

The Economic Ascent of the Hotel Business

Second Edition

Paul Slattery

(G) Goodfellow Publishing

(G) Published by Goodfellow Publishers Limited,
Woodeaton, Oxford, OX3 9TJ
<http://www.goodfellowpublishers.com>

British Library Cataloguing in Publication Data: a catalogue record for this title is available from the British Library.

Library of Congress Catalog Card Number: on file.

ISBN: 978-1-906884-68-0

First published 2009

This edition published 2012

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Design and typesetting by P.K. McBride, www.macbride.org.uk

Printed by Baker & Taylor, www.baker-taylor.com

Cover design by Cylinder, www.cylindermedia.com

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Preface

There are three gaps that this book seeks to narrow. First, the ideal combination for corporate executives in hotel chains is to have both a conceptual understanding of a business discipline and a conceptual knowledge of the hotel business. However, hotel chains frequently populate their corporate structures with executives drawn from the disciplines of accounting, marketing, finance and the other general business disciplines, but without a conceptual understanding of the hotel business. Once they have taken-up their position in a hotel chain their emerging understanding of the hotel business is only experiential and this can limit the effectiveness of their creativity. This book is designed to narrow that gap by providing a systematic analysis of high level strategic issues that confront the hotel business.

Second, most of the advisors to the hotel business: investment bankers, equity analysts, lenders, equity investors, management consultants, real estate agents, lawyers, accountants, developers, architects, construction companies, the media and a host of others have been sent to work on hotel projects, they have not chosen to work on them. As a result, there is a very high turnover of advisors involved in the hotel business. Only a few are sufficiently attracted to remain committed to it for a significant part of their careers, but even these stalwarts only have a piecemeal rather than a conceptual understanding of the hotel business, which constrains their interpretation of the challenges and can limit the effectiveness of their advice. This book is designed to narrow that gap and to help advisors gain a more comprehensive understanding of the dynamics of the hotel business.

Third, undergraduate and postgraduate degrees in hospitality management throughout the world pay too little attention to the understanding of the economic development of the hotel business, to the dynamics of economies, the hotel demand that they generate and the hotel supply needs that follow. Given that hotel chains dominate hotel development it is of concern that most graduates in hospitality management enter the business with inadequate understanding of hotel chains, their drivers, strategies and structures. This book is designed to narrow that gap and help academics and graduates to comprehend and get excited about one of the most dynamic and growing businesses in the world.

Preface to 2nd edition

In the three years since I completed writing *The Economic Ascent of the Hotel Business*, there have been monumental changes in the economic landscape of the world, there have been material changes in the pattern of hotel demand and supply and there have also been significant changes to the profile of hotel chains.

The 2nd edition incorporates these changes into the period to the end of 2010. A new Chapter 13 examines the options for the world economies, the hotel business and hotel chains in the decade to 2020 and it discusses the implications for the ongoing economic ascent of the hotel business.

I have also taken the opportunity to improve on two items in the book. First, many of the tables in the first edition have been replaced by graphs, which more clearly

illustrate the progressive development of hotel demand and supply over the past century and links them more obviously to the structural developments of the major economies. Second, I have incorporated new material about the structure of economies, of hotel demand and of hotel supply.

Kindly, David Litteljohn and Richard Carrick read the draft of the 2nd edition and made very helpful comments, most of which I have incorporated. Those that I have not will require another book to explore and that is for another day.

About Otus

Otus focuses on three sectors: Hospitality, Travel and Transport. Otus directors and partners are sector experts and experienced bankers with long experience in the strategic analysis of the hospitality, travel and transport businesses and an unrivalled record of advising on key transactions of all sizes, national and international in hospitality, travel and transport.

Otus Corporate Finance offers advice on a full range of corporate finance activities including: mergers and acquisitions, disposals, joint ventures, MBOs/MBIs and financing transactions.

Otus & Co provides independent, high level and innovative strategic advice drawing on a range of proprietary data and analytical tools.

For the hotel business we own and operate the Otus Hotel Brand Database, the most sophisticated hotel brand supply database covering all of Europe, the Middle East, Africa and Asia. We provide systematic analysis of hotel brand supply with consistent classification of hotel market levels, hotel configurations and hotel locations each economy.

We track developments in economic structure for each economy and economic policies to assess their implications for the hotel business. We also track the volume of domestic business demand, domestic leisure demand, foreign business demand and foreign leisure demand into hotels.

We use these resources to advise on portfolio and performance strategies of hotel brands to enable main boards to make more secure decisions about the medium to long-term directions of companies.

Our clients include international and national hotel companies, online travel agencies and capital providers in Europe, North America and elsewhere.



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Acknowledgements

The hospitality business has been the thread that has bound my three different careers as an academic, as an equity analyst and as an investment banker. Throughout, there have been countless colleagues, clients, corporate executives, competitors and students, most of whom are unaware that they sparked ideas, demanded solutions, inspired me and punctured the crazier ideas that I have had about the hospitality business. The 16 years to 1987 at the University of Huddersfield was a period of broad creativity with colleagues and friends such as Rita Carmouche, Keith Johnson, David Litteljohn, Ray Pine, Angela Roper and George Wilson, all of whom have left distinguished marks on the development of hospitality management in the academic world. We were very young academics charged with developing a degree in Hotel and Catering Administration and in pursuing research in hospitality management. It was at this time that my commitment to the analysis of hotel chains and to the creation of the hotel supply database was established.

At Kleinwort Benson Securities from 1987 to 1998 Simon Johnson and Greg Feehely were two graduates in hospitality management who crafted very successful careers in the investment community and worked with me when I first developed the idea that economic structure was a critical influence on the size, shape and performance of the hotel business.

Since 1998 my immediate colleagues in corporate finance at Kleinwort Benson and my close colleagues at Otus: Simon Read, Andrew Boshoff and Ian Gamse stretch my thinking because their talents are both wide and deep. It is with these colleagues and friends that I have been able to extend the wider strategic analysis of hotel chains and the hotel business.

As I was completing this book I received the news that Greg Dillon had died. Greg was one of the great statesmen of the hotel business who served as Vice Chairman Emeritus of Hilton Hotels Corporation after his retirement from the main board. His involvement with Hilton stretched from the acquisition of Statler Hotels in 1954, which was at the time the largest ever hotel chain transaction. He was responsible for the development of Hilton from the 1960s and was one of the executives who understood and drove the economic ascent of the hotel business in the US and elsewhere. Greg was also a great friend, a grand host and an inspiration.

Thanks also to Tim and Sally at Goodfellow Publishing, who have always been thoughtful and helpful.

My preoccupation with the hotel business is exceeded by my preoccupation with my family who have provided so many highs, a sprinkling of lows and a few scares. Libby has shared my whole adult life, wonderfully. Stephen and Natalia and the Ms – Martin, Millie and Markus – know that the time I spend thinking about, reading about, talking about and writing about the hotel business is secondary to my love for them.

Paul Slattery

Introduction

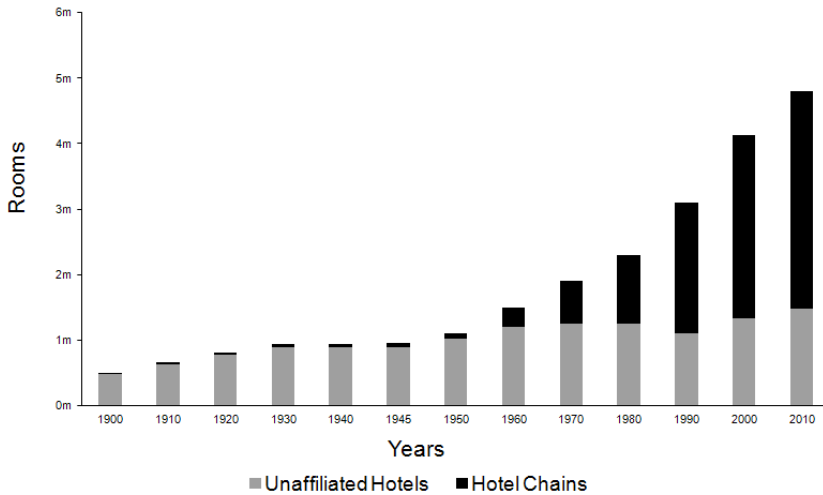
This book is about the hotel business and the economic contexts in which it has evolved. The central thesis is that the size, structure and growth of the hotel business in a country are functions of the prevailing economic structure. Thus, fundamental to comprehending the economic ascent of the hotel business is an understanding of the structural development of the economies in which hotels operate and which provide the fertility for hotel demand and supply to grow. The book aims to provide a more comprehensive interpretation of the dynamics of hotel demand and supply that befits a business of its economic significance. It draws on contemporary data and events to chart the historic development of economies and of the hotel business to illustrate patterns in this fundamental relationship. The book also focuses on the economic conditions that produced hotel chains of different sizes, structures and growth patterns and it seeks to provide a more effective basis on which future developments in hotel demand, supply and performance can be contemplated.

The economic ascent of the hotel business across the world has not been uniform because the development of economic structures has not been uniform. Europe and North America are the centre of the hotel universe, so that, with a combined population of around 700 million and with around 10 million hotel rooms, they have a supply ratio of 14 hotel rooms per 1,000 citizens. The rest of the world accounts for a population of more than 6 billion with more than 5 million hotel rooms, a supply ratio of one hotel room per 1,000 citizens. The fundamental question is: what is it about the economies of Europe and North America that generate a much higher volume of hotel supply, and by implication hotel demand, than the rest of the world? Those economies from Africa, parts of Asia, parts of South America and parts of Eastern Europe that are grounded in agriculture and basic manufacturing generate the lowest volume of demand for hotels, have the lowest supply of hotel rooms and throughout history the economic ascent of their hotel businesses has been minor. At the other end of the continuum of economic structure, the most advanced economies such as the US and Britain, have progressed to be driven more by service businesses and experience businesses. They generate the highest volumes of hotel demand and need high volumes of hotel room supply per citizen to accommodate them. It is in these countries that the economic ascent of the hotel business has been greatest. Thus, identifying the historical development of the economic structure of these countries and the parallel development of their hotel businesses is necessary to make sense of the different size, shape and prospects of their hotel businesses.

In the most advanced economies the hotel business has existed and grown throughout their economic history and has been dominated by two major trends. First, the provision of hotel facilities and services has developed from small inns with fewer than 10 rooms, which were an extension of the home of the innkeeper, with primitive sleeping and eating facilities for handfuls of travellers at any time, to modern mammoths such as Wynn Las Vegas, opened in 2005 with a development cost of \$2.7 billion in 2,716 rooms and suites, an 111,000 square-foot casino, 22 restaurants and bars, an 18-hole golf course, approximately 223,000 square feet of conference

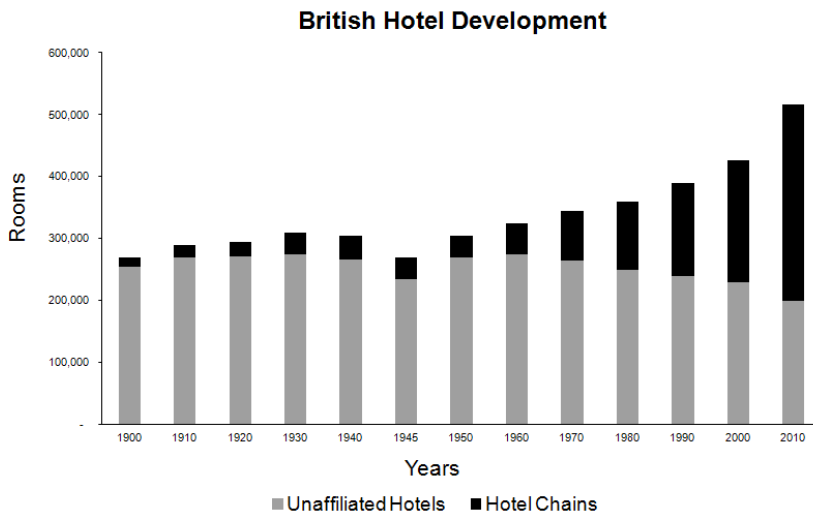
and meeting space, an on-site Ferrari and Maserati dealership and approximately 76,000 square feet of retail space. Second, from the middle of the 19th century in Britain, hotel chains emerged. They developed gingerly during the next 100 years, but the emergence of chains and therefore the growth in concentration of the hotel business was a feature of the second half of the 20th century, most notably in the US and Britain as Charts 1 and 2 illustrate.

Chart 1: US Hotel Development 1900 - 2010



Source: Otus & Co Ltd

Chart 2: British Hotel Development 1900 - 2010



Source: Otus & Co Ltd

The US has by far the larger hotel room stock and higher concentration of hotel rooms in chains. It is the larger economy with a larger and faster growing population and the larger physical size, but crucially, throughout the 20th century the structural development of the US economy also accelerated at a faster rate than Britain's. From the 1950s the US economy was driven by service businesses and experience businesses, whereas it took Britain until the 1980s to reach this stage. By 2010, the US had reached a rooms supply ratio of 15.5 hotel rooms per 1,000 citizens and 69% of its hotel rooms were concentrated into chains. In the same year, Britain reached a rooms supply ratio of 8.3 and hotel rooms concentration of 61%. In contrast, Germany with a less structurally developed economy than Britain had a room supply ratio of only 6.8 and rooms concentration of only 40%. The experience of the US and Britain is that when the structure of an economy is driven by service businesses and experience businesses the rooms supply ratio increases and hotel chains dominate the hotel market. Hotel chains are the most effective way to generate high volumes and diversity of hotel demand, to produce high operating margins and to attract professional capital. The history of the hotel business in the advanced economies is unequivocal in the effectiveness of hotel chains over unaffiliated hotels.

Hotel chains have also grown internationally, but are still at the early stage of development. It has taken all of economic history for four of the global major hotel chains: InterContinental Hotels Group, Wyndham Worldwide, Hilton Worldwide and Marriott International each to achieve more than half a million rooms, but the development of hotel chains has not only been about global majors. At the end of 2010, in the 52 countries of Europe, there were 892 hotel brands operating portfolios of more than four hotels, accounting for a total of 15,275 hotels with 1.92 million rooms. As the structural development of economies progress towards the service business and experience business segments so hotel demand and supply accelerates and hotel chains grow apace. The expectation is that by 2020 there will be at least five global hotel chains with more than one million hotel rooms each.

The case for the book

Otus estimates that at the end of 2010, there were 15.5 million hotel rooms in the world with a replacement cost of \$3 trillion. Hotel chains accounted for 42% of the total rooms and 53% of their replacement cost. The hotel business is now of too great an economic significance for the dynamics of demand and supply to be only casually understood and this requires an advance on conventional wisdom. The conventional wisdom about the development of the hotel business in any economy is based on three metrics: short term historic trends in hotel revenue per available room (RevPAR), the expected volume of new hotel construction and the current stage in the economic cycle. Each metric on its own provides useful information. The problems arise when these output measures are combined into a tabloid belief that changes in hotel RevPAR mirrors changes in GDP in the economy and that the rate of hotel construction accelerates when GDP and RevPAR are growing and it shrinks when they decline.

Much conventional wisdom about the dynamics of the hotel business does not take into account the complexities of economies, the intricacy of business or the diversity of social behaviour, but these realities cannot be ignored. Much conventional wisdom has little or nothing to say about the place of the hotel business in an economy. It has nothing to say about the economic ascent of the hotel business and it reduces the comprehension of the future of the hotel business to guesses. Conventional wisdom has produced too many flawed development strategies, too many flawed marketing strategies and too many flawed investment decisions resulting in low returns on capital.

The US, the largest and most concentrated hotel economy, exhibits the point. During the first decade of the 21st century, hotel supply grew at three times the average annual rate of hotel demand. In 2000, the US had already reached a high rooms supply ratio of 14.6, which did not deter the fast rate of supply growth to reach a ratio of 15.5 by 2010 with the net addition of 672,000 rooms. The increasing pipeline of planned new hotels was seen as a measure of virility of the US hotel business and during the period of the credit crunch and recession from 2007 to 2010 hotel supply growth accelerated while room nights sold declined. As a result, the rate of return on hotel investment in the US fell progressively and hotel chains did not earn incentive fees on high proportions of their management contracts. In short, the conventional wisdom about the dynamics of the hotel business in the US failed. Hotel owners proceeded zealously with hotel supply growth. Hotel chains, which were single-mindedly committed to expanding their portfolios, acquiesced with the supply growth proposed by hotel owners, ignoring the progressive imbalance between hotel supply, demand and performance.

This book aims to provide a more effective approach. Along with greater economic significance comes greater responsibility to investors and other stakeholders in the hotel business. An understanding of the structural development of economies enables us to identify more effective ways to measure the hotel demand and hotel supply needs of economies and enables us to plan investments more effectively. This book is about these big economic and investment issues. It presents a consistent understanding of the dynamics of economic structures as well as the patterns and volumes of hotel demand and supply that they generate and the development of hotel chains that they require.

Each economy has a unique structure expressed among other measures by the numbers employed in each of the five economic segments: agriculture, industry, public service, service business and experience business. Each segment is different in terms of the type of work undertaken and thus, is different in terms of its economic significance, the reasons for employees to travel on business and the frequency of their business travel. The book tracks employment in each economic segment over time and the economic policies that have been influential in making the changes in the patterns of employment. As the structure of an economy moves towards the service business and experience business segments so each emerging segment generates more hotel demand than the previous. Moreover, the greater the concentration of companies within each segment the more that the balance of employment shifts from blue collar to white collar and professional work and the more business travel that is generated.

In parallel, as the structure of an economy moves towards the service business and experience business segments and the numbers of white collar and professional employees increase so also does the leisure demand for hotels. To understand the development of hotels through history from small primitive inns to the very large extended feature hotels such as the Wynn Las Vegas and its equivalents we need to come to grips with the structure of the economy, the specific pattern of hotel demand that it generates and the specific pattern of hotel supply it requires. The range of reasons for using hotels and the frequency of both business and leisure demand grows as economic structure develops. The more that the structure of an economy moves towards the service business and experience business segments, the greater the volume and diversity of hotel demand, the greater the volume and diversity of hotel supply and the greater the concentration of hotels into hotel chains.

Over time, the structure of the US and British economies progressed from a heavy reliance on agriculture to a reliance on service businesses and experience businesses. Over the same time the structure of the Eurozone economies developed more slowly and had greater reliance on the industrial and public service segments. The book discusses the patterns and volumes of hotel demand that emerged at each time period in each country and explains why they emerged. It analyses the volume and pattern of hotel supply over the same time periods to explain how the economic structure, economic policies, hotel demand and hotel supply are related. In particular, it traces the emergence and growth of hotel chains and explains that they are integral to the economic ascent of the hotel business. The book concludes with an analysis of the growth options for the major economies of the world in the decade to 2020 and explores the implications of each economic option for the future economic ascent of the hotel business.

To illuminate the dynamics of the economic ascent of the hotel business, the book draws on data from the Otus Hotel Brands Database and its precursor that I started at the University of Huddersfield in the early 1980s and expanded at Kleinwort Benson Ltd until the end of the millennium.