

The demands of globalization on the lodging industry

by Laurence Geller

In this guest editorial the distinguished president and CEO of Strategic Hotel Capital, Inc., a leader in the lodging industry, outlines his views in a paper written for the Review which was also delivered at the Credit Lyonnaise Lodging Conference in Paris in March of 1998.

There is a need for a committed international approach to the lodging business because the globalization of the industry is its future.

Though many companies would deny this, the reality today is that most companies in the industry are local or regional, with only a mere handful being truly global. In Europe there is a popular television game show called *Jeux Sans Frontieres* — “Games Without Borders,” in which teams from different European cities compete against each other. Like this game, this industry is an industry without borders.

Approximately 6 percent of the world's GNP is derived from the tourism industry. It ranks as the eighth largest economic contributor to the world's economy. Despite this size and its global importance today, the tourism industry, of which lodging is a critical component, is still in the growth stage of its life cycle.

The rapidly increasing growth of communications, improved transportation, better and more widespread education, increased leisure time, and more disposable income have accelerated the demand for expanded and more sophisticated travel and tourism experiences. Demographic trends will support the increased demands for business and leisure-related tourism well into the next century. These have forced, are forcing, and will continue to force change not only in



Laurence Geller

consumer demands, but also in the very structure of the industry's organization.

There will be continual increase in the blending of business travel with leisure travel. Technology will enable radical changes in the channels of distribution for business within tourism and, more critically, within the lodging industry. As sophisticated management control, delivery, and booking and reservation distribution systems are developed and professionally implemented, the lodging industry will itself be critically affected.

Consumers of tourism services will become increasingly educated about their options. They will represent an increasingly global and homogeneous force in their tastes, expectations, and demands. Strong brand recognition will be increasingly important. The lodging industry as a whole must believe in brand and product integrity and be consistent in its application both locally and internationally. It must target its product's design and marking in a very specific and focused manner and assume the inherent capital risks associated with such a narrow focus. The lodging industry must realize that a hotel cannot be all things to all people. A hotel must become the equivalent of a GAP, or a Benetton, or a Banana Republic, or a Tiffany's, or a Gucci, etc.

The lodging industry will ultimately learn from other consumer product and brand-led industries. Resembling them in many aspects, one might say that it is simply a capital-intensive consumer product business. It must acquire this self-identity or it will fail to reap the benefits of today's trends.

Industry will be dominated by mega-vendors

The tourism industry will evolve into several clearly defined, interdependent segments, one of which will be the lodging industry segment. Each segment will be dominated by a handful of mega-vendors who will pursue constant consolidation in their respective industry segments. The overriding characteristic of these mega-organizations will be their marketing knowledge and strength, their use of increasingly sophisticated technology to understand and service their respective markets, and their ability to raise capital much more cheaply than any competitor.

Importantly, these organizations will be

- staffed by the "best and the brightest"
- growth oriented
- oligopolistic in their attitude, and single-mindedly focused and determined in their drive for profit-driven market domination
- flexible, with the ability to adapt to changing markets and consumer trends

- in possession of increasingly sophisticated operating and distribution systems.

Two principal prototypes will exist

Within this lodging industry segment, the mega-brands will be divided into two successful management prototypes. First, there will be the franchisors, who will invest heavily in franchising technology such as design, operating systems, reservations, marketing, quality control, training, and the like, but will rarely, and only reluctantly, invest in real estate. Among these could be Hospitality Franchise Systems (now Cedant), Holiday Inn, Choice, and Radisson.

By virtue of their earnings demands, these companies must be in the bulk hotel business. They depend on fees and used to have many worldwide locations (pins on the map) to generate these fees. But if history is any guide, it will likely be difficult for them to really control product consistency. Although these firms will work increasingly hard to meet these challenges, it will not be easy because historical obligations, culture, laws, and precedent will present practical difficulties.

The second lodging prototype will consist of those chains that are primarily operators and can truly control consistency and quality. These will be firms such as Hyatt, Marriott/Ritz Carlton, Sheraton/Westin, Four Seasons, and Hilton/Hilton International, among others. There will also be some hybrid franchisors who will invest in key locational and distributionally critical real estate assets but will build up their global presence largely through management contracts. Like the major prototypes mentioned above, these, too, will invest in their strategies and plans and will select only the very brightest and the best to join their ranks. They will invest heavily in operating systems, marketing systems, direct sales, and database collection. Above all, they will invest in training, management development, and human capital in general.

Management is distinct from real estate ownership

The trend toward globalization, market domination and niche marketing will be relentless as the pace of technological development forces constant reengineering in the tourism industry in general, and the lodging industry in particular. Therefore, the investment required by both groups of mega-companies to acquire assets and build their systems and infrastructures will become increasingly greater. They will be forced to invest ever-larger amounts in technology, and to seek global distribution and domination. But capital will become increasingly intelligent, and it will be relatively cheaper for them, giving them yet another edge over their smaller competitors.

Furthermore, the global lodging industry will be forced to realize that it has, in reality, two very separate and distinct components:

brand, chain and hotel management services on the one hand, and real estate ownership on the other. These are two fundamentally and completely separate types of businesses that the investment community will come to see as such. Investors will, of course, reward the best in each field with appropriately high valuations as reflected in high price/earnings ratios.

Companies will experience accelerated growth

From the above premise it follows that there will be a clear acceleration of growth in the pure management business, where the rewards for managers, skills are performance-based fees. In this case, the managers' capital investments will mostly be in brand, services, technology, human capital, training, and infrastructure, rather than in the bricks and mortar of real estate. Although they will occasionally build for strategic distributional reasons, their industry segment will be principally in the fee-for-services business.

The corollary to this will be a clear growth in the professional hospitality real estate ownership industry on a global basis.

Pure asset management will also experience growth

Because of the growth of real estate ownership as a business prototype distinct from the fee-for-services management business, there will be an inevitable growth in dedicated asset management as a distinct, clearly defined, well-respected profession within the real estate industry, as well as within the hospitality industry.

In general, today the term "asset manager" is ill-defined and generally abused, and can mean almost anything to anyone. One often sees consultants, retired general managers, bankers, institutional executives, and mixed-use real estate portfolio managers taking on that role. That type of almost ad hoc asset management will not enjoy much favor in the public arena of the future.

To put it simply, the asset manager will have a clear mission: to maximize the value of the particular hotel being managed by the fee-for-service operator. Therefore, tomorrow's breed of asset manager will be more a consultant and advisor to the operators than simply a cost controller. This will result in a more productive alignment between owners and managers of assets.

Greater flexibility for investors is the result

None of this is news. But as this trend accelerates, the clarity and necessity of this distinction will become increasingly obvious to, and demanded by, both the management companies and the worldwide investment community. Not only will the fee-for-services businesses be owned by the public, but, ever increasingly, so will the real estate itself. This is beneficial for investors who will now have the opportunity to

invest in management without investing in real estate, or vice versa, or perhaps invest in both sides of the lodging industry segment. Public ownership will tend to remove the capricious or inexperienced asset ownership groups of the past, as well as the vicissitudes and frailties of individually financed real estate holdings.

As these global trends become ever more apparent, the opportunity for new acquisitions will increase as lodging companies become increasingly willing to dispose of some, if not all, of their real estate to professional owners who are comfortable with long-term management agreements, and with whom they can have an ongoing growth relationship.

These opportunities should, of course, be viewed from a global perspective. As the opportunity for acquisitions diminishes in one market, perhaps due to pricing of assets, opportunities in other markets will inevitably arise. History has proven this to be the case, and history does repeat itself. At this moment some are saying that prices in the U.S. are becoming unattractive because growth rate expectations are diminishing. However, even those who suggest this will admit that this is not the case everywhere in the U.S. Historically different geographical areas and different product profiles have had different growth rates.

In Europe, as elsewhere, different countries and cities have different growth rate forecasts, as do the products and segment types within them. It is the job of investors to try to forecast what these growth rates will be and to try to invest in those markets with high barriers to entry, but with expectations or strong future growth.

Dynamics are similar in investment and management

The dynamics that affect real estate investment decisions are similar to those that affect lodging chains when deciding whether or not to enter a desired market. Therefore, the geographic distribution objectives of a strong brand will, most likely, be in line with those of the pure real estate investment side of the lodging industry segment.

Earlier this year, for example, Strategic Hotel Capital, Inc. acquired the newly-built Marriott on the Champs Elysees. Why? Research strongly showed high growth expectations for France in general and for Paris in particular. Furthermore, Marriott is, and will remain, one of the mega-organizations at the leading edge of global expansion. However, there are high barriers to entry in this market. The property was recently built at a cost well in excess of the purchase price.

Strategic Hotel Capital, Inc. felt that by combining its professional asset management skills and its proven techniques and services with Marriott's undoubted and proven systems and experience in the Paris market, both companies together would be in a position to make 2

plus 2 equal 5. Importantly, Strategic Hotel Capital, Inc. already has an extensive multi-property relationship with Marriott, as it does with others.

The global fundamentals of the lodging industry are powerfully compelling. If combined with professionalism, prudence, and caution, the industry will experience a continuum of success for many years to come. Also, as the giddy pace of consolidation continues, the real estate component of the lodging segment will grow and become not only a more clearly defined lodging industry prototype, but a much needed one as well.

Laurence Geller is president and CEO of Strategic Hotel Capital, Inc., of Chicago, Illinois, a multinational organization specializing in ownership and value added asset management services of first class and luxury lodging real estate. He has also served as executive vice president and COO of Hyatt Development Corporation and senior vice president of Holiday Inns.