain competitiveness, while establishing new swim lanes for their multiple brands. Increased requirements on ownership to reinvest, even in newer properties to meet brand, market and guest requirements. In addition to keeping up with continually evolving brand standards, owners are also challenged from a capital standpoint, to keep pace with the cost of new technology.
- **Invest markets** have slowed considerably in 2017, and we expect continued slowing in 2018, given the slowing of foreign investment and where we are in the economic cycle. That said, pay attention to adaptive reuse, rebranding and focused-service developments.
- **Industry under currents:** Wages, health care, immigration, tourism, Airbnb, Google, North Korea, Trump effect (and we're not just talking hair trends)! Lots bubbling below the surface, but nothing indicating a downturn is imminent.
- **Still in unchartered territory…**industry still growing in an unprecedented streak of growth. In short, it's been a LONG cycle of extraordinary growth. But, as Alan S. Blinder (former Federal Reserve vice chairman) says, "economic expansions don't die of old age, they go on until something kills them."
- **Active ownership** is a must in this operating environment; whether direct or through an asset manager, expertise and active engagement are required to optimized profitability and investment returns. Just because we did something one way last year does not mean we must continue in the future. Every dollar of income and expense need to be scrutinized to maximize revenue and flow-through

In light of the above, our focus remains on opportunities for enhancing revenue, and specifically implementing strategies for optimizing profits in 2018. In this regard, we offer the following as key topics of discussion as owners look to engage their operating teams and align performance objectives:

- ***Have an open discussion about National industry statistics and Brand guidance, and how each compares and contrasts to what is actually occurring at the local market level.***

  This type of critical evaluation will enable owners and operators to get on the same page about the degree to which broad based guidance, whether originating from industry prognosticators, brands or otherwise, bears relevance on a given property. Take the time to gain consensus on local market realities, as well as National trends, that should be driving strategies at property-level.

- ***Revisit original underwriting proforma.***

  All too often, owners assume that the management team is aware of the original underwriting proforma and the underlying investment goals upon which the deal was based. Budget season represents the opportune time to dust of the proforma as another tool for reacquainting the management team with the economics of the deal, above and beyond the "in-the-year-for-the-year" mentality. The 2018 budget is merely a stepping stone in a longer-term trajectory of performance expectations, and decisions made today can materially impact future results – this is a theme that bears repeating to elevate the team and foster strategic, long-term thinking.

- ***Shift conversations from "RevPAR" growth, to "Net RevPAR" growth (a.k.a. how can we grow RevPAR more profitably?)***

  RevPAR growth is widely discussed as a leading barometer of health for the lodging industry. From brands to prognosticators, everyone has an opinion on year-over-year RevPAR growth, and management relies heavily on this guidance when developing the budget. This issue is exacerbated by management bonuses and HMA performance clauses that have a RevPAR Index component. At the property level, the discussion of growth should not be limited to top line, but also include strategies for growing RevPAR more <u>profitably</u>. Challenge operators to focus on opportunities for yielding a higher "net" RevPAR, through pricing, booking, business segmentation and channel management strategies. To quote a phrase we regularly use in our shop, "not all RevPARs are created equal", and there are real opportunities for profit enhancement for those to collectively work with their operators to uncover them.

- ***Focus on opportunities, always.***

  Regardless of which way the tea leaves fall for this year's outlook, every year brings opportunity. Don't let your operating team adopt the "mood du jour" of the industry ("modest growth", "flat occupancy", "increased supply", "RevPAR decreasing in certain markets", etc.) but rather, center conversations around opportunities…they are always there if you look for them. Status quo is not an option.

- ***Back to basics (zero-base budgeting, that is).***

  While we would argue that the entire budget should be developed from scratch each year, this is not the going practice; If, however, significant changes have occurred or are planned (additional meeting space, F&B re-concepting, etc.), or an operating department is particularly challenged, ownership should make a case for a zero-base budgeting approach in these specific areas. Challenging the team to think about changes that have occurred or may be necessary to positively impact performance, can spark a more strategic thought process, as well as result in improved future forecasting.

- ***What were the top lessons learned in 2017?***

  This question is not intended to lay blame or rehash the past – good, bad or indifferent. This is intended to spark a strategic discussion about potentially emerging trends, risks taken during the past year and resulting outcomes, and really taking a critical look at how these learnings can be applied to the year ahead. Were there major surprises or unbudgeted events that are likely to impact the future (new tax assessments, increase in real estate taxes, increased wage rates)? Often when such events hit the P&L their overall impact may not be fully recognized if they occurred part way through the year. Request a list of significant events or impacts. The goal is to make sure all are accounted for the full year in 2018, which will not be the case if percent growth or POR/PARs are used as the basis for budgeted increases or decreases.

- ***Occupancy is flat…so where can we grow?***

  Again, this speaks to breaking through the tunnel vision often caused by "statistics". Yes, National average occupancy is forecasted to be flat (or decrease slightly), but, there likely are opportunities to still grow, whether by stealing share or inducing new demand (e.g., creative packaging, improved group sales, etc.). Look to debunk averages, norms and preconceived notions during budget season. Perhaps further digging will reveal that occupancy can be improved though smoothing out transient and group booking patterns; or maybe your property is under performing on weekends relatively to the competitive set. In short, don't settle for "flat" anything, but rather, always probe for more.

- ***Brand Initiatives***

  Make sure you understand all of the Brand initiatives recently implemented, underway or planned for the near future. Engage in dialogue with property management teams and ask them to translate what these initiatives mean, and how they will impact your specific hotel(s). Brand mergers, new comp sets, changing OTA commissions, loyalty rates and program costs, revised cancellation policies…there are so many moving parts that are important to understand and constantly monitor to be sure the impact can be measured and accounted for during the budgeting process.

- ***Brand Centralized Services***

  The list and description of assessed brand fees is overwhelming (think 100+ pages of disclosures!) and can be easily overlooked. It is important to work with the property team to understand changes to these fees, any caps on fees that may exist, and determine where these fees hit the P&L. Brands are constantly shifting costs to the hotels that once were part of the "base management fee" or marketing contribution; you need a detailed accounting for 2017 and a detailed projection for 2018. This is tedious work, but centralized fees should be audited closely (don't assume the calculations are correct) and push back where no value is added.

- ***Instill a sense of urgency***

  Your market may be healthy, your hotel may be doing well (or seemingly so). When setting the tone for budget discussions, remember these words from Gróf András István – "Success breeds *complacency...Complacency breeds failure...Only the paranoid survive*."

- ***Aspirational, yet achievable.***

  As a final tip, perhaps for owners (and their asset managers), more so than their operating teams, make sure the resulting budget for 2018 is *achievable*. This is not to say that the budget shouldn't include stretch goals, some new strategies and a healthy dose of questioning the status quo, but ultimately, the operating team needs to be on board directionally and believe that results can be achieved. If not, the budget can become demotivating for the operating team. Instead of a challenge, it will become an excuse because it wasn't achievable from day one.

Don't forget, CHMWarnick is here to help! Please call us at 978-522-7002 to speak with a client specialist to learn more about our services and how we have assisted clients from around the globe in achieving their hospitality investment objectives.

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About CHMWarnick

CHMWarnick is the leading provider of hotel asset management and owner advisory services. The company asset manages a client portfolio of over 65 hotels, 28,000 rooms and $15 billion in hospitality real estate. CHMWarnick's owner advisory services cover virtually every aspect of hospitality investment, and all phases of a hotel's lifecycle, including ground up development and repositioning. The company is currently providing development advisory services for client hotel and resort projects valued at over $3 billion. CHMWarnick has offices in Boston, Phoenix, New York, Los Angeles, San Francisco, Fort Lauderdale, Minneapolis and Honolulu. For more information visit our website at www.CHMWarnick.com.