



### How far is down?

The Sept. 11 meeting of the New York Hospitality Council began as it usually does, high up in the Rainbow Room at 30 Rockefeller Center in midtown Manhattan, with an 8 a.m. breakfast get-together of hospitality industry leaders. We were about to embark on a roundtable discussion on “How Far is Down? The Outlook for Hospitality.”

for many hotel owners, investors, lenders and hospitality companies. All of these interests are re-assessing their relationships and the prospects for a turnaround.

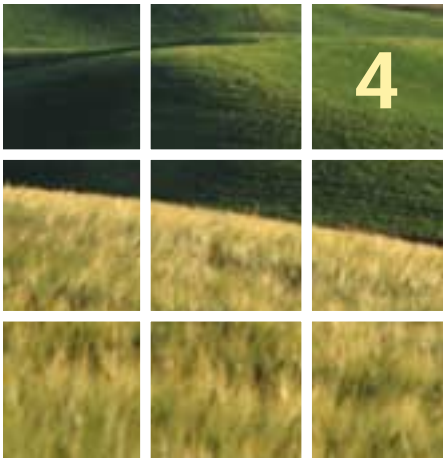
### Markets and pricing

While the recession has been affecting the sector broadly, the impacts of Sept. 11 appear to have been sharply bifurcated in the U.S. between urban markets

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# How and When Will Recovery Begin

## The outlook for the U.S. hospitality sector



The topic had been selected because of our increasing concerns with the U.S. recession that had actually started six months earlier. While the meeting began uneventfully, it was brusquely interrupted by the epic and infamous events that unrolled before our very eyes on that fateful morning. Much has changed since that day.

The industry has had to contend with nationwide cutbacks in corporate travel, canceled conventions, declining consumer confidence, sharp downturns in air travel, corporate restructurings, employee layoffs, capital spending deferrals and defaulting loan covenants. Hardly business as usual. One of the greatest challenges for our industry, therefore, is the uncertainty of the short- and medium-term future.

The current question is how and when will recovery begin? In the wake of Sept. 11 and the slowdown in the U.S. economy that was already well underway before the terrorist attacks, the hospitality sector has seen a sharp decline in both occupancy and pricing. This has affected both the short- and medium-term outlook

dependent on arrivals by air (down sharply) and those secondary and tertiary markets that rely more on drive-in business (down too, but not as sharply). For industry players with exposure in major urban markets, the return to some sense of normalcy will clearly be a slow one, with the prospect of lower stabilized occupancies than we have seen in a while and sharply lower pricing.

Prior to Sept. 11, the leisure market had been holding up reasonably well, while corporate travel had long since been slowing. With the precipitous decline in consumer confidence following the terrorist attacks, however, the hospitality industry saw the other shoe drop, with both commercial and leisure travel in sharp retrenchment. By the end of 2001, the market had begun to turn around with hopes by many for a recovery in the second quarter or, by latest, the second half of 2002.

But what kind of recovery?—hardly a fast return to the heady days of the economic boom that began to disappear in late 2000. Perhaps a long, steady uphill climb back to where we were, but over a



period of several years. And what might facilitate this? Certainly a sharp slowdown in supply growth as lenders for new-construction projects shun the sector except, under very special circumstances.

For U.S. destinations that attract a lot of foreign visitors, the post-Sept. 11 period has been a tough one. Gateway cities such as New York, Boston and San Francisco and resort destinations like

Orlando and southern Florida have been affected sharply as has Hawaii, reliant as it is on long-haul air arrivals to sustain its business. ers, this could be a lengthy wait. Postwar recessions have lasted from 6-16 months and averaged 11 months. The difference is that most of these recessions were preceded by inflation, which is not the case this time around. Now with weak profits, falling investment and the recession, it may take longer to purge the financial excesses (high personal and corporate debt levels) that built up during the boom years.

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Finally, the impact of another major terrorist attack in the U.S. within the short or medium term is clearly hard to assess but would in all probability be extremely negative on a jittery public that remains deeply shocked by the first one. We should study how other countries have seemingly inured themselves to a rhythm of terrorist activities of varying scale and yet return over time to some semblance of growth and prosperity. This is all somewhat relative, and only time will tell how additional instability, if it recurs, plays out in the U.S. context.



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The situation is worse for properties in many urban markets, which have experienced significant additions to supply in recent years. For hoteliers and the sales and marketing people who support them, the key question will be how and when will they be able to increase room rates to where they were earlier in the year, pre-recession and pre-Sept. 11?

Since pricing tends to move in tandem with occupancy, we can't expect much improvement in yields until demand turns around and occupancies strengthen. Depending on how the economy recov-

The difficulty in predicting a turnaround is compounded by the fact that economic indices, which occasionally require re-statement after the fact, do not provide much in the way of guidance. For example, when asset prices decline, companies and households try to restore their financial positions, leading to further pessimism and falling demand. If this occurs, the recession may be longer—perhaps as much as two years—which from the now-acknowledged start of the current downturn, March 2001, would take us to the spring of 2003.

While it may be premature to determine when the U.S. hospitality sector returns to strong market dynamics, the years 2004 and 2005 have a solid ring to them. But when it does come, the recovery in

#### Yield management and e-Distribution

While we wait for a full recovery, yield management strategies and the leveraging of some of the newer forms of distribution especially, via the Internet, will become increasingly important. Hospitality businesses that are still dithering with their approach to the Internet are doing so at their peril. An entertaining, convenient, information-rich and value-adding web presence with a booking engine is no longer an option—it is a requirement.

With significant cutbacks in corporate travel, we'll probably see many companies getting accustomed to the benefits of controlling what had become an out-of-control expense category—travel and entertainment. Conventional wisdom suggests that business is frequently best done with the personal contact that comes from visiting customers, vendors, alliance partners and the like. But the cost of these interactions is brought down by a couple of important trends the hospitality industry must take note of: first, the increasing use of web-based corporate travel portals that dictate the terms of travel to employees in large organizations. And as this booking model permeates many large companies, we



can easily see it migrating to medium-size companies. A second trend is the rapid growth of broadband communications and the increasing quality and declining cost of teleconferencing—a trend with obvious longer-term implications for business travel and the small corporate meetings market.

Since leisure travel is projected to grow significantly faster than business travel, product innovators in the hospitality sector will need to focus more attention to this important reality, which has been brought into sharper focus by the current slowdown. Marketers may need to completely re-think their strategies as market sentiments shift in immediate response to day-to-day events. Mode of arrival, distance from destination, lead-time to book, domestic versus international travel, perception of security and exposure are all factors in a state of flux and are significantly complicating the dynamic that hospitality marketing executives must now deal with.

#### Lenders back in the breach?

For some time to come, lenders will be preoccupied with the troubled hotel loans they made to poorly capitalized borrowers during the latter stages of the economic boom. We shouldn't see the problems we faced in the early 1990s with the Gulf War and the trauma that followed for grossly over-leveraged properties in markets of declining value. During the recent cycle, most lenders were focused on conservative underwriting standards with low loan-to-value ratios and higher standards on forecasts. Inevitably, such rigorous approaches to hotel lending weren't applied across the universe, and we will probably see some rapid-fire foreclosures in the second quarter of 2002 for those deals that have little prospect for an early turnaround or have weak ownership, management and/or marketing. Unfortunately, the financial lexicon of growth—leverage, mezzanine financing, securitization, preferred

returns, etc.—will be pushed aside in favor of the language of recession—workouts, restructuring, cram-downs, Chapter XI and receivership etc.

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Sept. 11 with an understanding that the circumstances were indeed extraordinary. The covenants were either re-written or at least temporarily amended. But in the growing light of the spring, when some of these agreements will be up for a re-visit, there may be different attitudes, particularly if little progress is made in turning around the business.

For those companies with plenty of real estate, the concern will be deterioration of underlying asset values. Meanwhile, for those firms with less real estate but more in the way of customers, brands, relationships, technology and the like (the intangible assets of the management and franchising business), there will an increased focus on how expenses can be trimmed, organizations rationalized and capital allocated.

Some bankers will need to tap into their long-term memories to recall the last time the U.S. hospitality industry was under such stress. For many others, the workout specialists of the early 1990s have departed, to be replaced by production types who during the long

extended boom of the 1990s were focused exclusively on getting capital into the sector, albeit more sheepishly than the last time around. As a result of the rapidly changing focus of the lending community, we can expect some differing outcomes as some lenders take a proactive role early in the cycle, while others wait things out. Asset management will move to the center stage as owners and lenders focus their attention on how to best turn around the declining

values in their property portfolios.

Those borrowers lucky enough to have the attention of their lenders on new business can expect a far more conservative take on underwriting. Lenders are also likely to stress-test their forecasts to allow for recurring sharp downturns in the future as the previously unthinkable or unplanned actually occurs—if it does. As with most business people, lenders don't care much for uncertainty. And of the many lessons delivered on Sept. 11, one we can count on is more uncertainty, at least into the unforeseeable future.

#### The Fed tries to help

Of some help in all of this is the continuing decline in interest rates as the Federal Reserve attempts to influence a turnaround using one of the very few tools at its disposal—the cost of money. At a certain point, however, even this tool has its limits, especially when rates are as low as they are already.

Since Sept. 11, we've also seen various suggestions for federal government assistance for the hospitality sector.



These have included tax relief to stimulate travel, extended employment benefits for workers, government healthcare coverage, reinstatement of the 100-percent tax deduction for business meals and entertainment, delayed federal tax payments for companies and temporary suspension of payroll taxes. As to which of these, if any, will gain traction in Congress remains to be seen. One factor working against all of them is the industry's several and conflicting voices on these kinds of relief.

For years, industry leaders have been complaining about the lukewarm attitude of the U.S. government to tourism. This may be changing with the realization, as the travel and hospitality sectors take a center stage in the downturn since Sept. 11, that it actually represents a significant component of the economy and can have a major impact on other sectors. As they used to say about General Motors, the new mantra needs to be "if it's good for tourism, it's good for America!"

#### Right-sizing the operations

For hotel companies with brand standards to consider, the right-sizing of the industry in terms of cost structure means a careful assessment of what this might mean in terms of the products and services delivered to customers. Pleasing customers and unifying standards has been a clarion call for the major brands, but it has come at some serious expense both to the hospitality company in terms of infrastructure and to the third-party owners of hotel property they frequently serve. We can thus expect some increasing tension as owners looking for expense relief look to their management companies for help.

#### Taking a hard look at fixed costs

With a distinct shortage of customers, another casualty of the downturn has been the employees, or as so many companies like to say these days, associates. For those with pink slips, it

has not been much of an association. The drama is in the numbers, which have been very high—many laid off permanently, others on furlough awaiting a return to business normalcy. In addition to staffing cutbacks, large swaths of middle management have been cut, particularly where a philosophy of employee empowerment in recent years has encouraged less management and more leadership.

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Converting payroll from fixed into variable appears to be a popular current strategy, particularly within the middle management ranks where costs have accumulated in recent years. Multi-tasking and cross-training have become important aspects of the new operational paradigm, designed for optimum utilization of human resources in a period of sharp fluctuation in business volumes.

The right-sizing strategies of most hospitality companies should serve them well for a robust recovery when demand growth returns and the economy turns around. With a lower cost basis and break-even point, the profit curve becomes ever steeper in the upturn. As a consequence, all these efforts will help pave the way for a solid recovery.

While managers focus on the costs they can control, they won't be able to do much about a couple of expense items that are surely set to increase—that of insurance and security. How they will recoup these costs over the short- and medium-term in the face of soft trading conditions and downward pressure on pricing will clearly be a challenge.

#### Wither product and service standards?

Products and services present two additional challenges: the maintenance and protection of physical assets in a period of capital constraint; and the delivery of consistent and high-quality service. On the product side, owners and lenders need to understand just how quickly a hotel property can lose value if it is allowed to deteriorate physically.

Furniture, fixture and equipment reserves are frequently the first items reduced or eliminated during a downturn. Unfortunately, this can lead a marginal business into a fast downward spiral. When looking for relief from lenders or seeking a restructuring plan with new capital, property owners cannot afford to ignore the fundamental need to keep their hotel properties in good condition. It's not an option; it is what customers expect and deserve. Customers have, for better or worse, in recent years grown accustomed to high-quality lodging product, and they will generally not put up with second-rate facilities.

For these same customers, many hotels upped the ante on service during the past decade of plenty. Any cutbacks that affect the service experience will not go unnoticed by an increasingly discerning, discriminating and demanding customer.

#### The property market languishes

While hospitality companies focused on products and services, the folks playing the real estate game have witnessed a



hotel property transactions market in slow mode for a long while—well prior to Sept. 11.

Bid-ask spreads on pricing remained too wide to generate much volume, with sellers unconvinced the boom was over and buyers insisting on high going-in yields, especially in the face of growing evidence of an economic downturn.

Post Sept. 11 the market largely came to a halt. It should produce signs of recovery as property owners face new stress-points with their lenders, or worse, are forced to walk away, leaving the keys for their reluctant bankers. In response to this prospect, yesterday's opportunity funds, and indeed some new ones attracted to a sector in obvious trouble, have begun to surface and will likely play an important role in the property market in the coming year or two. They should not, however, expect the kinds of bargain-basement prices that prevailed in the early 1990s, especially since plenty of capital appears poised to rapidly take opportunities as they arise, suggesting a more balanced transactional environment than before.

#### Foreign investors to the rescue?

One market to watch in the U.S. is that of the foreign investor—a capital source largely sidelined in the face of aggressive investing by domestic players during the 1990s. Foreign investors in the U.S. were not always so inactive, however, and can be expected to again see opportunity where domestic investors do not. Being able to see beyond the immediacy of the events of Sept. 11 to a new normalcy

may be easier for foreign investors than for their American counterparts still trying to adjust to a much more uncertain environment.

Since during economic downturns there tends to be flight to quality, we should expect to see the strong hospitality brands benefit in the near-term as owners and operators of independent hotels and those keen to switch look for the advantages brands can offer: security and strength backed up by robust marketing and distribution infrastructures.

#### The prospects for more consolidation

As the flight to quality continues, one also wonders about the prospects for consolidation. For years we have been expecting the hospitality industry to undergo further consolidation, and yet the process has been spasmodic occurring in fits and starts. It also seems that we have as many brands in the sector as ever before—hardly a sign of much consolidation. In reality, however, just a small handful of very large hospitality companies control a number of the most valuable brands, and this concentration is likely to continue into the foreseeable future. And while there will always be room for small niche players and regional companies that command customer loyalty through consistent delivery, medium-sized companies will be under the greatest stress in the next few years. It will be a struggle for these companies, and some will succumb to the overtures of larger players or be consolidated by like-sized companies with greater capital

resources at their disposal. The pace of this process will somewhat depend on the duration of the current recession and the ability of larger players to wield their cash reserves, if any, or their stock, when and if share prices recover in value.

In the meantime, the outlook for the U.S. hospitality sector remains in flux. Longer term, we will undoubtedly return to periods of great progress, growth, stability and prosperity. The road to such recovery, however, is fraught with uncertainty, at least in the immediate aftermath of the events of Sept. 11. The relationship the hospitality industry has to the economy at large, however, has always been very close, and this has not changed. As the economy turns around, which it inevitably must, then demand for hospitality will return along with it. The question therefore, is not if but when?



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