

In Hindsight 2007 Looks Great - Labor Costs Are A Concern - By Robert Mandelbaum

2008-08-20

As we struggle through declining occupancy and below average ADR growth in 2008, the U.S. lodging industry looks back fondly at 2007. Throughout last year, hoteliers grouched about slower RevPAR growth and single-digit gains in profits. By the time we finish 2008, the 7.2 percent bottom-line growth achieved in 2007 will seem like nirvana.

In 2007, the typical hotel in our Trends in the Hotel Industry report sample enjoyed a 5.5 percent increase in total revenue, while experiencing a 4.8 rise in operating expenses. The net result was a 7.2 percent increase in Net Operating Income (NOI). While this bottom-line improvement was more than twice the pace of inflation for the year, the single-digit gain was the lowest year-over-year increase since 2004 and represents a slowdown in hotel incomes that typifies expected performance in the near future. For the purposes of our analysis, NOI is defined as income before deductions for capital reserve, rent, interest, income taxes, depreciation, and amortization.

The following paragraphs highlight the 2007 movements in unit-level hotel revenues and expenses found in our 2008 Trends in the Hotel Industry report.

Its All ADR

Despite the strong performance of the U.S. lodging industry since 2004, the economic viability of significant hotel development activity was undermined by high construction costs and disciplined lending practices. While the number of properties proposed for construction reached record levels, the net increases in annual supply from 2003 through 2006, according to Smith Travel Research, averaged just 0.4 percent. However, in 2007, we observed the first signs of a breakthrough in the pipeline back-up. During 2007, the net available inventory of U.S. hotel rooms grew 1.3 percent. While this level of new supply growth is still well below the long-term average for this measure, it was a contributory factor to the decline in average occupancy for our Trends sample.

Just over half (50.9 percent) of the properties that participated in our Trends survey reported fewer occupied rooms in 2007 than 2006. Overall sample occupancy declined from 70.9 percent in 2006 to 70.8 percent in 2007.

Fortunately for hotel owners, management continued to be aggressive with their pricing policies. The average daily room rate for our Trends sample increased 6.2 percent in 2007. This compares favorably to the 2.9 percent annual inflation rate for the year. The 6.2 percent increase also served to make up for the 0.2 percent decline in occupancy. Thus, RevPAR for the Trends sample grew 6.0 percent in 2007.

In 2007, hotels also enjoyed the benefit of increased revenue from sources other than the rental of guest rooms. Food and beverage revenues grew 5.0 percent, while the combined sales from Other Operated Departments and Rentals and Other Income increased 2.1 percent.

Controlling Costs

Tighter control of costs in response to a slowdown in revenue growth, combined with fewer occupied rooms, resulted in a slowdown in the pace of operating expense growth in 2007. During the year, the combined costs associated with all operated departments, undistributed departments, and fixed charges grew 4.8 percent. While this level of expense growth is above the pace of inflation, it is less than the 6.3 percent annual average recorded from 2004 through 2006.

- Labor

Increased labor costs accounted for three-quarters of the expense growth at the average property in our Trends sample. From 2006 to 2007, total labor costs grew 7.8 percent, the largest single year increase since 1984. As a result, labor costs represented 46.8 percent of total operating expenses in 2007, compared to 45.5 percent in 2006.

- Total Departmental Expenses

Total Departmental Expenses (rooms, F&B, minor operated) increased a relatively low 3.6 percent from 2006 to 2007. Within these operating departments, labor costs increased 8.9 percent, but all other costs declined 3.8 percent.

It should be noted that the 10th edition of the Uniform System of Accounts for the Lodging Industry revised the handling of contract labor costs. This change in contract labor cost classification from 'other operating department expenses' to 'labor costs' served to increase 'labor costs', while reducing 'other operating department expenses' at those hotels that hire significant numbers of seasonal or temporary workers through outside agencies.

Another factor that influenced the moderate growth in 'other operating department expenses' within the operated departments was the decline in occupancy. Given the reduced number of occupied rooms and guest counts at the average hotel, there is less of a need to purchase operating supplies, guest supplies, and food and beverage for re-sale.

- Administrative and General

Administrative and General expenses (A&G) increased 7.4 percent in 2007, the greatest increase among all the undistributed expense categories. Within the A&G Department, labor costs increased 6.9 percent, while other expenses grew 8.0 percent.

- Marketing

Marketing expenses grew a modest 5.2 percent in 2007. Continuing a trend we started to see in 2006, the majority of increased expenditures within the marketing department were in non-labor related areas. In 2007, labor costs associated with sales personnel grew just 2.9 percent, while other expenses increased 6.3 percent.

- Property Operation and Maintenance

Property Operation and Maintenance expenditures grew 6.9 percent in 2007, the largest year-over-year increase since 1984. Within the maintenance department, labor costs increased by 4.8 percent, while all other expenses jumped 8.9 percent.

- Utilities

The cost for electricity, gas, water, and other utilities at the hotels in our sample grew a relatively modest 4.6 percent in 2007. This is down from the 7.3 percent spike we observed in 2006. Given the rise in commodity prices we have seen through the first few months of 2008, hotel managers will be challenged once again to effectively control this line item.

- Management Fees

In 2007, management fees rose 7.9 percent while total revenues increased just 5.5 percent. This implies that the profit-based incentive component grew at a greater pace than the base management fee. This marks the third consecutive year we have observed an escalation of incentive fees.

- Fixed Charges

Property taxes increased 4.9 percent in 2007, a slight decline compared to the 5.5 percent growth rate observed in 2006. On the other hand, insurance costs continued a two-year trend of above-average growth. For the year, the cost of general liability and property insurance grew 7.9 percent.

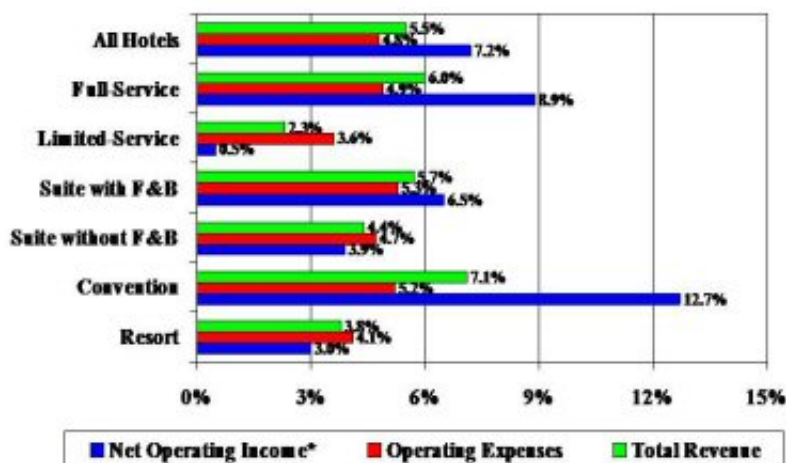
Profit Growth Varies

Net Operating Income for the average hotel in our Trends sample increased 7.2 percent in 2007. While all property type categories achieved a gain in NOI, the amount of increase varied greatly among industry sectors.

Convention and full-service hotels achieved the greatest gains in NOI among the six property categories covered in our Trends survey. These property types enjoyed profit gains of 12.7 percent and 8.9 percent, respectively. Suite hotels with food and beverage operations saw their bottom-lines improve by 6.5 percent.

Not enjoying such high gains in profitability were limited-service, suite hotels without food and beverage, and resort hotels. All of these property type categories experienced NOI growth of less than 4.0 percent. Not coincidentally, these three property types also achieved the lowest growth in ADR.

U.S. HOTEL INDUSTRY
Change In Unit Level Revenues, Expenses, and Profits*
2006 to 2007



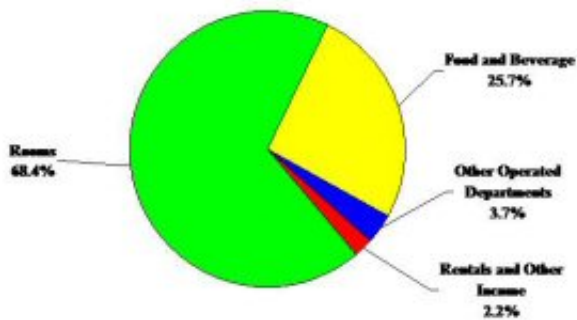
Note: * Before deductions for capital reserve, rent, interest, income taxes, depreciation, and amortization.

Source: PKF Hospitality Research

U.S. HOTEL INDUSTRY

Mix Of Revenues

2007



Source: PKF Hospitality Research

Author's Note: The 2008 Trends report reflects changes in the Uniform System of Accounts for the Lodging Industry (USALI), which PKF-HR adopted this year. The USALI changes in revenue and expense classifications may result in some comparability issues from year to year. While PKF-HR does not believe that these changes had a material impact on the overall report findings, readers of the Trends report should be aware of these issues. A full explanation/description of the USALI revisions and their impact on the data contained in the Trends report is available at PKF's web site, www.pkfc.com/USALIchanges.

Robert Mandelbaum is the Director of Research Information Services for PKF Hospitality Research. To purchase a copy of the 2008 Trends in the Hotel Industry report, visit www.pkfc.com/store. This article was published in the July 2008 issue of Lodging.

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