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Limited-Service/Economy Lodging Sector Faces Challenges Ahead

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Limited-Service/Economy Lodging Sector Faces Challenges Ahead

Abstract
Changing cost structures and discounting by more upscale hotels are creating the need for new competitive methods in order to attract and retain guests. One author contends that only those chains that can quickly embrace change and find innovative ways for providing more with less are likely to survive.

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Limited-service/economy lodging sector faces challenges ahead

by Daniel J. Connolly

Changing cost structures and discounting by more upscale hotels are creating the need for new competitive methods in order to attract and retain guests. One author contends that only those chains that can quickly embrace change and find innovative ways for providing more with less are likely to survive.

Throughout the late 1980s and early 1990s, the industry's rising star was the limited-service/economy lodging segment. This segment was popularized in the 1980s when market segmentation was first introduced. It was the "no frills" provider of lodging accommodations at "affordable" rates. With low overhead, limited-service/economy hotels could provide substantial savings to their guests. Consequently, when the recession set in, this segment became the hottest, most profitable area of the industry as business and leisure travelers alike looked to reduce their travel expenditures.

Presently, the picture is less optimistic. Increased demands for services and amenities have added to a limited-service hotel's overhead, triggered significant rate hikes, and removed the "no frills" focus that once made this segment successful and popular. The situation is compounded as more upscale hotels offer discounts and create the perception of better price-value relationships. Further complicating the marketplace dynamics are the recent product announcements by many large chains, the merger mania that characterized the past year, and the number of new rooms being added in markets that are already approaching saturation. From 1990 to 1996, the net supply of guest rooms in this segment alone has been in excess of 31 percent.

The result for limited-service/economy lodging hotels is a paradoxical situation or a "catch-22." Older properties will need to maintain a fresh image to compete with new market entrants, and for all prop-
erties, the challenge will be to find ways to provide more services and amenities while controlling overhead and minimizing rate increases.

**Outlook for industry is promising**

According to the American Hotel and Motel Association, the U.S. hotel industry is comprised of over 45,000 properties with more than 3.3 million rooms. The limited-service/economy segment's portion represents 17,000 properties and 1.3 million rooms. With industry sales reaching more than $75.4 billion, the outlook for the lodging industry as a whole appears promising. Industry-wide occupancies and revenue per available room (REVPAR) are both at 10-year highs, with growth in room rates outpacing the rate of inflation. The recovery is being led by the full-service and luxury segments of the industry. Overall, U.S. hotels are experiencing positive cash flows and are becoming attractive to the investment community once again.

Reshaped by market segmentation in the 1980s, the lodging industry is comprised of several key segments. Smith Travel Research suggests that there are five categories which are defined by price:

- **Budget** - 1st to 19th percentile
- **Economy** - 20th to 39th percentile
- **Midprice** - 40th to 69th percentile
- **Upscale** - 70th to 84th percentile
- **Luxury** - 85th to 100th percentile

Others choose to subdivide these categories into more detailed divisions to include a lower boundary, midpoint, and upper boundary (based on price) for each segment. Price alone, however, is not a sufficient means by which to classify hotels because many of the new economy hotels are charging room rates that rival those who are clearly competing in the midprice or upper midprice segments. Figure 1 suggests a framework for this categorization, taking into account Randall Smith's classification scheme and the general definition noted above.

**Simplicity attracts price-conscious travelers**

The limited-service/economy lodging segment benefited greatly during the recessionary period by attracting price-sensitive travelers. As a sign of its success, hotel companies embarked on aggressive building campaigns. Growth in hotel construction in this sector has outpaced that for any other segment. From October 1993 to October 1996, this sector accounted for more than 73 percent of the new room inventory or 89 percent of the hotels added to the marketplace. These new properties have been successful in drawing guests away from older, less modern facilities in the midscale sector.
For example, when Hampton Inns were first developed, they provided newer accommodations with comparable amenities and more affordable rates than their former sister product Holiday Inns. The result was a shift in market share from the midprice segment to the economy segment as guests recognized a good value (i.e., a clean, comfortable room, basic services and amenities, a convenient location, and an “affordable” rate). This shift is still observed today even though Hampton Inns command a higher price and offer more amenities and perks to lure guests than they did when the concept was first introduced. In fact, some industry observers would even question positioning based on rates alone by Hampton Inns, or, for that matter, other economy lodging products.

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Another example can be illustrated when considering a recently-opened Fairfield Inn by Marriott in San Antonio, Texas. This property advertised double occupancy rates as high as $75, a far cry from the initial $29 to $39 rates when Marriott first introduced the brand. Based on price, this property should be positioned in the midprice segment, yet its service levels and brand perception suggest that it belongs in the upper economy segment of the industry.

Economy/limited-service hotels are characterized by their simple product offerings, small staffs, few amenities, and limited decor. Typical average daily rates are $50 or less. Development costs average between $25,000 and $40,000 per room versus $90,000 or more for standard guest rooms in full-service hotels. This cost savings is achieved by reducing the size of guest rooms and the amount of public space within the hotel. Although guest rooms can be as much as one-third smaller than standard guest rooms in full-service hotels, creative space utilization and modular furniture have enabled limited-service/economy hotels to provide comfortable and functional rooms for their guests. Innovative product design and furnishings have also led to improved operating efficiencies and shared job responsibilities to further reduce overhead. For example, guest room furniture attached to walls and the use of enlarged showers in lieu of bathtubs in the guest bathrooms facilitate and expedite the cleaning of rooms. By locating the laundry facilities behind the front desk, desk clerks and night auditors can wash linen and towels during off-peak periods. As a result of their scaled-down offerings and their staff's ability to multitask, these hotels are able to pass on substantial savings to their customers, often amounting to as much as 20 to 50 percent less than hotels in more upscale categories.

A few major chains dominate

While there are many lodging products in the limited-service/economy segment, there are, as the result of acquisitions, relatively few major players. According to industry statistics, two lodging companies control the lion's share of the room supply in this segment. Cendant Corporation (formerly Hospitality Franchise Systems, or HFS) is the largest with six limited-service/economy concepts and almost 500,000 rooms. Its holdings in this segment include Days Inn, Ramada, Super 8, Howard Johnson, Travelodge, and Knights Inn. The number two front-runner in this segment is Choice Hotels, with nearly 200,000 rooms. Its economy lodging products include Comfort Inn, Econo Lodge, Rodeway Inns, Friendship Inns, and Sleep Inns. Both Cendant Corporation and Choice Hotels are experts in niche marketing, segmentation, and product positioning. Their product portfolios essentially offer accommodations for nearly every price-point in the industry. In fact, they have done this at the risk of cannibalizing their own markets
and blurring the distinction between their different lodging brands.

Other major players in this segment include Accor's Motel 6 (87,000 rooms), Holiday Hospitality's Holiday Inn Express and Holiday Inn Select (69,831 rooms), Promus' Hampton Inns (75,829 rooms), Marriott's Fairfield Inn (30,400 rooms), La Quinta Inns (29,936 rooms), and Red Roof Inns (28,782 rooms). Of the top 15 chains, all but three are predominately franchisors. Motel 6, La Quinta Inns, and Red Roof Inns are predominately company-owned and operated, though this will likely change. Motel 6, for example, is targeting franchising as its primary growth vehicle for the future. This segment has relatively few management contracts as compared to the full-service sector. This is due in part to the simplicity of the operation and the large focus on franchising as the means to win market share. It may also be a sign of where the main profits lie.

Cendant Corporation leads market

Based on room supply, Cendant clearly leads the market in the limited-service arena. The company's strategy is to continue this market dominance, to grow aggressively through franchising, and to upgrade the image of each of its product lines. Upgrading the chain's technology infrastructure is a key component to the company's long-term plan. Cendant has embarked on a $75 million campaign called Project Power-up, which will provide a common systems architecture (software and hardware) in all of its properties, chain-wide.

Days Inn, its largest brand, has embarked on a $1 million renovation program to improve curb appeal (exterior renovations, landscaping, and signage). To entice member commitment, Days Inn has agreed to fund up to $25,000, or 25 percent, of the cost of the improvements. A similar program is being offered in its sister brand, Howard Johnson. In addition, the company is taking a more aggressive stance on quality control. It has introduced a new rating system to grade each property on certain standards. Unannounced inspections are conducted throughout the year, and scores are published in the company's property directory for guests to see. Properties with repeatedly low scores will be removed from the chain.

Choice Hotels has announced an aggressive expansion program. Its goal is to have 10,000 properties in its portfolio by the year 2000. Much of this expansion will come from international markets. As part of an image improvement program, its Rodeway Inns brand is implementing a new room design called the Rodeway Choice Room. Designed specifically for senior citizens, the Rodeway Choice Room features levered door handles, hand railings in the bathrooms, and large buttons on the telephone and TV remote. The cost of upgrading each new room is $400. In addition, this brand has 12 new facilities under construction with estimated construction costs at $22,000 per
Comfort Inns is upgrading its complimentary continental breakfast and testing "Vroom Service," a joint program with Pizza Hut for pizza delivery. Sleep Inns, Choice's newest brand, has been a pioneer in this segment by featuring a new bathroom design with an expanded shower stall versus a bathtub.

Promus' Hampton Inns has been a strong player in the limited-service/economy market. It was one of the first to offer complimentary continental breakfast and was an innovator with its satisfaction-guarantee program. Customers are issued full refunds, with no questions asked, if they are not fully satisfied with their stay. Other innovative programs offered by Hampton Inns include an employee recognition program called "Catch Me at My Best" and a marketing program called "Lifestyle 50" to attract senior citizens. Hampton Inns' expansion plans will focus on the development of Hampton Inns and Suites, a hybrid product of its Hampton Inns and Homewood Suites concepts. The company is also testing new forms of distribution. It was one of the first lodging products to establish a marketing presence on the Internet and will soon add on-line booking capabilities for Internet users.

Marriott’s Fairfield Inn concept soared to a position of leadership in this segment after only a few years in existence. The company opened its first property in 1987 in Atlanta and has since grown to over 230 properties with a presence in almost every state. Marriott announced plans to develop a Fairfield Suites product, with the first hotel scheduled to open in 1997. Fairfield Inn enjoys the "halo effect" from its well-established sister brands and is frequently recognized by business travelers for its quality in this segment. It has received top honors from Business Travel News and others for its strong performance, attention to customer detail, and its ScoreCard automated guest feedback system.

The company’s focus is to grow through franchising. At one time, all Fairfield Inn properties were company-owned and managed. Today, Fairfield Inn is almost entirely franchised, representing a major departure from the company’s original plan. Through franchising, the company can achieve lucrative financial rewards through franchise fees and royalties without significant investment and without assuming the risks associated with oversaturation, which is already starting to occur in this segment. Fairfield Inn continues to focus on staff consistency and training. Working with Gallup, Inc., the company has implemented a diagnostic tool to assist with employee recruiting and selection.

Motel 6 leads budget sector

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share. The company intends to grow aggressively through franchising while maintaining its focus on providing only the basic necessities—a clean, comfortable room and free local telephone calls. Perhaps this company's strength is in avoiding amenity creep despite succumbing to market pressures to implement a toll-free reservations number.

Holiday Hospitality is another company with an aggressive expansion program underway, with particular focus on international markets. The company continues to be a leader and innovator in the industry. It was one of the first to establish an Internet presence and was the first to accept on-line booking with a direct interface to its central reservation system. The company has embarked on a major image improvement campaign and plans to introduce several new brands in upcoming years. In addition, the company is implementing a new integrated computer system called HIRO to improve operating efficiencies and maximize revenues. The system includes property management, reservations, and yield management functionality. Once rollout and implementation are completed, the company will have a common systems architecture in place to facilitate information sharing and data transfer between properties and corporate.

**Competition, consumer expectations drive services, amenities**

As competition becomes greater in the limited-service sector and as consumers grow to expect more services and amenities when traveling, the challenges for limited-service/economy lodging operators will increase, and the struggle for survival will be greater than ever before. A number of major trends are impacting this segment of the lodging industry.

First, customers are more value-conscious and demand more for less. They have become accustomed to many of the technological conveniences of the home and office (e.g., fax, voice mail, VCR's, and computer access) and have grown to expect these same features while on the road. This creates an interesting challenge for limited-service/economy lodging properties, which, when first developed, intended to provide only the basic essentials, not all of the extras the customers are seeking today.

Dominance by major industry players will create a greater gap between the “haves” and the “have nots.” Due to their size, they will be able to leverage their resources, buying power, and information systems development projects to create greater efficiencies and economies-of-scale that can only be enjoyed by companies of their size. This will place smaller players — particularly independents — at a disadvantage and force many of them out of business or into alliances (most likely through franchising) with larger players. Additionally, cluster management by industry leaders (e.g., Marriott) will create new opportunities for leveraging a company's resources and reducing
costs, especially for the economy segment. Shared resources and services (e.g., vans, laundry facilities, reservation systems, purchasing, and management staff) will help economy lodging units contain costs.

Smaller properties must remain competitive

Many properties within this segment require extensive investment to remain competitive with newer, more modern facilities. A number of properties that have been downgraded from other segments will need to be renovated or else risk being retired. In addition, many facilities, the first entrants in this segment, are nearing the end of their life cycles. They are showing signs of wear and aging and will require costly renovations to remain competitive with the new construction.

Safety and security continue to be in the forefront of every guest’s concerns—particularly in the economy segment. Properties that have not already upgraded lighting, access control systems, door locks, and security monitoring systems should do so at once. It is just a matter of time before these items become mandatory.

For the economy lodging sector, staffing problems are particularly pronounced due to the remote areas in which they are located and an increase in competition tapping the same labor pool. The pool of resources from which to draw is less skilled and fewer in number than in major metropolitan areas. In addition, staffing costs are likely to rise slightly as a result of increases in minimum wage and mandated health care. These issues, however, will affect this segment less than others because most part-time positions are already compensated above minimum wage and because the number of full-time employees, and subsequently the number of people entitled to health benefits, is smaller than in larger, full-service properties.

Managers must forecast the future

Since many of today’s failures are a direct result of an organization’s failure or inability to forecast the future, it is imperative that managers scan the environment to formulate a view of the challenges and opportunities that will shape the future. Industry growth will continue, creating more competition and overbuilt markets. For new construction projects, properties will be smaller in size so they can be built in tertiary markets and still achieve high occupancy rates. For these properties, the challenge will be in recovering construction costs. Because there will be a smaller room pool over which to spread certain high fixed costs (e.g., lobby, telephone system, property management system), room rates are likely to be higher than in larger properties within the same chain. As development continues, this segment will approach saturation.

Economy properties, as with all segments of the industry, are going to seek new distribution methods, particularly as the cost of automa-
tion becomes more affordable for smaller hotels. When first conceived, the number of advance reservations was very small. The majority of guests were walk-ins. Today, the number has risen to more than 20 percent of all guest stays. The result is better planning for hotels, but at higher operating costs. Franchisors who provide global reservation systems are using these systems as a major source of revenue. Costs per reservation can average between $3 and $6, a rather large amount for such small room rates. The situation is further aggravated when a reservation is made through a travel agent who expects to receive at least a 10-percent commission. The profit margin erosion is significant for an industry that relies on such small margins.

Industry segmentation will continue to be blurred. Full-service lodging providers are discounting rates in order to build and maintain market share. To offset lower room revenues, full-service hotels have reduced staffing levels, services, and amenities. At the other end of the spectrum, limited-service providers are being challenged to provide more amenities and services at reasonable rates. They are caught in a catch-22, faced with having to provide many of the same features, services, and amenities of their full-service counterparts but at a fraction of the cost. The end result will be a balancing effect between the high end of the spectrum and the low end of the spectrum. As both ends push closer to the middle, the delineations between segments will become obsolete, and product identity will become confused.

Early warning signs indicate trouble ahead

The most significant concern is continued building in markets that lack sufficient demand to fill the new rooms. The limited-service/economy segment is already seeing warning flags. Analysts at Coopers and Lybrand are predicting declining occupancies and only slight gains in REVPAR and ADR. Their projections for the two-year period 1997 to 1999 are that REVPAR will increase 1.35 percent in the budget segment and 1.44 percent in the economy segment while ADR will increase $3.36 for budget hotels and $4.34 in economy hotels. 

Growth can be attributed to the initial success of this sector and the low barriers of entry. Early entrants have performed well and have had success in developing untapped markets. These hotels are also less complex, so that a “cookie cutter” model can be used for aggressive expansion. Financing is more attractive in this segment because budget/economy properties involve less capital. Financing often comes from small business loans, real estate investment trusts (REITs), and, in some cases, from large corporations interested in having low-cost lodging accommodations in markets where their employees travel.

Higher operating costs will drive the limited-service segment out of business unless it can raise rates to cover these costs or find ways to
contain costs. As properties become smaller, they lose the room base in which high fixed costs can be allocated. Another concern is that not all costs are directly scaleable based on property size, and since there are certain minimum costs a property must absorb regardless of size, the result is smaller profit margins.

The performance of the lodging industry is cyclical and highly correlated to the performance of the economy. Demand closely parallels growth in GDP, while supply is dependent upon the availability of capital or financing. Figure 2 summarizes the remote factors and the operating factors impacting this segment of the industry. Although many of the leaders in this segment are performing quite well, this segment is mature and nearing saturation as the rate of growth in room supply outpaces that of demand. Evidence can be seen by lackluster performance in occupancy growth and REVPAR (revenue per available room). Furthermore, an increased focus on providing more services and amenities without corresponding rate increases reduces this segment's profit potential.

**Future looks promising**

The future outlook for the lodging industry as a whole looks promising, especially with the rebound in full-service and luxury hotels. However, for the economy/budget segment, the future looks less optimistic. It seems that this segment is following many of the same trends that were experienced by the full-service segment in the late 1980s and early 1990s. It is almost as if lodging operators have not learned from their previous mistakes. Due to rising costs, amenity creep, overbuilding, and trading up, the economy/budget segment is losing market share. While there will always be low-cost providers, the differential between these players and the more expensive players will become much smaller. The notion of what constitutes budget or economy will be redefined as hotels raise rates—especially as rates approach those of more service-oriented hotels. For the customer, the ability to find a bargain is becoming increasingly more difficult.

The future promises to be full of excitement and opportunity for those who look at these environmental threats as opportunities rather than hindrances. The industry will likely see more consolidation, creating several large players much in the same manner as in the airline industry. More advanced uses of technology will give suppliers better control over their inventory and rate structures. In addition, there will be a tendency for more depersonalization as skilled resources become more scarce and more costly. While the challenges appear to be great, the industry as a whole will benefit from the solutions developed. It will be these major challenges that drive innovation, business process re-engineering, and additional applications of technology.
### Figure 2  
Remote Factors

#### Ecology
- Greater emphasis on environmental awareness and recycling
- Introduction of Green Rooms
- Recycling programs to reduce waste removal costs and promote environmental consciousness

#### Economy
- Reduced number of vacations and average length of stay
- Demand is cyclical and parallels trends in the economy
- Fluctuating interest rates could impact ability to pay debt service
- Consumer confidence is slow to respond in economy segment
- Segment is nearing its saturation point
- More opportunities for financing

#### Political
- Instability in international markets
- Increased terrorism, both domestically and internationally
- New tax could hurt industry directly and indirectly
- Healthcare reform will change benefit and compensation packages
- Increased regulation on small business loans

#### Social
- Rising concerns for personal safety and security
- Aging demographics means rising senior citizen market
- More sophisticated, value-conscious consumers
- Focus on quality of life and balance of work and family

#### Technology
- Computer costs are now affordable for this segment
- Rise of the Internet and company intranets
- Growing trend for consumers to book their own reservations through PCs and the Internet
- Telecommunications upgrades to property PBXs
- Better information sharing between properties and home offices
- Technology applications will drive franchise selection
- More applications to be explored to decrease operating costs

*Connolly*
Figure 2 (continued)
Operating Factors

Suppliers
- Gasoline costs are on the rise, impacting consumer travel by automobile
- Airline travel is being discounted, encouraging more travel
- Rising costs of reservation services and higher transaction fees
- The successful restructuring of travel agent commissions in the airline industry may be followed by the hotel industry as a way to reduce operating overhead
- New channels of distribution are emerging via the Internet

Competition
- Substantial growth in room supply
- Introduction of new brands
- Discounting in midpriced hotels is luring away customers
- Increased market dominance by large chains

Customers
- More sophisticated, value-conscious consumers
- Business travelers are returning to more upscale facilities
- Consumers are demanding more services and amenities
- Access to better tools that facilitate comparison shopping

Labor
- High turnover continues to hurt the industry
- Lack of qualified applicants, especially in remote markets
- Difficulty in training
- Screening becomes more important as crime in the workplace rises
- Cultural diversity
- Increased competition tapping the same labor pool
- Rising labor costs

Creditors
- Investment community is responding to limited-service lodging segment
- New financing opportunities include small business loans and real estate investment trusts
- Traditional lenders are lending to this segment of the industry
- Franchisors to assist with product refurbishments
References

7. It should also be noted that this segment is comprised of a number of independent properties typically referred to as “Mom and Pop” operations. However, no statistics for the limited-service/economy segment were readily available to define what percentage of the market is controlled by these properties.

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