Hotel Market Analysis

Drivers of Change (factors influencing the profitability of Hotels)

Business risk and uncertainty

The hotel industry is cyclical in nature; lenders extending credit to individuals who are looking to franchise, manage, or own a hotel must assess the economic climate. Hotel profitability and cash flow generation (which are important factors assessing a firm ability to cover interest and principal payments) is highly dependent on the economic factors such as the unemployment rate, consumer confidence, disposable income, and interest rates. For instance, the unemployment rate in the United States was 7.8% in 2012. According to the Hoovers Hotel Industry report, "about 40% of the U.S Hotel industry customers are business travelers and 60% are tourist". Tourists are more likely than business travelers to cut discretionary items such as travel spending when the economy tanks. To combat these challenges, hotel firms differentiate themselves on price, service, and location. For example, InterContinental Hotel (IHG) own multiple hotels that caters to different market segments. InterContinental Hotels & Resorts is IHG's 5 star hotel operating in more than 60 countries while Candlewood Suites is a midscale hotel focused only in the North America.

Even though Americans real disposable personal income rose 3.8 in 2011 and S&P economics was projecting that real disposable personal income would grow 3.3% in 2012 and 3.1% in 2013", lenders should assess the long term solvency (which is dependent earning power of a firm), liquidity (the ability to meet cash outflows with adequate cash inflows) and financial flexibility (a firm's ability to respond to and meet opportunities and challenges in the marketplace) of individual firms. Greater disposable income and corporate profits is an important indicator gauging purchasing power of leisure and business travelers. Even though growth in personal income is expected, a lender must assess a hotel profitability, demand, size, industry position, capital structure and credit markets when deciding to lend capital. For instance, more competition is expected in midscale due to low cost of maintenance and limited services; however, full service hotels with many amenities appeal to less price conscious consumers thus achieving higher average daily rate.

Furthermore, lenders should gauge consumer confidence of consumers to determine the outlook on jobs and consumption. According to S&P Hotel and Gaming Industry survey "consumer confidence index which measures both consumer attitudes towards current conditions and their short term expectations was at 60.6% (1985=100) up, form the recession low of 25.3." To mitigate these economic forces, a hotel firm is likely to reduce cut headcount and be in cash conservation mode.
Changes in cost and efficiency

The hotel industry is highly capital intensive requiring investment to build, maintain and acquire hotels. Hotels companies also incur large fixed cost such as payrolls, insurance, property taxes, interest and principal payments, rent and lease payments. According to S&P 500, "a large hotel/casino project, capital spending can total hundreds of millions of dollars". To assess the financial risk, lenders need to investigate the number properties owned, franchised or managed by the hotel operator. High amounts property owned can be a drain on free cash, which is the cash available for distribution to owners of the firm (common, preferred and stockholders). Because of the inherent risk of incurring the whole cost the investment, some hotel operators will adhere to a franchise and/or management fee based model which collects a certain percentage of revenue, and profits regardless of unfavorable conditions. This allows for more stability of cash flow and earnings.

To mitigate the risk of hotel firms defaulting on their loans, lenders should take protective measures such as ensuring hotels firms are able to meet current and upcoming claims on cash flow. To conduct the analysis, an analyst should assess cash flow generated from the core business. Hotel firm's main revenue generators are room fees, food, and alcohol, consisting of 75%, 15%, and 5% respectively. However, room fees account for a larger portion of revenue of limited services hotels (93%) than full service hotels (62%). This is due to the category of food. By offering attractive dining options, hotel firms can price these services into the pricing structure of their plans thus achieving higher average daily rates and revenue per available room. Therefore lenders must examine a hotel strategy and demand characteristics. For instance, the cost of refurbishing a hotel is essential investment to maintain the earning power of a hotel, whose customer's value cleanliness, aesthetics and amenities. Customer loyalty could be at risk for upper midscale to luxury hotels that negate investments that does not maintain the productive capacity of the hotel. Even if demand becomes subdued to economic calamity, investors and analysts should assess the long term efficiency of the firm.

Who buys the product (buyer needs) leisure, business or group travelers industry overview

Business and leisure travelers drive demand in the US lodging industry. Business and leisure travelers account for 40% to 60% the industry revenue. US personal income rose 4.1% in November 2012 compared to the same month in 2011. Furthermore, US tourism spending on traveler accommodation increased 4.9% in the third quarter of 2012 compared to the same period in 2011. According to an October 2012 forecast provided from Global Business Travel Association, “business travel is expected to increase 4.9% to $270 billion in 2013.” The graph taken from the PWC Hospitality and Leisure report indicates
a greater percentage share of consumer spending above the trend for 2012. Lenders should be cautious of the favorable trend going forward. Although US have the largest lodging market in the world, lenders should examine the markets in which hotel operates. For instance, greater demand for lodging is expected in California, Florida and Texas due to tourist's attractions. Lenders should assess the impact of economic indicators such as unemployment rate and real GDP on business and leisure demand in their local economies.

With US unemployment rate hovering around 7.8% in 2012, may signal caution to lenders about the health of the US consumer. However, the analysis would not be complete without examining it in the context where growth in hotel demand is likely to occur. For instance, the unemployment rate in Texas is currently at a stunted level of 6.1%, 1.7% below the national average. Likewise, GDP growth which is a measure of the health of the US economy expanded 1.7% in the second quarter of 2012 and is forecasted to rise 2.2% in 2012 and 1.8% in 2013. Both GDP and unemployment should be closely watched indicators due to the seasonality of hotel demand. Furthermore, a hotel which has multiple operations in states where demand is robust, established brand recognition and loyalty programs are
likely to experience less variability in earnings and cash flow which is essential in an industry which is highly fragmented (50 largest companies generate 45% of the revenue).

**Changing buyer preferences (Full Service vs. Limited service) and/or luxury vs. midscale**

Since the hotel industry is a highly fragmented market, with no single firm exercising excessive market power, lenders should evaluate a hotel strategy in terms of service, price and location to ensure a hotel has successfully differentiated itself from competitors to drive current and prospective cash flows and earnings. For instance, a limited service hotel such as Hampton Inn, Days Inn and La Quinta INN can achieve efficiency due less capital intensive refurbishing and maintenance and fewer amenities. On the other hand, a full service hotel such as Hyatt, Radisson and Marriot strives to achieve higher price points by providing a full service restaurant, fitness centers, swimming pool, banquet rooms, and wedding receptions. These features offer convenience to travelers and are likely to experience patronage from consumers whose disposable income is greater than the US average. Furthermore, prices hotels can range from more than $200 per night for luxury, usually more to $100 for upscale, about $60 to $100 for midscale and under $60 for economy. As stated in the PWC Hospitality and Leisure report, “in the luxury, upper upscale and upscale segments, 2012 occupancy is on track to meet or exceed each segment's 2007 average...).” Occupancy is a key success factors any hotel. Without bodies in rooms, firms will find it difficult covering fixed cost and breaking even.

**Service innovations (reservations and it technology) allows them to retain customers**

To gain a competitive advantage in the highly competitive hotel industry, hotel firms are investing in their marketing and service capabilities such as Web 2.0 and Travel 2.0. The purpose for Travel 2.0 is to increase transparency, collaboration, better basics, and speed for travelers looking for opinions and reviews. According to Strategy + Business, a published magazine by the global management consulting firm Booz & Company its states

> Indeed, success in the travel industry in the coming years will be defined by a keen understanding of customer habits and tastes and by an ability to tailor products, services, and channel strategies to highly differentiated, carefully delineated consumer segments — whether high-touch service seekers, online power shoppers, holiday traditionalists, or bargain hunters. To succeed, segmentation criteria will have to address sales potential, complexity of service, and profitability of consumer options.

Lenders will need to assess a hotel company service capability in terms of how it uses technology to make decisions faster to deliver the value to a traveler who is looking to be accommodated anywhere at any time. Hotels with websites and reservation capability will be able to respond quickly to customer needs.

**Legal/regulatory influences and political and governmental policy**

The hotel industry is scrutinized by government officials due to the violation of labor law. Before lending funds to a hotel company to build, operate or manage a property, lenders should whether or not a hotel has been in compliance with government laws over the years. Incompliance with the labor laws can increase the cost of doing business. According to a United States Department of Labor, "Willful violations may be prosecuted criminally and the violator fined up to $10,000... Employers who willfully or repeatedly violate the minimum wage or overtime pay requirements are subject to a civil money penalty of up to $1,000 for each violation". Even though hotel firms with large operating budgets can
absorb the cost of hiring an undocumented worker, customer loyalty and corporate reputation need not be overlooked.

**Key Success Factors**

**Occupancy rate**

Due to the capital intensiveness of the industry and demand being highly influenced by the health of the economy, hotel firms must achieve satisfactory - favorable occupancy rates in order to break even and achieve profitability. Lenders should examine the health and strength of consumers in a particular hotel segment to determine a hotel long run financial ability to cover its long term obligations. For instance, strong occupancy rate in the luxury market is expected to show increases in 2012 and 2013. However, in upscale to midscale hotels segments occupancy is around the STR reported Industry occupancy level of 59.8% in 2011 and showing gradual increases but way below aforementioned. This is due to intense competition because of low entry barriers and the economic makeup of their consumer. Luxury and upscale hotels are more likely to attract business professionals and travelers who value quality and many amenities.

![Occupancy Rate for Hotel Segments](image)

**Figure 1 Source: Smith Travel Barney Research**

**Average Daily Rate**

To assess the long run profitability of a hotel unit, lender should gauge a hotel unit average daily rate. Average daily is calculated by dividing the number of rooms by the total room revenues. Average daily is an important metric to determine management effectiveness at driving revenues. Average daily is similar to a pricing power of an industrial company. A hotel daily pricing structure and hence its average daily rate according to the Accounting and Finance for International Hospitality Industry will be determined by the following: age and physical conditions of the subject facility, visibility and accessibility, location relative to demand generators, hotel amenities, quality services, market segments utilized, and quality of marketing efforts and reservations systems. Lenders should look at the trend in ADR in congruence with metrics occupancy rates and RevPAR. Excessive increases in ADR could stagnant
occupancy rates and future earning power if a hotel does not forecast demand accurately from its target market. Growth in ADR from the luxury sector is expected to strengthen 2012 and 2013. PWCs forecasting growth rate in ADR of 4.3% in 2012 and 4.8% in 2013. When economic growth is robust, in the near future; consumers will value the added amenities, such as a pool, room service, in-house restaurant, and weight room facilities.

RevPAR (Revenue per Available Room)

RevPAR is calculated by multiplying a hotel average daily rate by its occupancy rate. According to Smith Travel Research RevPAR is expected to decrease from 6.5 in 2012 to 5.6% in 2013. Any decline in economic growth will have a more adversely affect RevPAR for economy and midscale segments due to their budget conscious nature.
Financial Attractiveness

Industry Profitability

The US lodging industry is the largest global hotel industry in the world. In 2011, US hotel industry demand was 5.0% and supply growth was 0.6%. S&P is expecting improving demand and higher pricing power due limited supply growth and expensive capital.

Level of Investment

The hotel industry is a capital intensive industry with many fixed costs consisting of payrolls, property taxes, insurance, interest and principal payments affecting the profitability of the company. To combat paltry earnings, hotel companies need to acquire capital to expand and/or acquire companies. As noted in the S&P 500 Industry survey investments project/capital spending for hotel companies can total millions of dollars. Hotel firms with large asset bases, diversified operations and financial strength with receive favorable credit terms with lenders.
Interest rates which are influenced by the credit market and the economy will factor in determining the return on an investment.

**Risk**

The biggest risk for a firm operating in the hotel industry is the economy and its impact on leisure and business travelers. When corporate profits are growing and consumers feel confident about the current and future prospects they will be more likely to spend money on travel. Predicting whether a boom or bust will occur in the U.S economy is mystical because of the vast amount variables. An analyst or investor should carefully examine a firm strategy, value proposition and business capabilities along with financial ratios to compare their operating, financial and market performance with comparable hotels.

**Market Attractiveness**

*from Hoover’s/D&B subsidiary First Research*

The output of US hotels is forecast to grow at an annual compounded rate of 3 percent between 2012 and 2016. Data Published: September 2012

**Market growth potential**

Business travel spending is expected to increase 4.9 percent to $270 billion in 2013, according to an October 2012 forecast from the Global Business Travel Association and the lodging industry is expected to grow by 3% in 2013. Luxuries to upper midscale hotels will be the markets segments experiencing the benefits from this favorable outlook.

**Concentration ratio**

The hotel industry is intensely competitive with to 50 companies generating 45% of the industry revenue. Due to the intense competition firms, lenders should assess the strategy of a hotel firm. To earn economic profits, hotels differentiate themselves in terms or service, price and location. Upscale and midscale hotels are able to achieve higher ADR and RevPar than economy hotels by providing greater amenities and services, which allows hotels to increase to their room rates.
Competition in the midscale and economy market is intense due to little differentiation and low entry costs. Large companies such as IHG with greater financial flexibility can buy into any market by acquiring or consolidating with other hotel operators to efficiently and profitably. Lenders should carefully examine a hotel operator strategy in terms of market/product focus and value proposition and the strength and intensity of current and future competitors.

Company Analysis

Company overview

Intercontinental Hotels Group is one of the world's largest franchiser (6,382 hotels), manager (637 hotels) and owner (11 hotels) of hotels in the world with more than 4480 hotels world, 658,348 open hotel rooms distributed across nearly 100 countries and territories.

Strategy

IHG strategy and vision is to be one of the world's best companies through its preferred brand portfolio consisted of seven companies, best in class delivery system through its call centres, loyalty schemes, sales/marketing expertise and talented people. IHG is focused on three segments that generate over 90% branded hotel revenue: midscale (broadly three star hotels), upscale (mostly four star), and luxury (five stars). This product portfolio has had a favorable impact on IHG operation. Global IHG RevPAR growth (+6.2%) exceeded Global Industry RevPAR growth (+5.9%) and Global GDP growth of (+3.8). EBIT and Profit before tax growth of 22. % and 35% was management conscious effort increasing rev par by closely aligning the product portfolio to the demographics of their segments.

Product and services

IHG generates 87% of their operating profit from franchised and managed operations. By focusing on franchising and managing properties, IHG is able to evade these fixed investments, reducing the variability in earnings and cash flow due to the more steady nature of fees generated from management and franchisors. This business model allows IHG to achieve high returns on invested capital and margins. Although IHG is able to mitigate the risk of their asset composition, tightened credit markets may increase the cost borrowers or franchisees. This may be hamper growth if borrowers are not willing to incur the risk and cost due to market conditions. To provide an incentive, managers to grow the business IHG will need to provide financial assistance to reduce the cost of the investment and allow for a greater return.
Customer and Supplier

Bargaining power of a customer is not issue for ISG. With operations in over 100 countries, ISG is not dependent on any customer, supplier or hotel owner due to its brand, geographic reach and market segments.

Management and employees

To execute the strategy of being one the best companies in the world, IHG has initiated activities to build brand hearted leaders and employees through training, building employees morale and opportunities for advancement. For instance in 2011, IHG delivered three cascade kits that included brand hearted exercise and videos from their brand heads explaining more about the brand. Furthermore in 2010, IHG opened up a leadership academy which offers e-modules pertaining to finance, strategy, communications and coaching. Also, myRoomtogrow, which was introduced in 2011, is a performance management tool to acknowledge high performance employees. IHG investments in human capital are essential to build a culture that customers and employees admire and respect. Energetic and motivated employees can help foster customer loyalty further strengthen IHG presence in the hotel industry.

Operations Overview

Sales Marketing
As mentioned earlier in the industry analysis, a hotel firm can increase their sales by making in investments in service and technology that allows travelers to make lodging decisions. For instance, Roomkey, launched in January 2012, provides consumers with the ability to compare and contrast room rates across multiple hotel companies. Since its conception, Roomkey has generated close to $150 million annually. Furthermore, IHG has combated the intense competition in the lodging industry by a being first mover providing a customer loyalty program. As of 2011, the program currently has 63 million members and generates on average 600,000 new members every month and contributes $6.9 billion to global systems revenue.
**Distribution**

IHG has developed strong capabilities in distribution by setting up reservations systems such as 11 call centre's with 12 different languages, web mobile that comes in 11 language sites and eight language apps, sales force of 17,600 sales professionals and 3500 accounts, industry leadership in 13 of top 20 markets and scale (4,480 hotels and 153 guests annually).

**Information systems**

IHG investments in information technology have strengthened its distribution and sales/ marketing capabilities. For instance, information allows IHG to keep track of a consumer's data after they departed from their hotel. This information can be used to offer discounts, special packing, or accommodations due to the customer response survey.

**Financial analysis**

Profitability (IHG)

IHG return on assets of 19.0%, operating margin of 35.6%, net margin of 32.6% has all succeed industry. This is due to financial economies of scale and the ability to drive revenue per available room growth faster than the industry. By maintaining a fee based business strategy, IHG avoids incurring debt to own the property. Regarding the fee based business strategy IHG states “that it is highly cash generative, with a high return on capital employed." 87% of IHG operating profits is generated from franchisees fees. In addition, ISG management is further able to drive RevPAR growth due to its ability to closely align its product portfolio with its market segments. IHG is able to mitigate the risk of an uncertainty economy by using its size, financial and intangible resources to buy into various markets segments. If one market segment fails to deliver RevPAR growth, this will be offset by another business segment reducing the amount of variability of cash flow and earnings. With most of IHG investment coming from franchisees, asset, earnings, and equity growth will likely to remain above the industry.
**Liquidity (ISG)**

Low debt levels, a franchisee fee business model, high returns on invested capital and strong cash flow generation due to geographic diversification, IHG has the financial strength to combat changing economic and industry conditions.

**Solvency ratios (ISG)**

With 87% percent of their business coming from franchisees, IHG has greater solvency and financial flexibility to meet and challenges and opportunities in the hotel industry.

**Trend Analysis**