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A 20th Century History and Delphi Study to Predict Changes in  
the Lodging Industry Structure, Performance and Capital Sources

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Arjun Singh

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of the requirements for

Doctoral degree in Parks, Recreation & Tourism

  
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**A 20<sup>TH</sup> CENTURY HISTORY AND DELPHI STUDY TO PREDICT CHANGES IN  
THE LODGING INDUSTRY STRUCTURE, PERFORMANCE AND CAPITAL  
SOURCES**

By

Arjun Singh

A DISSERTATION

Submitted to  
Michigan State University  
in partial fulfillment of the requirements  
for the degree of

DOCTOR OF PHILOSOPHY

**Department of Parks, Recreation and Tourism Management**

1999



The purpose of this study is to examine the role of business owners and managers in the development of the lodging industry, which also represents a significant change in the structure of financial institutions.

The overall design of the study is descriptive. The descriptive component of the study involves a review of the secondary literature and the use of a qualitative research technique.

The study is designed to examine the role of business owners and managers in the development of the lodging industry. Given the nature of the study, it is argued that the study is a qualitative study that is designed to explore the experiences of business owners and managers in the lodging industry.

## ABSTRACT

# A 20<sup>TH</sup> CENTURY HISTORY AND DELPHI STUDY TO PREDICT CHANGES IN THE LODGING INDUSTRY STRUCTURE, PERFORMANCE AND CAPITAL SOURCES

By

Arjun Singh

The purpose of **this** study is to make predictions in six areas of concern for lenders, investors, **owners and managers** associated with the U.S. lodging industry. These six areas, which **also represent** “uncertainties,” are: 1) capital needs of the lodging industry, 2) availability of **capital** for the lodging industry, 3) cost and terms of capital, 4) structural changes in the lodging industry, 5) operating and investment performance and 6) role of **financial institutions** as suppliers of capital to the lodging industry.

The overall **design** of this study includes a descriptive component and a predictive component. The **descriptive** component includes a review and analysis of historical (secondary) **literature and** interview data. The predictive component uses the Delphi technique, a **qualitative forecasting** method.

The study is **designed** within the context of the “open systems theory”, which views organizations as **open**, interacting and dependent on resources from the environment. Given **this premise**, the purpose of using this underlying theory to design the study (it is argued) is that the source of “uncertainties” impacting organizations originates from their **environment**. As a result, if this environment is clearly identified, systematically studied, some of these uncertainties can be converted into quantifiable

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risks with the desired result of an improved estimate of future U.S. lodging capital markets.

While the economy is expected to enter into a slower period by year 2000 and possibly even reach the bottom of the business cycle in the year 2005, the prediction of key economic indicators (such as inflation, interest rates) for both the periods is positive. This anomaly is explained by the fact that whereas business cycles indicate growth or decline as measured by GDP, other key indicators measure the overall business climate.

The financial services industry, which is a source of both debt and equity capital for the lodging industry, is expected to be operating in a more deregulated and fiercely competitive climate in the future. Regulations that segregate the various financial institutions are expected to be removed, opening up opportunities for each institution to expand the financial products that it can sell.

While the average firm in the lodging industry is predicted to become much larger through consolidation, this increase in size not expected to be the result of major increases in room supply in the U.S. However, the firm size is expected to grow through a combination of mergers, international expansion and introduction of new lodging products. (Example: Extended stay, assisted living facilities)

While Delphi panelists concur that capital will be available in both the prediction periods, lenders are likely to become increasingly selective as to whom and for what lodging products they will lend. Only those who meet lenders toughening operating and investment return requirements are likely to have ready access to capital in the future. While lending terms and criteria are not expected to be overly stringent panelists hope there will be enough capital market discipline to prevent overbuilding of the hotel industry.

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This Dissertation is primarily

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This dissertation is

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**This Dissertation is primarily dedicated to Maharaj Kumar Sahib, whose grace has helped me finish this project.**

**This dissertation is especially dedicated to my wife Kirti Singh for her moral support, help in keeping my priorities straight and continued love and guidance to our daughter Rajshree.**

During this long and arduous

process, he had a role in helping

prepare students and admini-

strators, however, the focus

was on the dissertation and to the

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ing my dissertation on

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of dissertation. Other pro-

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# INTRODUCTION

## Introduction (Study Context)

The lodging industry

beginning of the century, re-

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Specific examples

include the follow-

1. In 1909, hotels domi-

change because of the

2. During the 1950s, gro-

re, the popular "Road-

3. Accommodating Amer-

US hotel companies

## **Chapter 1**

### **INTRODUCTION AND STATEMENT OF THE PROBLEM**

#### **Introduction (Study Context)**

As the U.S. lodging industry approaches the end of the millennium, a glance back to the beginning of the century reveals that the industry's present structure and characteristics are very different from what they were earlier in the century. In its present form, the industry consists of a wide variety of facilities, ranging from small "mom-and-pop" operations to 5,000-room casino resorts. The average size of a typical hotel has grown from 46 rooms in 1933 to 73 rooms in 1996 (AH&MA). Furthermore, the industry has experienced broad changes in its structure, changes characterized by a major increase in the industry's size (room supply), a greater diversity of product, an increased complexity of ownership, a greater variety in organizational form operating arrangements, a broader geographic dispersion of properties, and an increasing trend for independents to be replaced by chains.

Specific examples of these changing trends in the U.S. lodging industry's structure include the following:

1. In 1939, hotels dominated the lodging industry supply, but by the 1950s this started to change because of the increasing presence of motels (Gomes, 1985).
2. During the 1950s, growth through franchising as a concept of ownership started to become popular (Rushmore, 1992).
3. As non-lodging American businesses went overseas in the 1950s and 1960s, many U.S. hotel companies followed (Kundu, 1994).

4. The passage of the Interstate Highway Act of 1956 led to the rapid growth of highway hotels.

5. In the early 1970s, the rising oil prices and inflationary pressure on the economy led to a decline in travel.

6. From time to time, new changes in demographics, such as the baby boom and extended life expectancy, have led to changes in travel patterns.

7. The changing management structure of hotels, from family-owned to publicly-traded companies, has led to a more professional and efficient management of the industry.

8. By the 1990s, the U.S. economy had recovered from the recession, and a growing middle class was able to afford more frequent travel.

The changes that have taken place in the hotel industry since the 1950s have been significant. The industry has grown from a small, family-owned business to a large, publicly-traded company. The industry has also become more professional and efficient, with a focus on customer service and quality. These changes have led to a more competitive and dynamic industry, one that is better equipped to meet the needs of a changing market.

Looking back to various periods in the history of the hotel industry, there were several key factors that shaped the industry's development. The early 20th century saw the rise of the hotel as a major mode of transportation, with the construction of the first hotels and the establishment of the hotel industry. The mid-20th century saw the rise of the motel and the expansion of the hotel industry into new markets. The late 20th century saw the rise of the resort and the expansion of the hotel industry into new markets. The early 21st century saw the rise of the boutique hotel and the expansion of the hotel industry into new markets. The late 21st century saw the rise of the luxury hotel and the expansion of the hotel industry into new markets.

The industry has also seen a significant increase in the number of hotels and the number of rooms. The number of hotels in the United States has increased from approximately 10,000 in 1950 to over 20,000 in 2000. The number of rooms has increased from approximately 10 million in 1950 to over 20 million in 2000. This growth has been driven by a number of factors, including the increasing demand for travel and the increasing competition from other modes of transportation.

During the 1950s, the hotel industry was largely dominated by family-owned businesses. These businesses were typically small and local, with a focus on providing a high level of service to their customers. However, as the industry grew, it became more difficult for family-owned businesses to compete. This led to the rise of publicly-traded companies, which were able to raise capital more easily and expand their operations more quickly.

For example, the Hilton Hotels Corporation was founded in 1919 and became a publicly-traded company in 1954. By the 1960s, Hilton was one of the largest hotel companies in the world, with over 100 hotels and over 1 million rooms. This growth was driven by a number of factors, including the company's focus on customer service and quality, its expansion into new markets, and its ability to raise capital from the public.

By the 1970s, the hotel industry was facing a number of challenges, including rising oil prices and inflationary pressure on the economy. These challenges led to a decline in travel and a decline in the hotel industry. However, by the 1980s, the economy had recovered and travel had increased. This led to a resurgence in the hotel industry, with many companies expanding their operations and raising their room rates.

The hotel industry has also seen a significant increase in the number of hotels and the number of rooms. The number of hotels in the United States has increased from approximately 10,000 in 1950 to over 20,000 in 2000. The number of rooms has increased from approximately 10 million in 1950 to over 20 million in 2000. This growth has been driven by a number of factors, including the increasing demand for travel and the increasing competition from other modes of transportation.

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During the 1950s, the hotel industry was largely dominated by family-owned businesses. These businesses were typically small and local, with a focus on providing a high level of service to their customers. However, as the industry grew, it became more difficult for family-owned businesses to compete. This led to the rise of publicly-traded companies, which were able to raise capital more easily and expand their operations more quickly.

4. The passage of the Interstate Highway Act of 1956 spurred auto travel and the further growth of highway lodging properties.
5. In the early 1970s, the supply/demand imbalance reduced national occupancies, putting pressure on hotels to expand via market segmentation (Ader & Lafleur, 1997).
6. From time to time new products were introduced by the lodging industry in response to changes in demographics and customer tastes and preferences. Two such products, all-suite and extended-stay properties, were introduced in the 1980s and continue to thrive today.
7. Operating arrangements have also undergone a change. Prior to the 1970s, owners mainly operated their own hotels, but by the 1980s, management contracts were prevalent. Management contracts ushered in new operating arrangements that separated management from the owners of hotels (Bell, 1993).
8. By the 1990s the U.S. lodging industry was considered a mature industry, with limited domestic growth, increasing consolidation, complex operating and ownership structures, and a growing international presence (especially on the part of U.S. hotel chains).

The changes that have taken place in the lodging industry are by no means linear. A glance back to various periods during the twentieth century reveals the cyclical nature of the industry. There were periods when hotel room rates, occupancies, and values were rising or peaking; during other periods, the same measures were declining or reaching rock bottom. For example, in 1990 the lodging industry reported a loss of \$5.7 billion, with occupancies of 63 percent and average room rates of \$57.96. In 1996, however, the lodging industry enjoyed record profits of \$12.5 billion, with occupancies of 65.2 percent and average room rates of \$69.66 (Smith Travel Research, 1997).

Closely associated with the structural evolution of the lodging industry and its growth rate have been changes in its need for and in the availability of debt and equity capital. During certain periods, capital has been readily available, while during other

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...products were fav ...  
...in the 1960s, whil ...  
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periods the industry has suffered from a dearth of capital. In the 1980s, for example, excess capital availability resulted in a period of overbuilding, whereas the early 1990s were characterized by a financing drought. Similarly, in different periods, different types of hotel products were favored by funding sources. For example, highway motels were favored in the 1960s, while the present focus is on financing full-service hotels (Hotel Partners Capital Group, 1997).

Various financial institutions have played a prominent role in financing the lodging industry during each of these periods. Until the 1960s, commercial banks, life insurance companies, and credit companies provided the majority of lodging industry mortgages. During the 1960s and 1970s, much of the growth in the lodging industry was financed by Real Estate Investment Trusts (REITs). As a result of deregulation in the early 1980s, the savings and loan industry began making commercial loans to hotel companies.

As a result of losses that incurred in the 1980s, the traditional lenders withdrew from financing the hotel industry. To fill the void, investment banks sold “financially engineered” derivative products (such as commercial mortgage-backed securities) to raise capital for the industry. Although traditional lenders have resumed making loans to the lodging industry, the scope of financing has been revolutionized because of access to public capital markets and the use of securitization to finance the industry.

The financial-services industry itself is currently undergoing various changes in its competitive and regulatory environment. These changes will have an impact on its future role as a supplier of capital to the lodging industry. The primary changes in the

regulatory environment  
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**Problem to Be Studied**

As noted, many change  
in the lodging industry  
in the lodging industry  
significant transformation.  
has many uncertainties. T  
lodging industry is depende  
of the literature and d  
following six types of uncer

- 1. Capital needs of the loc
- 2. Availability of capital
- 3. Cost and terms of cap
- 4. Structural changes of t
- 5. Operating performance
- 6. Future

regulatory environment of financial institutions relate to their ability to sell financial products. Firewall regulations such as the Glass-Steagall act of 1933 are in the process of being dismantled. If financial institutions are not restricted or segregated from selling different financial products, this will have implications for the competition amongst them and ultimately on the availability of capital for the lodging industry.

### **Problem to Be Studied**

As just noted, many changes have taken place in the structure of the lodging industry, how the lodging industry is financed, and the role of financial institutions as suppliers of capital to the lodging industry. The financial-services industry has itself experienced a significant transformation. As we approach the new millennium, the lodging industry faces many uncertainties. These uncertainties are based on the underlying premise that the lodging industry is dependent on financing for its growth and development. Through a study of the literature and discussions with financial and lodging industry experts, the following six types of uncertainties were identified as primary concerns for the industry:

1. **Capital needs** of the lodging industry in the future
2. **Availability of capital** in the future
3. **Cost and terms** of capital availability in the future
4. **Structural changes** of the lodging industry in the future
5. **Operating performance and investment returns** of the lodging industry in the future

Lenders, investors

confronted with uncertainty

economist's perspective on

whether or not the problem

the distribution is known

uncertainty prevails (Pyrrhus)

will say that in practice

uncertainty has limited

existence of future events

unique and ill-defined fees

Nevertheless, lenders

function of actual changes

which is after-the-fact

which is unanticipated

then there would be little

state of risk (Sinkovics)

While the six sectors

dependent of each other

technology industry

future uncertainty 4

already overbuilt, the

**6. Role of financial institutions as suppliers of capital to the lodging industry in the future**

Lenders, investors, owners, and managers involved in the lodging industry are not comfortable with uncertainties and the associated risks that they imply. From an economist's perspective, risk and uncertainty are different. One basis for this distinction is whether or not the probability distribution of outcomes is known or can be estimated. If the distribution is known or can be estimated, risk exists; if it cannot be estimated, uncertainty prevails (Pyhrr, Cooper, Wofford, Kaplan & Lapides, 1989). The authors go on to say that in practical business situations this pure dichotomy between risk and uncertainty has limited use. Most decision-makers have some feeling about the occurrence of future events. These may range from a high degree of confidence to a vague and ill-defined feeling of discomfort (Pyhrr, et. al., 1989).

Nevertheless, lenders, investors, owners, and managers are concerned about the direction of *actual change* in any future event. Sinkley (1992) states that actual change, which is after-the-fact future change, can be broken down into an *anticipated component* and an *unanticipated component*. If change consisted of only an anticipated component, then there would be little or no risk involved. The unanticipated component is clearly the source of risk (Sinkley, 1992).

While the six sources of future uncertainties stated above appear to be random and independent of each other, they are in fact related. For example, the future capital needs of the lodging industry (uncertainty 1) will depend on the current supply of various hotel products (uncertainty 4 - lodging industry structure). If the extended-stay segment is currently overbuilt, the demand for capital for that type of product may be limited in the

face. Similarly, as the firm's  
brand products, its op-  
erations determine its ability to  
succeed. As such, these under-  
standings are

Furthermore, the re-  
searcher's context of a the-  
oretical framework is the environment-  
based. Organizations exist in an en-  
vironment that impact an orga-  
nization's competitive customers, re-  
sources, and the management of the organization.  
Organizations within these  
environments face anticipated uncertainty  
and risk by analyzing  
this study will seek to

future. Similarly, as the hotel industry competes for capital with other real estate and financial products, its operating performance and return on investment (uncertainty 5) will determine availability of capital in the future (uncertainty 2) (Ostroff & Toman, 1995). As such, these uncertainties facing the lodging industry can be studied and anticipated.

Furthermore, the relationships illustrated in the previous paragraph can be studied within the context of a theoretical framework. The theoretical framework chosen for this study is the environment-structure-strategy paradigm. This paradigm suggest that all organizations exist in an environment and the various changes taking place in the environment impact an organization's strategy (and structure). Changes in the regulatory, competitive, customers, economic, demographic and technological issues in the environment of the lodging and financial services industry are a source of uncertainty for organizations within these industries. Any study that attempts to predict the unanticipated (uncertain) component of change in the environment would be converting uncertainty to risk by anticipating the occurrence of uncertain events. That is the problem that this study will seek to address.

## Deficiencies in the Literature

Review of the literature

Addressing the current problem

The literature addresses

Literature narrowly addresses

existing theses. The current

overall problem

A review of the literature

Industry-specific literature

Industry, but not between

between the lodge and

Although individual

proprietary reports

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in the role of financial

This study seeks

addressed in the literature

in which the problem

business environments

growth and development



## **Deficiencies in the Literature**

A review of the literature revealed the following deficiencies and shortcomings in addressing the current problem to be studied:

1. The literature addresses the problem in a piecemeal fashion. The scientific/academic literature narrowly identifies a theoretical construct and then uses various industries to test hypotheses. The expert opinion literature on the other hand studies parts of the overall problem.
2. A review of the literature also indicates that the available studies and reports are industry-specific. Either they address the lodging industry or the financial-services industry, but not both. No study was found that broadly studied the relationship between the lodging industry and the financial-services industry.
3. Although individual forecasts and surveys were found in the literature (generally proprietary reports) that include forecasts about the future of financing the lodging industry and the future of the lodging industry in general, no systematic study was found that addresses the changes in the lodging industry's structure and the changes in the role of financial institutions as suppliers of capital to the lodging industry.

This study seeks to address shortcomings in the way that this problem has been addressed in the literature by first identifying and reviewing the theoretical construct within which the problem is addressed. Next, using the theoretical model of organizations and their environments, the study will comprehensively and systematically analyze the disparate and disjointed expert-opinion literature to create a coherent historic and current

analysis of the problem

future scenario related to

literature on this problem

## Problem Purpose Statement

The central problem is that

current and issues that have

emerging industry. In

regulate some of the uncer-

tain

## Research Questions Statement

As mentioned previously,

emerging industry, and

industry. These changes

structure and the role of

through some information

comprehensively or sys-

discrepancy, a series of

analysis of the problem. Finally, the study will use experts to make predictions about the future scenario related to these issues and thereby make a new contribution to the existing literature on this problem.

### **Problem/Purpose Statement**

The central problem of the present study is to identify and comprehensively review the events and issues that have historically impacted the structure, performance and financing of the lodging industry. This historical insight, combined with predictions by experts, will mitigate some of the uncertainty surrounding lodging industry investment decisions in the future.

### **Research Questions/Study Objectives**

As mentioned previously, there are a number of changes taking place in the structure of the lodging industry, in how the lodging industry is financed, and in the financial-services industry. These changes create uncertainties about the future of the lodging industry's structure and the role of financial institutions as suppliers of capital to the industry. Even though some information exists on these changes, the documentation is anecdotal and not comprehensively or systematically treated in the literature. In order to mitigate the level of uncertainty, a series of research questions have to be sequentially posed and addressed.

Research questions related to:

1. What events and issues have shaped the industry from the early 20th century to the present?

2. What have been the major trends in the industry from the early 20th century to the present?

3. What have been the major trends in the industry from the early 20th century to the present?

4. What have been the major trends in the industry from the early 20th century to the present?

5. What have been the major trends in the industry from the early 20th century to the present?

6. What have been the major trends in the industry from the early 20th century to the present?

Research questions related to:

and financing trends:

1. What have been the major trends in the industry from the early 20th century to the present?

2. What have been the major trends in the industry from the early 20th century to the present?

3. What have been the major trends in the industry from the early 20th century to the present?

4. What have been the major trends in the industry from the early 20th century to the present?

5. What have been the major trends in the industry from the early 20th century to the present?

6. What have been the major trends in the industry from the early 20th century to the present?

7. What have been the major trends in the industry from the early 20th century to the present?

8. What have been the major trends in the industry from the early 20th century to the present?

Research question related to:

industry:

1. What major economic factors have shaped the industry from the early 20th century to the present?

2. What major economic factors have shaped the industry from the early 20th century to the present?

3. What major economic factors have shaped the industry from the early 20th century to the present?

**Research questions related to historic lodging industry structure and performance:**

1. *What events and issues in the environment have impacted the structure of the lodging industry from the early twentieth century to the current period?*
2. *What have been the structural changes in the lodging industry from the early twentieth century to the current period?*
3. *What have been the changes in the operating and investment performance of the lodging industry from the early 1990s to the current period?*

**Research questions related to historic lodging industry capital needs, availability, and financing trends:**

1. *What have been the current needs for which capital has been used by the lodging industry?*
2. *What have been the key events that have impacted the availability of capital to the lodging industry from the 1970s to the current period?*
3. *What financing trends have had an impact on the lodging industry from the 1970s to the current period?*
4. *What has been the role of individual financial institutions as suppliers of capital to the lodging industry in the latter half of the twentieth century?*

**Research question related to the current transformation of the financial-services industry:**

1. *What major economic, regulatory, and competitive issues and events are currently impacting and transforming the structure of the financial-services industry?*

Research questions relate

institutions; the lodging

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In the years 2000 and 20

1. The economic recovery

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5. The role of financial in

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## Significance of the Study

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**Research questions related to future changes in the environment of financial institutions; the lodging industry's structure, operating performance, and capital needs; and the role of financial institutions as suppliers of capital to the industry:**

**In the years 2000 and 2005, what will be:**

1. *The economic, regulatory, and competitive environment of financial institutions?*
2. *The structure of the lodging industry?*
3. *The operating and investment performance of the lodging industry?*
4. *The lodging industry's need for capital?*
5. *The role of financial institutions as suppliers of capital to the lodging industry?*

By successfully addressing these research questions, the study seeks to fulfill its objective of reducing the uncertainty associated with the flow of capital into lodging industry investments in the future.

### **Significance of the Study**

As Terenzini, Pascarella & Lorang (1982) state, "All good writers have an audience in mind." Similarly, the significance of the present study may be stated by keeping in mind the different audiences or users of the present study.

From a purely scholarly perspective, the study is important for two reasons. First, the approach used in this study to address the problem is unique, in that it combines disparate and disjointed expert-opinion literature from two separate industries and systematically analyzes it, based on a unified theoretical construct.

Second, the study  
examines investors' analysis  
of the future of the lodging  
industry, including changes in the  
industry that are expected to be used by the  
industry.

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Second, the study results will also appeal directly to industry practitioners such as lenders, investors, analysts, consultants, and lodging industry managers who have a stake in the future of the lodging industry and its sources of capital. By systematically chronicling changes in the past and predicting changes in the future, the study results are expected to be used by decision-makers in both the lodging and financial-services industry.

During the twentieth century many changes occurred in the structure of the lodging industry, the financing of the lodging industry, and the relationship between financial institutions and the lodging industry. These changes have been especially prominent in the past two decades. While scholars and industry practitioners representing both of these industries recognize the importance of these changes as well as the importance of the horizontal relationship between users and suppliers of capital, no inter-industry research has been conducted.

This study's lasting contribution is to open the door for inter-industry research between the lodging industry and the financial-services industry.

### **Delimitations**

There are various sources of debt and equity capital. However, the focus of this study is on financial institutions as suppliers of capital.

The study is focused on changes in the structure of the U.S. lodging industry and not on changes in the lodging industries of other countries.

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The historic review of the lodging industry and the financial services industry was restricted to the twentieth century.

The prediction component of this study focuses on two time periods in the future. Year 2000 and Year 2005.

### **Limitations**

The greatest criticism facing a study that attempts make long term predictions on financial issues is that markets are volatile and ever changing. The study's detractors may ask for instance, how can one possibly predict five years from now the lodging industry's performance or the cost of capital, its sources and whether or not capital will be available? The researcher realizes that these are limitations faced by this and other predictive studies.

However, in anticipation of this limitation, the study was designed to improve the accuracy of its predictions. First, the study was designed within the context of a theoretical framework. Most predictive studies don't do this increasing the possibilities of omitting important explanatory variables from the analyses. Second, a proven long-term prediction method was selected for this research, the Delphi technique. Third, this method was fortified by conducting a historical analysis of past and current trends, issues and events. I feel that these three features of the study improve the accuracy of the predictions that result.

Another limitation of the study is associated with the unequal response rates in the different rounds. While a total of 25 responses were received at the end of round one,

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### Definitions

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Financial institution

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#### 1. Depository institution

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#### 2. Contractual institution

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#### 3. Other financial institution

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only 20 responses were received at the end of the second round. As a result, the proportion of each type of responding institution was different between the two rounds.

### **Definitions**

**Financial institutions.** Financial institutions, as defined and discussed in this study, are those institutions involved in both semi-direct finance and indirect finance. The Semi-direct financial institutions included for the purpose of this study are investment banks (Rose, 1994). The primary purpose of these institutions is to raise or find capital from various sources. They generally do not use their own capital to make loans to hotels; rather they find capital through private placement by selling securities to institutional or high-net-worth investors or by selling securities in the open market.

Financial institutions involved in indirect finance may be categorized into three groups:

1. **Depository institutions:** These include commercial banks and non-bank thrifts (savings-and-loan associations, savings banks, and credit unions). These institutions derive their funds from depositors and use those funds to make loans to hotels.
2. **Contractual institutions:** These include life insurance companies and pension funds. They derive their funds from life insurance contracts or employee retirement plans. These funds are then used to make loans to or invest in hotels.
3. **Other financial institutions:** These include finance companies and investment companies (mutual funds). The former derive their funds by securing loans in the open market, which they then use to make loans at a higher rate. Investment

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companies (mutual funds) derive their funds from the investing public; these funds are pooled to make investments in various debt and equity securities. Investment companies do not make loans to or invest directly in hotels.

**Financial-services industry.** The financial-services industry consists of all of the institutions just defined, which provide both semi-direct and indirect financing. The scope of the industry is global and the industry's customers include governments, other financial institutions, businesses, and individuals. The industry is impacted by a number of regulatory, competitive, technological, and general economic factors in its environment. It is currently in a state of significant and accelerated transformation.

**Capital.** Capital may be defined as both debt capital and equity capital. Debt capital includes both direct loans and the issuance of debt securities such as bonds. Equity capital includes both direct investment in a hotel and investment in hotel company stock.

**Securitization.** For many years hotel mortgages were considered illiquid (difficult to convert to cash). This situation was highlighted in the wake of the savings-and-loan crisis and the subsequent abundance of non-performing hotel loans. Nomura Securities (an investment bank) pioneered a way to package these loans and sell them as units similar to stocks or bonds. An investor who invests in a unit of this type can then buy or sell his unit in a secondary market, much like buying or selling a stock or bond. This conversion of a mortgage from an illiquid instrument to a liquid and tradable unit has come to be known as "securitization." It has revolutionized investment in real estate in general, including hotel real estate. The most popular form of this security, which is backed by mortgages, is called CMBS, or commercial mortgage-backed security.

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## **Summary of Subsequent Chapters**

The study first sets the stage by reviewing the pertinent theoretical and industry literature and then provides a detailed explanation of the procedures adopted. This is followed by an historical analysis of the lodging industry that includes changes in its structure and operating and investment performance. Next, lodging industry capital needs, capital availability, and financing trends are discussed. Following this, an in-depth analysis of the transformation of the financial-services industry is presented. Finally, results of the Delphi Study are analyzed, with appropriate discussion of results.

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## **Chapter 2**

### **REVIEW OF LITERATURE**

The purpose of this chapter is to provide a theoretical basis for the study and summarize relevant and current literature that was used confirm the theoretical construct. The chapter is divided into two parts. Part I provides an overview of the relevant foundation literature on macro organizational behavior. This is a subfield of organizational behavior and focuses on the understanding of the “behaviors” of groups and organizations (Wagner & Hollenbeck, 1995). The primary purpose of reviewing the foundation/conceptual literature is to provide a base upon which the current study will be designed. As outlined in the problem statement discussed in Chapter 1, the central problem of this study deals with uncertainty facing organizations in both the lodging and financial-services industries. The source of this uncertainty originates from the environments of these organizations. Therefore, before researching the issues related to the central problem, it is important to review and understand the theoretical literature about organizations and their environments.

This is all the more important because the current problem has been previously studied in a piecemeal fashion (see “Deficiencies in Literature,” Chapter 1) without first identifying and reviewing a theoretical construct. This study seeks to overcome this deficiency by first establishing a theoretical framework within which the study will be designed and conducted. Therefore, Part I of the literature review will include: (1) the evolution of the concept of organizations from closed to open systems, (2) the various

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concepts of organizational environments, (3) levels of analysis, and (4) dimensions of the environment.

Part II of the chapter summarizes current and relevant studies that have specifically tested the organization-environment construct described in the foundation literature. These studies include organizations in the financial-services industry, other service industries, and the manufacturing sector. The purpose of Part II is to show the ongoing dialogue in the literature about the relationship between organizations and their environments and provide evidence of support for the theoretical basis for the study.

## **Part I: Foundation Literature**

### **Evolution of Organizational Concepts from Closed to Open Systems**

The traditional organizational theorists may be called “closed-system” theorists. Their primary focus was on the internal workings of organizations. From 1900 to about 1950 this “mechanistic” school of thought was dominant. Factors such as efficiency, achievement of specific organizational goals, and formalization of structure and regulations were some of the key concepts focused on by these theorists. Some of the principal early theorists and their works included Fredrick W. Taylor’s *Scientific Management School* (1911), Max Weber’s *Theory of Social and Economic Organization* (1947), Henri Fayol’s *General and Administrative Management Theory* (1949), and Herbert Simon’s *Theory of Administrative Behavior* (1957).

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The second wave of closed-system theorists also focused on the internal workings of organizations; however, they focused more on the behavioral structure of organizations rather than their “mechanistic” workings. These theorists emphasized the behavior and motivations of the participants (employees) within an organization. This “behavioral school” was dominant from 1945 to 1960. Some of the principal theorists and their works during this period included Elton Mayo’s Human Relations School (1945), Daniel Katz and Robert L. Kahn’s Informal Group Processes (1952), and Douglas McGregor’s Theory X and Theory Y (1960).

The major departure of the modern organizational theorists from their traditional counterparts was that, while the latter viewed organizations as sealed off from their environment (closed), the modern theorists viewed organizations as open, interacting, and dependent on resources from the environment. This “open-systems” perspective was based on the general systems theory, whose founder, Ludwig von Bertalanffy, stated that most scientific inquiries such as nuclear particles, atoms, molecules, cells, communities, organizations, and societies can be collapsed under the general rubric of a “system” (Bertalanffy, 1956).

Buckley (1967) described the twin characteristics of open systems. First, open systems have processes that preserve their form, structure, or state. In a human body, circulation and respiration would provide that function, while in social systems such as organizations, control activities and socialization would serve this role. The second characteristic refers to those processes that change the system through growth, learning, and differentiation. Organizations in the financial-services industry and the lodging

theory today bear little

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### Contingency Theory

"Contingency theory" is a

that challenges the "one-size-

fits-all" system theorists. It

argues that organizations should

reorganize and that

reorganization operates

as—or should be—contingent

on the order to be effective

alignment between management

practices and the environment

(Lewin & Nathan, 1967).

The empirical studies

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industry today bear little resemblance to their respective structures at the turn of the century.

As the open-systems approach became accepted, various organizational behaviorists established different schools of thought to typify the open-systems approach. Three of the most popular schools are briefly discussed in the following sections.

### **Contingency Theory**

“Contingency theory” is a term coined by Paul R. Lawrence and Jay W. Lorsch (1967) that challenges the “one-best-way-to-organize” assumption of Fredrick Taylor and other closed-system theorists. The contingency theory states, in fact, that there is no one best way to organize, and that the best way depends on the nature of the environment in which the organization operates. According to the contingency theory, organization designs are—or should be—contingent upon the environment. The implication of this approach is that in order to be effective, organizations must achieve a “fit” (that is, a match or alignment) between management processes, structure, strategy, and the environment (Galbraith & Nathanson, 1978).

The empirical study conducted by Lawrence and Lorsch (1967) included environments of organizations in different industries, such as the plastics, food processing, and standardized-container industries. The organizations in each of these industries operated in a different environment, ranging from the plastics industry, which operated in a dynamic environment, to the container industry, which operated in a stable

environment. Their findings  
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### Strategic-Choice Approach

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environment. Their findings indicated that the organizations within these industries were structured differently, based on the type of environment in which they operated.

Although Lawrence and Lorsch coined the term “contingency theory,” other theorists conducted studies that substantially expanded the theory. Each of these studies had different methodologies, populations, and “contingencies”; however, they all confirmed the impact of the environment on organizations. These other contingency theorists include Tom Burns and G. M. Stalker, who published a study entitled *Management of Innovation* (1961), and Stanley Udys, who published a study entitled *Organization of Work: A Comparative Analysis of Production Among Non-Industrial Peoples* (1959).

The contingency theory and the related studies just cited, established the “open” nature of organizations and their “contingent” relationship with various aspects of the environment. Thus, the performance of an organization is dependent on the “fit” achieved between the organization’s strategy, structure, and environment.

### **Strategic-Choice Approach**

The contingency theory established the importance of variables in the environment as sources of influence on organizations. However, in the 1970s a new set of organizational theories—the “strategic-choice approach”—emerged that criticized the contingency approach as being too “deterministic.” On the one hand, these new theories further defined the environment as a source of resources and information upon which organizations depend, but, on the other hand, they argued that organizations were not

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passive recipients of these organizational influences. Managers, through the agency of “choice,” could influence the direction of the organization. John Child (1972) and his “strategic choice” perspective countered the deterministic perspective of the contingency theorists by presenting three arguments in favor of organizational participants: (1) decision-makers have more autonomy than implied by contingency theorists, (2) organizations have the power to manipulate and control their environments, and (3) perceptions and evaluations of events are an important intervening link between environments and an organization’s actions.

### **Population Ecology**

Initially proposed by Michael Hannan and John Freeman in the 1970s, “population ecology” stated that organizations adapt to changes in their environment. However, the focus of Hannan and Freeman’s investigation was not individual organizations but groups of organizations (known as “populations”) that shared similar forms—for example, banks or restaurants. They argued that adaptation takes place by the creation of populations with new forms that replace existing populations. The reason for this is that strong “inertial forces” prevent organizations from changing, but new environmental forms, more suitable for the changed environment, enter and take the place of these old forms (Hannan & Freeman, 1977). For example: Advances in computer and information technology are placing pressure on traditional banks, which have a physical location. Will these new “virtual banks” replace banking, as we currently know it?

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This brief review of the literature of the open-systems approach has established the relationship of organizations and their environments as discussed in the foundation literature. Despite the lack of complete unity among theorists, it is clear that the environment is not a residual factor, something completely “outside” the organization. It is indeed a “causal force influencing the structure or activities of organizations as a set of independent or interdependent variables” (Scott, 1981).

### **Concept of Organizational Environment**

Having established that organizations are open systems that interact with their environment, the next question to ask is: what is the environment and how is it viewed? To answer that question, it is important to review the foundation literature related to the concept of the organizational environment. R. T. Lenz and J. L. Engledow (1986) performed an extensive review of the literature on environments and developed five concepts of environments. Three of these concepts are summarized below, as they are the concepts used when viewing the environment for the present study.

From an industry-structure perspective, the environment is viewed as consisting of competitive forces. The forces of buyers, suppliers, customers, and competitors act upon an organization to create opportunities and threats. For example, if the number of financial institutions that want to loan capital to the lodging industry increases, the bargaining power favors the lodging industry and an opportunity exists. The opposite is the case if fewer suppliers of capital exist. Michael Porter advanced this view (Porter, 1980).

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The **organizational-field model** views the environment from the viewpoint of interacting organizations. From this perspective, the environment could be viewed as a focal organization, such as a hotel company, surrounded by interacting organizations, such as competitors, suppliers of capital, and regulators. (A more detailed explanation of the literature on this conceptual approach will be presented in the “Level of Analysis” section later in the chapter.)

Finally, from a **resource-dependency perspective**, the environment has finite resources (such as capital), and organizations that need these resources (such as lodging companies) compete to get these resources. Pfeffer and Salancik (1978) advanced this viewpoint.

### **Level of Environmental Analysis**

A review of the literature on environments indicates that researchers study the environment at one of the following three levels:

1. Level 1: Organization Set
2. Level 2: Organization Population
3. Level 3: Communities of Organizations/Organizational Field

Each of these levels will be briefly discussed in the following sections.

#### **Level 1: Organization Set**

An “organization set” consists of those organizations with which the focal organization (organization being studied) has direct links (Aldrich, 1979). For example, an individual banking organization such as Bank of America, has an organization set that includes

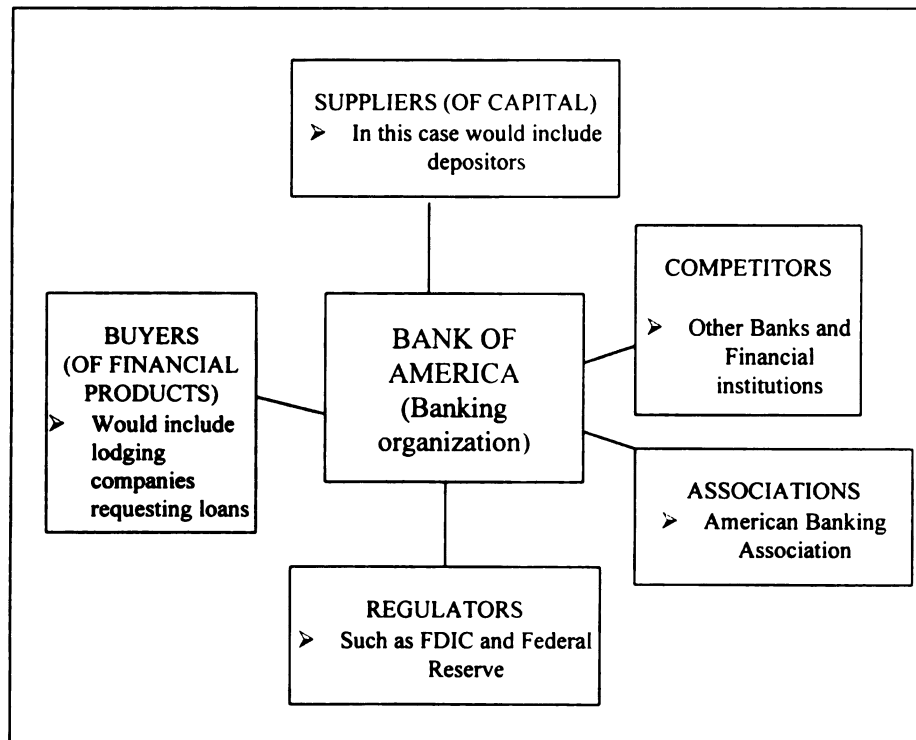
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buyers (customers such as borrowers), suppliers (depositors), competitors (other financial institutions), and regulators. Lodging companies borrowing capital would be included in the customer component in this organizational set. The concept of the organization set is graphically illustrated in Figure 1.



**Figure 1. EXAMPLE OF AN ORGANIZATION SET**

A concept related to that of the organization set is that of the “task environment.” This term was coined by William R. Dill and has served the purpose of providing a parameter

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According to Dill, the task environment consists of four elements that have the most impact on goal attainment: customers; suppliers (labor, capital, material); competitors (markets and resources); and regulatory groups.

### Level 2: Organization Population

An “organization population” consists of those organizations with similar “forms.” In the organization-behavior literature, an “organizational form” is defined as those organizations that have similar goals, technology, structure, and markets (Hannan & Freeman, 1977). An organization population of hotels (with similar forms) may consist of organizations that operate luxury hotels in the United States. These may include companies such as Ritz-Carlton, Four Seasons, Marriott, Westin, and other similar organizations. A population of investment banks (with similar forms) may consist of Merrill Lynch, Goldman Sachs, Morgan Stanley, Bear Stearns, and other investment banks. The concept of organization populations is graphically illustrated in Figure 2.

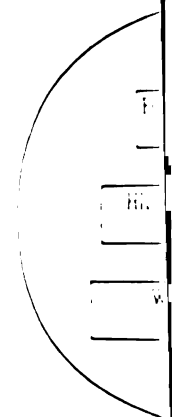


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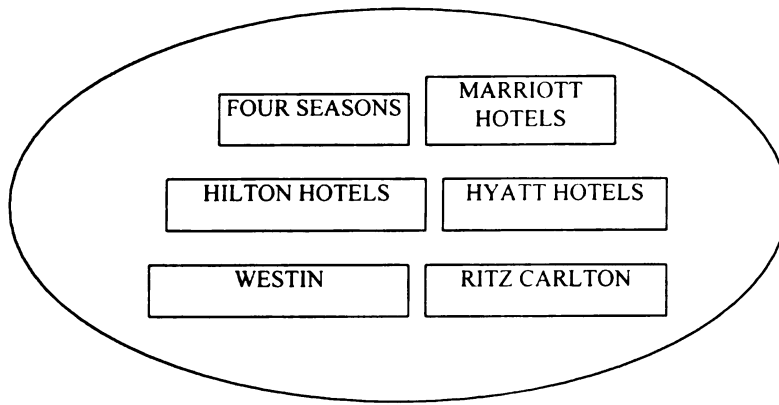
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Figure 3.



**Figure 2. EXAMPLE OF AN ORGANIZATION POPULATION CONSISTING OF LUXURY HOTEL COMPANIES**

Level 3: Communities of Organizations/Organizational Field

The community level of environmental analysis is concerned with sets of interacting organizations or with interdependent populations of organizations (Aldrich & Marsden, 1988). At this level, the researcher could focus on relations linking a collection of organizations within a limited geographic area. The main emphasis in this analysis is on the pattern or network of relations connecting them (Scott, 1987).

A community of organizations could include organizations in the lodging industry and various organizations that supply capital to those organizations, such as organizations in the financial-services industry. Each of these organizations interacts with others in an interdependent relationship. Organizations such as banks, thrifts, finance companies, investment banks, life insurance companies, and pension funds seek to lend and invest in organizations. At the same time, organizations in the lodging industry perceive these capital-providing organizations as sources of funds to finance their growth and development. The concept of organization communities is graphically illustrated in Figure 3.

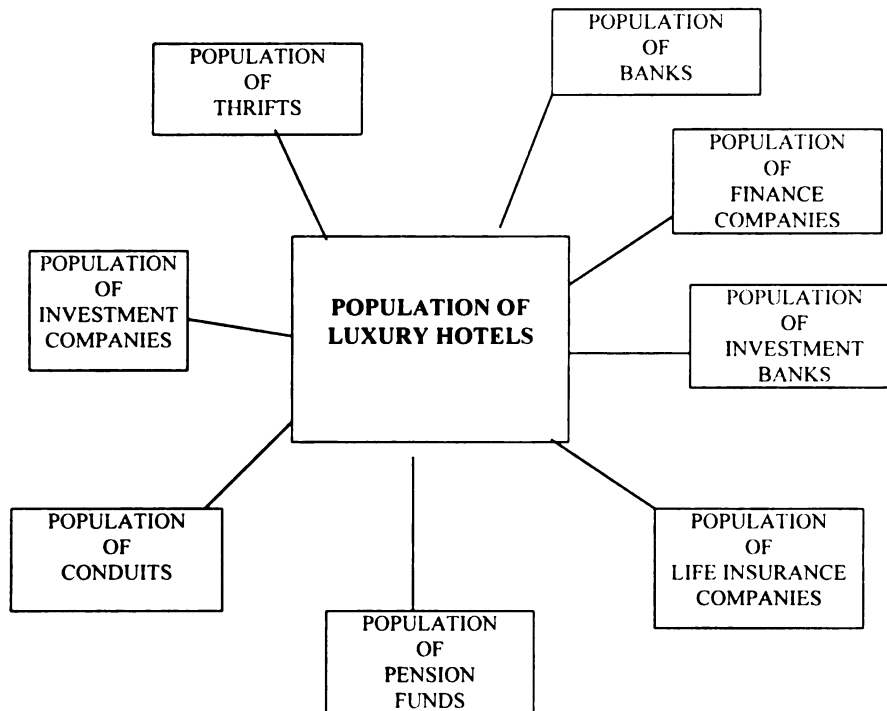
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**Figure 3. EXAMPLE OF COMMUNITIES OF ORGANIZATIONS, SHOWING INTERACTION AND INTERDEPENDENCIES BETWEEN LUXURY HOTELS AND THE FINANCIAL-SERVICES INDUSTRY**

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## Dimensions of Environ

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At the narrowest level, the present study analyzes the environment of financial institutions at the organizational-set level. Questions having to do with the impact of regulations and competitors on a financial institution's decision to lend or invest capital, or the impact of the financial performance of customers (hotels, for example) on a financial institution's decision to lend or invest capital, are asked at this level of analysis. At the organization-population level, questions in the present study relate to the structure of the lodging and financial-services industry. Questions having to do with the introduction of new lodging concepts and the demise of old ones are asked at this level of analysis. The introduction of an all-suite "population" of hotels and a population of "time-share" properties are examples of new organizational forms that have had an impact on the structure of the lodging industry. At the broadest level, however, the present study analyzes the environment of organizations at the community level—that is, it analyzes the interdependent relationship between populations of various financial-service organizations and populations of hotels. Questions at this level of analysis pertain to the role of financial institutions as suppliers of capital to the various "populations" of hotels.

### **Dimensions of Environments**

After conceptualizing the environment and identifying the level at which the observation will take place, the next step is to identify the components and dimensions of the environment to be studied. The purpose of this preliminary step of identifying the dimensions is to provide a concrete structure to the environment. Whereas

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conceptualizing the environment helped to establish a viewpoint about the environment (forces, or a stock of resources) and the level of analysis helped determine at what level the observation will take place, the dimensions of the environment will help identify the variables for this study.

Fortunately, various theorists have identified the dimensions of organizational environments. Richard W. Scott and Howard E. Aldrich, after reviewing the literature of organizations and their environments, have compiled and summarized the most comprehensive typology of environmental dimensions (Scott, 1987; Aldrich, 1979). These dimensions are summarized in the seven categories discussed below. This typology was used as a basis to identify the dimensions along which the variables were measured for the current research.

**1. Degree of homogeneity-heterogeneity:** This dimension deals with the degree of similarity or differentiation between elements of the environment, such as customers, suppliers, and competitors. Environments with a large number of elements are considered heterogeneous; those with just a few elements are considered homogeneous. For example, in a period of rapid consolidation within the financial-services industry, the environment would be moving towards homogeneity, while during a period of divestitures, the financial-services environment would be more heterogeneous. A more homogeneous environment within the financial-services industry might mean less competition among suppliers of capital and therefore higher costs of capital.

**2. Degree of stability-change:** This dimension refers to the degree to which the elements in the environment are undergoing change. For example, an environment with

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new competitors coming into the market at a rapid rate would be considered unstable, while a market with no change in competitors would be stable. In the 1960s, the banking industry was considered to be regulated and stable. The interest rate paid for deposits and interest rates charged for loans was fairly stable. The level of competition was also limited. However, the current environment of the financial-services industry is characterized by a high degree of change.

**3. Degree of interconnectedness-isolation:** Interconnectedness relates to the number of linkages among organizations. “The greater the level of system connectedness, the more uncertain and unstable the environment for given organizations. Changes can come from anywhere without notice and produce consequences unanticipated by those initiating the changes and those experiencing the consequences” (Pfeffer & Salancik, 1978). The increase in globalization of the financial-services industry is an example of this system interconnectedness. Changes in the economies of Asia, Russia, or Brazil have financial repercussions throughout the world. As the lodging industry moves more from private sources of capital to public sources of capital, its exposure to this interconnectedness increases.

**4. Degree of domain consensus-dissensus:** This dimension indicates the degree to which an organization’s claim to a specific domain is disputed or recognized by other organizations, including government agencies. For example, the current environment for financial institutions reveals a lack of consensus as to the ability of banks to provide investment-bank services and sell investment products.

**5. Degree of munificence-scarcity:** This dimension relates to the resources required by an organization and how available they are in its environment. In an environment where

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capital is abundant and readily available, the environment for the lodging industry is munificent. If few financial institutions are making loans or investing in commercial real estate, the environment for the lodging industry is characterized by scarcity.

**6. Degree of concentration-dispersion:** This dimension deals with the extent to which the environmental resources available to an organization are evenly distributed and available or are concentrated in just a few places. For example, sources of capital may be evenly spread among many financial institutions or concentrated in the hands of just a few. Restrictions on the geographic or product expansion of banks may limit their lending capability to particular geographic locations or types of financial products, which works against dispersion.

**7. Degree of environmental hostility-benevolence:** This refers to the disposition of the environmental actors (such as government regulators) toward the focal organization. For example, tax laws can be hostile or benevolent and act to dampen or promote investment in certain industries.

Based on the analysis of the literature on environmental dimensions, it is clear that there are various dimensions to an organization's environment. Each of these dimensions are not static conditions but change over a period of time. The environments of both the financial-services industry and the lodging industry have changed from earlier *in this century* to the current period, and continue to change. These changes, which appear *to be* taking place at random, are easier to understand when reviewed in the context of the *dimen*sions of organizational environments just discussed. The present study will attempt

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### **Theoretical Basis for the Current Research**

After reviewing the foundation literature on macro organizational behavior in general and on specific organizations and their environments, a theoretical foundation for the current research may be summarized as follows:

- A. All organizations exist in an environment. These environments are central and are not a residual part of the organization.
- B. Organizations are “open systems” in that they interact with the environments in which they exist.
- C. The interaction with the environment may take the form of adaptation or strategic response, as stated by the contingency and strategic-choice theorists, or take the form of evolution and replacement, as stated by the population-ecology theorists.
- D. The environment within which organizations interact may be identified and analyzed at various levels, ranging from “organization sets” at the narrowest level, to “organization communities” at the broadest.
- E. In order to observe the environment of organizations, it is important to understand the environment’s dimensions. These can be measured by looking at the degrees of **homogeneity-heterogeneity**, stability-change, interconnectedness-isolation,

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- F. In the process of interacting with the environment organizations (such as financial institutions) make decisions and choices in response to their perception of the environment.
- G. The present study will review the environment of both the financial-services industry and the lodging industry. Furthermore, the study will ask a panel of experts to predict their perception of the environment and their lending and investing decisions to the lodging industry in the future. The theoretical literature summarized in Part I of this chapter provides the necessary structure and framework to conduct this analysis.

## **Part II: Summaries of Current and Relevant Literature on Organization and Environment Relations**

Part I reviewed the theoretical/foundation literature on organizations and their environments. Part II reviews research that has used various open-systems constructs to test hypotheses about the relationship between organizations and their environments. The studies reviewed in Part II have been divided into two categories: studies using organizations in the financial-services industry, and studies using general business *organizations*.

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## **Studies Focusing on Organizations in the Financial-Services Industry**

Ari Ginsberg (1985) studied the strategic adaptation of financial depository institutions in a changing environment. His study included 168 commercial banks and savings institutions in Pennsylvania. The data were analyzed using regression analysis, and it was discovered that product development and increases in the entrepreneurial orientation of the institutions were influenced by increases in environmental heterogeneity. Furthermore, it was found that cost-reduction strategies were influenced by environmental hostility. It was also found that growth-related strategic changes were influenced by changes in environmental heterogeneity.

Leith Wain (1995) studied the strategic response of U.S. commercial banks to environmental changes from 1975-1990. His study chronicled the major environmental events during this 16-year period and, using regression analysis, showed that environmental change and environmental uncertainty are significant predictors of financial institutions' strategic actions. "Banks respond to a combination of regulatory change and economic uncertainty by altering their lending practices . . . and lines of business" (Wain, 1995).

His research confirms three facts about the environment: (1) environmental change and uncertainty are important predictors of organizational strategy, (2) government regulation plays a key role in predicting strategic responses, and (3) the response to government regulation may be opposite to that expected in the traditional strategic-management literature but is consistent with financial literature, which identifies the factors that may encourage risk-taking activities.

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Zajac and Shortell (1989) found that, in general, firms adapt their strategies in response to major environmental variation. Furthermore, this study showed that changes in the environment affecting the population of firms may result in an industry-wide shift in strategy. As an example, changes in the regulatory environment for financial institutions in the 1980s resulted in an industry-wide shift that increased real estate loans by savings-and-loan institutions.

Sarah Blaine Kendall (1987) focused on the factors that induced risk-taking by banks in various economic environments. Her study took the form of an essay, which proposed a model of a bank's portfolio choice. According to the model, the portfolio choice is a function of a bank's net-worth-to-asset ratio and the regulatory constraints imposed on the bank. The essay concludes that when banks have a low net-worth-to-asset ratio and the probability of regulator intervention is high, the banks will engage in "high roller" behavior, in which high-risk investments are undertaken. Essentially, the conclusion of this essay on banking supports the "contingency-theory" construct of organization-environment relations, by stating that a bank's portfolio strategy is determined by regulatory constraints.

Based on a study of 80 savings-and-loan firms into the antecedents of performance, Lenz (1980) investigated the effect on performance of an organization's environment, strategy (measured by resource allocation), and structure. His basic hypothesis was that performance is a function of environment, strategy, and organizational structure. He used Dill's (1958) goal-attainment concept of "relevant environment" to operationalize the environment. Strategy was measured in terms of resource allocations and policies that had an impact on the competitive position of the

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firm. His measures of organizational structure included the design and processes of an organization. Most of the data for the study were collected using secondary federal and state government sources and field and telephone interviews. He found that the environment, strategy, structure, and performance of high-performing firms are different from low-performing firms. This conclusion lends credence to the theory that the performance of an organization is influenced by the co-alignment of environment, strategy, and structure.

McKee, Varadarajan, and Pride (1989) studied the banking industry in 50 standard metropolitan statistical areas in seven unit banking states. A sample of 560 banks were surveyed. Using contingency theory as the theoretical construct, they tested the hypothesis that the environment (market volatility in this case) affects strategy and performance. They found that firms that are able to adapt their strategy to fit the environment perform at a higher level. Certain types of strategies work better in certain environments than in others. The findings of the study suggest that market volatility is a “quasi-moderator” of the strategy-performance relationship. However, not all of the a priori expectations of these relationships were supported by the study.

Haveman (1993) tabulated data on California savings-and-loan institutions or “thrifts” from 1977-1986 to show changes in their asset portfolios from the pre-deregulated environment to the deregulated environment. The data for this study were from the Federal Home Loan Bank (FHLB). The data revealed the substantial change in *the* *thrifts’* domain from 1977 to 1986. For example, home loans, which accounted for 77 percent of the thrift portfolio in 1977, fell to 50 percent in 1986. Non-residential mortgage lending increased from 5 percent in 1977 to 16 percent in 1986.

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Using the contingency-theory approach. Haveman studied the effect of an organization's size on its ability to change as a result of changes in the environment. The study used the regulatory changes of the savings-and-loan industry in the early 1980s to test the hypotheses. The sample data for the study were derived from published information on savings-and-loan institutions by the Federal Home Loan Bank (FHLB). The histories of 308 California thrifts that operated from June 1977 to December 1986 were analyzed for the study.

The study results indicated that the size of the organization does affect the degree to which organizations diversify and shift strategy. In the case of this study, the strategy pertained to changes in the nature of investments made by the thrifts. Of the three sizes of savings-and-loan institutions examined, medium-size firms were able to shift their strategy faster than small or large ones. His study attributed this to the small firms' lack of resources and the large firms' bureaucratic inertia. However, the results also indicated that the large thrifts expanded into mortgage-backed securities, real estate, and investment securities faster than smaller firms.

Jennings and Seaman (1994) studied 270 savings-and-loan associations for the 1980-1983 period. The purpose of the study was to determine if savings-and-loan institutions that adapted their strategy and structure to the changes in the environment performed at a higher level than those that did not. The results of the study indicated that savings-and-loan institutions that have an optimal strategy-structure alignment perform at *a higher level* than those that do not.

In order to investigate the influence of banks on firms to whom they provide *capital*, Gopinath (1995) investigated the strategies used by banks when their client firms

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### **Studies Focusing on General Business Organizations**

It is important to note that the two studies summarized in the following two paragraphs, Miles (1982) and Miles and Snow (1978), are important not because they test existing theories about organizations and their environment, but because they are instrumental in establishing typologies of environments and types of strategies. Various researchers using diverse industries have since further tested these typologies.

Miles (1982) studied the hostile environment facing the tobacco industry and the industry's strategic response to this threat. His study stressed the strategic choices that top managers of organizations have to make to shape their organizations' strategies. This study did not seek to test a specific hypothesis; it sought to accurately describe events, *their* causes, and effects. The study put forth optimal strategies that organizations may adopt when faced with various environmental conditions. These strategies were primarily

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divided into three categories: “domain defense,” “domain offense,” and “domain creation.” In the case of the tobacco companies studied, the “domain defense” strategies had the goal of legitimizing the nature of the tobacco business. These strategies resulted in various cooperative moves by the tobacco industry participants. The “domain offense” strategies were aimed at improving organizational performance through product innovation and market segmentation. Finally, the “domain creation” strategies were aimed at finding new markets (such as new international markets) in which to sell tobacco products, given the hostile environment in the United States.

Miles and Snow (1978) studied a series of industries such as textbook publishing, hospitals, electronics, and food-processing industries. Based on these studies, they identified three strategies adopted by organizations faced with changes in their environment. These strategies were labeled “defender,” “prospector,” and “analyzer.” The premise was that successful organizations “fitted” their strategy, structure, and environment. These “matched” organizations performed at a higher level than those organizations that were “mismatched.” Over the years, many researchers have tested this hypothesis, some successfully, some not. In the hospitality industry, two researchers—Schaffer (1986) and Dev (1988)—have tested this “fit” hypothesis using Miles and Snow’s typology of strategies. Dev’s study showed empirical support for the hypothesis, while Schaffer’s showed partial support.

Smith and Grimm (1987) studied strategic change as a response to a shift in environmental characteristics after the deregulation of the U.S. railroad industry. The study collected data via mail questionnaires from the National Industrial Transportation League’s railroad transportation committee. The total sample consisted of 180 committee

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**members.** Smith and Grimm's study supports the concept that alignment between an **organization** and its environment is a critical element for good performance. Their **findings indicate** that most firms change their strategies in response to environmental **variation.** Furthermore, those firms that align their strategies to changed environmental **conditions** perform better than those that do not.

**Other** studies that involved regulated industries include the Ramaswamy, Thomas, and **Litschert** (1994) study of the air carrier industry. This study shows that even when **environments** are heavily regulated, organizations can alter strategies to maintain **profitability.** However, regulation does act as an environmental constraint on the **organization.** The Gruca and Nath (1994) study, which noted that regulatory change acts **as an inertial block** on an organization's strategy, further supports this.

Dev (1988) investigated the relationship between perceived environmental **uncertainty,** business strategy, and financial performance in the lodging industry. Testing **Miles** and Snow's typology of strategies, the Dev study indicated that hotels that matched **their** strategy to the environmental condition performed better than hotels employing **other** strategies.

Lindsey and Rue (1980), in a study of 198 firms in durable, nondurable, and **service** industries, investigated the relationship between the state of an organization's **environment** (as measured by the degree of stability-complexity) and the completeness of **the** organization's long-range planning process. Their premise was that the type of **environment** in which a firm operates will impact its long-range planning. The results of **the** study indicate that managers of large firms attempt to fit their long-term strategies to

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In a study of 64 firms in eight major domestic manufacturing industries, Hall (1980) investigated the nature of strategies employed by firms facing hostile environments and related them to financial performance. A variety of strategies existed among firms facing hostile environments. Successful firms followed similar strategies when faced with hostile conditions.

In a study of 15 industrial organizations in South Wales, Britain, Dastmalchian (1986) investigated the relationship between an organization's dependencies on its environment and the organization's goal orientation. The basic argument of his study used the resource-dependence perspective (Salancik & Pfeffer, 1978). Dastmalchian hypothesized that the task elements of an organization's environment (labor, capital sources, customers, and owners) have an impact on its goal orientation. As such, organizational goals cannot be made independent of the organization's task environment. Depending on the availability or scarcity of these resources, the organization may be dependent on the different elements of the task environment. This, in turn, will affect the organization's goal orientation. The data were collected by personal interviews with senior executives of the 15 companies in South Wales. In addition, 144 employees at these companies were surveyed (86 surveys were useable). Acknowledging the study's small size, Dastmalchian nevertheless said that his results tentatively support the hypothesis. His study shows that as there is an increase in an organization's dependency on its customers and market, the employees perceive that the organization's goals are oriented primarily toward major customers and competitors. This exploratory study

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In a study of hospitals, Gruca and Nath (1994) analyzed the ability of hospitals to change in the face of regulatory changes in their environment. With the introduction of the Medicare prospective-payment system (PPS) in 1983, a constraint was imposed on hospitals operating in that period. The constraint was the fixed amount of reimbursement that hospitals could receive for the medical care given to patients. If hospitals were unable to draw upon alternative sources of revenue, they would be constrained by the regulation. The central focus of this study was to determine the factors that influenced the adaptability of a hospital to these changes. The data used for the study were taken from the AHA Annual Survey of Hospitals (1986) and HCFA Medicare cost reports for hospitals in Illinois. Ninety-six hospitals were sampled for the study. The results of the study indicate that the ability of a hospital to adapt to regulatory constraints depended on its individual posture. Those that had high occupancies, a diversified customer base, and a broad range of products and services were more likely to be able to adapt and thrive rather than fail.

Jauch, Osborn, and Glueck, (1980) performed a content analysis on 358 *Fortune* case studies of public corporations from 1930-1974. Only 2 percent of the cases were of banking and investment companies. The result pertinent to the current study involves the similarity of response to environmental stimuli. It was found that increases in government regulation resulted in firms retrenching various aspects of their business. As the number of competitors increased, firms tended to consolidate via mergers. If the supply of materials for the product declines, then firms either try to increase market share or

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Miller (1988) studied the relationship of the environment to the business strategies Michael Porter studied in 89 Canadian firms (Porter, 1980). Porters' three generic strategies of "differentiation," "cost leadership," and "focus" were used for the study. Each of these strategies is expected to have a certain type of relationship with environmental uncertainty and heterogeneity. The results of the study indicate that Porter's strategies relate to the environment. However, these a priori relationships are stronger in successful firms than in unsuccessful firms. Innovative and product-differentiation strategies are best suited in uncertain (unpredictable and dynamic) environments.

### **Synthesis of Current Literature on Organization and Environment Relations**

The studies just discussed in Part II of the chapter may be synthesized to reveal the following general conclusions:

- A. General support is found in the literature to indicate that organizations do respond to a variety of elements in the environment. Successful organizations are those that are able to achieve a co-alignment between the environment and organizational strategy. The studies reviewed tested hypotheses using some type of open-systems theory, such as contingency, strategic choice, resource dependency, or population ecology.

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- B. The studies also reveal that the environment, as described in the foundation literature, is identifiable and the environmental concepts (such as task environment) can be measured. The studies have measured regulatory elements of the environment, competitive elements of the environment, the environment as a stock of resources, and the environment as a source of threat or opportunity.
- C. Most of the studies have focused primarily on the organization set, followed by the organization-population level of analysis. There are no recent studies that use the highest level of analysis—organization communities.
- D. The literature reviewed includes studies that have measured a number of different dimensions of the environment, such as uncertainty, heterogeneity, degree of change, hostility, and complexity.
- E. It may also be noted from the studies that researchers have tested the hypothesis of the relationship between organizations and their environments in a variety of industries, including many in the financial-services industry.

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## **Chapter 3**

### **PROCEDURES AND RESEARCH DESIGN**

The overall design of this study includes two components: (1) a descriptive component, and (2) a predictive component. The descriptive component includes interview data and a review of secondary literature, which establishes a base, gathers background material, and assists in planning the predictive component of the study. The predictive component was designed using a qualitative method (Delphi technique). The overall study was designed within the context of the “open systems theory”, which views organizations as open, interacting and dependent on resources from the environment (see chapter 2). The procedures used in this study are described in sufficient detail so that this study may be replicated. As Behling states, “Science is based upon replication—that is, the capacity to validate a piece of research by using the same methods of the study” (Behling, 1984).

### **Graphical Overview of Study Design**

The current study may be divided into three steps:

1. Historical research—review of historical and current literature
2. Qualitative research—interviews
3. Delphi study

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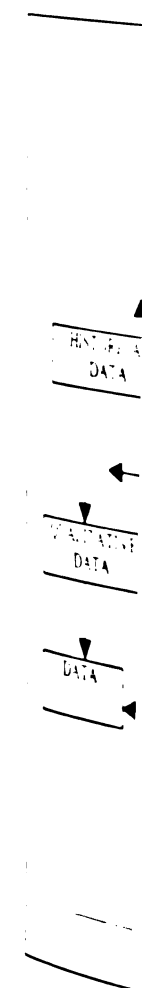
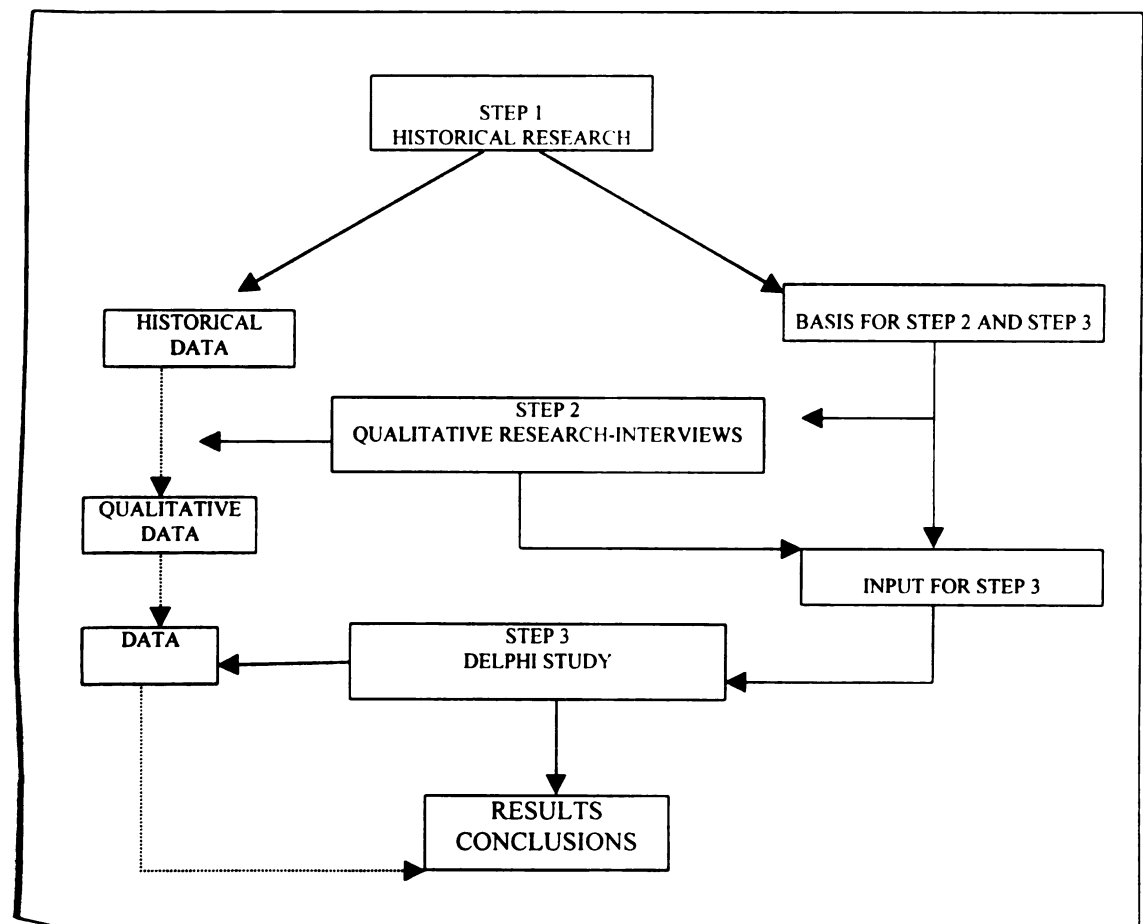


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Each step is related to the other and was designed and conducted within the parameters of the organization-environment relationship. The research in each step is independent yet related to the other steps. The planning and design of the Delphi study was dependent on information from the research in the first and second steps. The intent of the interviews was to verify and supplement information from the historical review in Step 1. An overview of the research design used in this study is provided in Figure 4.



**Figure 4. OVERVIEW OF THE RESEARCH STRATEGY USED IN THIS STUDY**

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### **Historical Research (Step 1)**

Commenting on historical research, Baumgartner states that “Using the historical approach, the researcher endeavors to record and understand events of the past. In turn, *interpretations* of recorded history hold to provide better understanding of the present and *suggest* possible future directions” (Baumgartner & Strong, 1994). Although the current *study* does not rely completely on a historical approach to reach its conclusions, it serves **as a base** for the next two steps in the study.

#### **Purpose of Step 1 of the Study**

**This** stage of the research—the review of historical and current literature—was designed **to fulfill** the following three objectives:

1. **To** review the historic and current events in the environment of the lodging industry **and** their impact on the structure of the industry and its operating and investment **performance**.
2. **To** review the historic and current financing trends of the lodging industry and the **specific** role of financial institutions in financing the lodging industry.
3. **To** evaluate the historical and current environment of financial institutions, **specifically** to include their economic, regulatory, and competitive environment.

## Relationship of Research

Step 1 of the study is to

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## Value of Data

The data collected

1. Textbooks

2. Journal articles

3. Expert opinion

### Relationship of Research in Step 1 to Steps 2 and 3

Step1 of the study serves an important role in providing a base for the next two steps of the study. The historic and current review of events in the lodging industry provides information about key issues related to the lodging industry, financing trends, and the environment of financial institutions, which helped in designing the interview questionnaire for Step 2. This information was not only helpful when it came time to formulating questions for the interviews, but also provided necessary “training” to the administrator of the instrument and hence improved its reliability. In order to knowledgeably and meaningfully conduct open-ended interviews with industry experts (Step 2), this historical foundation was essential.

The historical and current review also yielded information that was provided to Delphi participants (Step 3 of the research) as a resource to be used in developing their future projections. Each participant was given a compendium entitled “A Compendium of Useful Information for Delphi Participants.” This compendium included key statistics compiled from secondary sources. (See Appendix A at the end of the study for a copy of the compendium.) Furthermore, the historical and current review also served as a basis for analyzing and interpreting the results of the Delphi study.

### Nature of Data

The data collected and analyzed were from secondary sources. These sources included:

1. Textbooks
2. Journal articles
3. Expert-opinion literature published in periodicals

4. Research reports
5. Research reports  
services industry
6. Research reports
7. Reports and summaries
8. Reports published
9. Research publications
10. Information gathering  
(conference)
11. Tape recording

#### Data Collection Techniques

The data were collected

conference attendance

#### Data Analysis

Most of the data collected

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percent were used.

#### Internal and External

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4. Research reports published by industry consultants
5. Research reports published by the lodging, commercial real estate, and financial-services industry trade associations
6. Research reports published by the research departments of investment banks
7. Reports and surveys from government sources (such as the Federal Reserve Board)
8. Reports published by university think tanks
9. Research published in conference proceedings
10. Information gathered at industry conferences (such as the UCLA investment conference)
11. Tape recordings of industry conference workshops

#### Data Collection Technique

The data were collected through a combination of library research, industry contacts, conference attendance, purchase of industry reports, and taped workshops.

#### Data Analysis

Most of the data collected in Step 1 of the study were presented in a descriptive fashion.

The analysis included interpretation, compilation, summarization, and presentation of information in a tabular form to show trends. Summary statistics such as mean and percent were used.

#### Internal and External Criticism

Baumgartner states, "Historical data, once gathered, must be critically evaluated to determine whether or not it can be considered fact and, consequently, as historical evidence" (Baumgartner, 1994). As such, it is recommended that the secondary and primary (documentary) data gathered be subjected to two forms of critical review.

External criticism is used to establish the authenticity, genuineness, and validity of the source of the primary data. Internal criticism has to do with the accuracy of the data.

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Since Step 1 relied only on secondary data, external criticism was not an available alternative. Original documents, which would be considered primary data (such as memos or the minutes of meetings) were not part of the research.

However, the data were subjected to internal criticism, as accuracy of the data was a concern to the researcher. Gay states that there are generally four tests in determining the accuracy of documents, or secondary data (Gay, 1987):

1. Knowledge and competence of the author
2. Time delay—the interval between when the event occurred and when it was recorded
3. Bias and motives of the author
4. Consistency of data

The documentary data used for the study were primarily tested using knowledge, time delay, and bias tests. No journal, periodical, or research report was used that was either unfamiliar to the author or not identifiable by publisher and author. Research statistics quoted were from industry-recognized publications and sources. Furthermore, if the researcher found discrepancies in the views of two or more publications, they were not used unless the discrepancies were resolved. For example, occupancy statistics quoted by two consulting companies were different. However, their databases were also different. So, to resolve this conflict and be consistent, the study relied on statistics from just one of the companies (bearing in mind that both consulting companies would be considered equally reliable based on the “knowledge test”). To avoid “time delay” inaccuracies, when providing information about an event, publications were used with dates close to the actual occurrence of the event.

## Qualitative Research

Commenting on qualitative research

understand phenomenon

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learn in the natural

Step 2 of the research process

### Purpose of Step 2

Step 1 was the first

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1. Identify type of

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2. Identify the

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## **Qualitative Research (Step 2)**

Commenting on qualitative research, McLaughlin (1994) states, “When there is a need to understand phenomenon, or to learn the subject’s perspective, qualitative methods can help the researcher generate detailed descriptive data using naturalistic inquiry. The term ‘naturalistic’ in qualitative research denotes being in the natural environment or gathering data in the natural setting.” This definition of qualitative research was kept in mind when Step 2 of the research was designed.

### **Purpose of Step 2 of the Study**

Step 1 was the historical component of the study’s research. Building on the knowledge and information gained from Step 1, Step 2 served as a link to Step 3 of the study. As such, the research during Step 2 was designed to achieve the following four direct objectives:

1. Identify types of financial institutions that are providers of capital to the lodging industry.
2. Identify the factors in the environment of financial institutions that have an impact on their decisions to lend capital or invest in the lodging industry. This was an essential first step to operationalize the environment by identifying the specific variables that needed to be studied.

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3. Learn firsthand the characteristics and trends in the current environments of financial institutions. This cross-validated the characteristics and trends of the current environments derived in Step 1 of the study.
4. Generate a preliminary list of issues and questions of concern or interest to the lodging industry with regard to the future of lodging finance.

In addition to the four direct objectives of this stage of the study, Step 2 was also conducted to achieve the following two indirect objectives:

1. Familiarize the researcher with the organizational structure, decision-making processes, and industry structure of the various institutions in the financial-services industry.
2. Start generating a list of potential participants for the Delphi study.

#### Relationship of Research in Step 2 to Steps 1 and 3

Step 2 served as a link between Step 1 and Step 3 by confirming some of the issues identified by the secondary research conducted in Step 1. Combined with Step 1, Step 2 provided the necessary raw material to identify the questions and issues for the Delphi study.

#### Nature of Data

The data collected for Step 2 of the study may be considered primary, as the data source consisted of experts in the financial-services industry.

## Data Collection Techniques

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### Data Collection Technique and Detailed Procedures

The data collection technique employed was primarily focused interviews. The collection of data was divided into two stages:

1. *Telephone interviews and open-ended discussions.* Initially, a series of ten interviews and discussions were scheduled with a predetermined sample of financial-services executives. These executives were hospitality industry consultants and senior officials in mortgage and investment banking. The selection of these executives was based on personal acquaintances and referrals from professional colleagues. A majority of these executives work in Michigan. The main purpose of these discussions, which were informal in nature, was to: (1) learn firsthand about the lending and investment decision-making processes of financial institutions, (2) verify the significance of the study, and (3) identify the financial institutions involved in lending capital to and investing in the lodging industry.
2. *Formal interviews and conference.* The interviewee sample was selected from IREFAC (Industry Real Estate Advisory Council) members who had agreed to participate in the proposed Delphi study. (See Appendix B at the end of the study for an IREFAC membership listing.) This sample consists of a select group representing large hotel chains and large money-center banks, investment banks, and other financial-services industry executives. Twelve of the IREFAC members agreed to participate in the study, and ten agreed to be interviewed. The profile of the ten interviewees was as follows: four senior executives from investment banking companies, one executive from a money-center bank, two life insurance company

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### Data Analysis

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executives, one hospitality consultant, one senior executive from a large hotel chain, and a chief financial officer of a public hotel company.

Most of those who agreed to be interviewed attended the IREFAC meeting in New York City in November of 1997. A brief presentation regarding the Delphi study was made to all IREFAC members in attendance at the meeting. This provided an opportunity to introduce them to the research and set the stage for the interviews, which were conducted during the week of November 8<sup>th</sup>, 1997.

The interviews achieved the four direct and two indirect objectives stated earlier in this section. All interviews were conducted in the subject's offices (with the exception of one interview in a hotel room), and all of the interviewees were provided with the list of interview questions approximately one week before the interview date. The questions were provided to alert the interviewees to the purpose and broad parameters of the interview. Because of this, the interviews were conducted in a semi-structured manner (see Appendix C for the interview format). At various times during the interviews, the participants were allowed to deviate from the questions because their personal experiences in the industry provided rich narratives. The interviews lasted 30 minutes on average. Some interviews were as long as one hour, with a few as short as 15 minutes. Every interview was tape recorded and later transcribed.

### Data Analysis

The tape-recorded interview data were transcribed for analysis. The information from the interviews was used to list specific areas of concern that the respondents had about the future of capital for the lodging industry. These were then used when developing the

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Delphi instrument. Selected observations are directly quoted (where applicable) in various chapters of the study.

### **Delphi Study (Step 3)**

#### Forecasting Methods in General

There are primarily two types of forecasting methods: quantitative and qualitative.

Quantitative approaches may be further divided into causal and time series (Schmidgall, 1997). Causal methods such as regression analysis and econometrics “assume that the value of a certain variable is a function of other variables” (Schmidgall, 1997). Time series analysis, on the other hand, uses the occurrence of a past pattern to predict future events. Naïve methods, moving averages, and exponential smoothing are some examples of time series analyses.

The value of quantitative methods depends on three factors. The first is the availability of historical data upon which to base future projections. The second is the assumption that the historical trends will continue into the future. The third is the ability to narrow the problem in order to make a concise predictive model.

Certain forecasting problems are not readily handled using a quantitative approach. In such cases, one has to rely on qualitative forecasting methods, which are holistic in nature and rely more on human judgment when they are used to make predictions. One such qualitative (long-term) forecasting technique is the Delphi technique.

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### The Delphi Technique

“The Delphi technique is a method used to systematically combine expert knowledge and opinion to arrive at an informed group consensus about the likely occurrence of future events” (Moeller & Shafer, 1994). In the third step of the overall study design, the Delphi technique was used to predict future levels of specific variables relevant to lodging industry financing. According to Helmer and Rescher (1960), the original proponents of the Delphi technique, “the technique derives its importance from the realization that projections of future events, on which decisions must often be based, are formed largely through the insight of informed individuals, rather than through predictions derived from well-established theory” (Moeller & Shafer, 1994).

According to Linstone and Turoff (1979), the Delphi technique should be used when one or more of the following properties exist in the problem:

1. The problem does not lend itself to precise analytical techniques but can benefit from subjective judgment on a collective basis.
2. The individuals needed to contribute to the examination of a broad or complex problem have no history of adequate communication and may represent diverse backgrounds with respect to experience or expertise.
3. More individuals are needed than can effectively interact in a face-to-face exchange.
4. Time and cost make frequent group meetings infeasible.
5. The heterogeneity of the participants must be preserved to assure the validity of the results; i.e., the participants must not be dominated by quantity or by strength of personality (called the “bandwagon effect” and the “halo effect,” respectively).

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In addition to the above factors, Paliwoda (1983) states that when studies involve “multiple dimensions,” a Delphi study may be the preferred choice. Johnson (1976) states that the Delphi technique is especially suited for long-term forecasts—more than five years out in rapidly changing, volatile fields.

All of these reasons had some impact on why the Delphi technique was selected as the method of choice for the present forecasting problem. Most important, however, was that the problem was multi-dimensional in nature and involved expertise, such that no individual had sufficient knowledge to affect a solution. Therefore, the problem required a group decision-making method. The traditional, face-to-face group decision-making processes would have inserted a study bias (particularly due to the “bandwagon effect” and the “halo effect”).

### Delphi Procedures

Rand Corporation conducted the first Delphi study in the early 1950s as a defense research project. Since that first Rand Corporation Delphi study, many variations of the Delphi technique have evolved over the years. However, a review of the literature revealed a widespread commonality in the basic Delphi procedures. The steps in conducting a Delphi study listed below are combined from various sources in the Delphi literature, which include Moeller and Shafer (1994), Martino (1983), Deveau (1994), Linstone and Turoff (1979), and Tersine and Riggs (1976):

Step 1: Identify a

Step 2: Select a p

Step 3: Explore

Step 4: Design a

Step 5: Pilot-test

Step 6: Mail Re

Step 7: Summar

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Step 8: Continu

Step 9: Analyze

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- Step 1: Identify the basic issues, problems, and events to be predicted
- Step 2: Select a panel of experts
- Step 3: Explore, discuss, and finalize the basic issues and events to be predicted
- Step 4: Design a draft questionnaire
- Step 5: Pilot-test the draft questionnaire
- Step 6: Mail Round 1 of the Delphi questionnaire
- Step 7: Summarize the statistical results of Round 1 and include these results with the  
Round 2 mailing of the questionnaire
- Step 8: Continue future rounds similar to steps 6 and 7
- Step 9: Analyze the data to show consensus of participants over progressive rounds

#### A Review of Previously Conducted Delphi Studies

The original study, entitled “Project Delphi,” was conducted by the Rand Corporation.

Two of the original authors have summarized this study in an article published in *Management Science* (1963). The technique employed in this study is called the Delphi method. “Its object is to obtain the most reliable consensus of opinion of a group of experts. It attempts to achieve this by a series of intensive questionnaires interspersed with controlled opinion feedback” (Dalkey & Helmer, 1963).

The purpose of this original study was technological, in that it was designed to apply expert opinion to the selection, from the viewpoint of a Soviet strategic planner, of an optimal U.S. industrial target and to estimate the number of atom bombs required to reduce ammunitions output by a specified amount.

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The design of the original study included seven experts. There were five rounds of questionnaires conducted, each sent at weekly intervals. At the end of the first and the third round, the panelists were each interviewed. The estimates that the respondents made were numerical (total number of bombs), and the numerical estimates were stated at a 10 percent and a 90 percent estimate of success. The participants were also allowed to refer to any data that might be available to make their estimates. The second questionnaire recapped the first questionnaire and asked six open-ended questions. The third questionnaire asked the experts to reconsider their original bomb estimates and also provided them with some facts and estimates to use for their revised estimate. The respondents were given two more opportunities to revise their bomb estimates before a final bombing estimate was reported.

It was noted that the five rounds brought a convergence of bomb estimates. The range of bomb estimates at the end of round one was 4,500 (5,000 was the highest response, 50 the lowest). At the end of round five, the range was reduced to 335 (the highest response was 494, the lowest, 159).

After this original study, a wide range of disciplines have used the Delphi method to conduct a variety of studies using expert opinion. The purpose and methods used by a few relevant studies are briefly outlined below.

The Delphi technique was used as part of a doctoral dissertation to determine the future direction and focus of doctoral programs in hospitality education, as perceived by administrators and faculty members of hospitality administration graduate programs (Deveau, 1994). The specific questions of the study focused on the goals of doctoral study, areas of specialization, admission requirements, qualification of faculty, and

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resources and facilities needed for a doctoral program in hospitality administration. The study population consisted of administrators and graduate faculty. A total of eight programs and 16 individuals participated in the study. The instrument developed for the study included 49 preference statements, divided into six categories. The instrument designed used the Likert scale of preference. The Delphi sequence was conducted over three rounds and data analysis included medians and inter-quartile ranges.

The Delphi technique was used in a study to investigate the social, managerial, and technological events that are likely to shape the future of park and recreation management in the year 2000 (Moeller, Shafer, & Getty, 1974). The expert panel consisted of 900 individuals representing diverse disciplines, including biological sciences, ecology, conservation, recreation resource management, and environmental technology. The instrument design asked the panelists to predict the events that had a 50 percent chance of occurring in the year 2000. The Delphi sequence was conducted through four rounds and the data were summarized using medians and inter-quartile ranges.

The National Restaurant Association conducted a Delphi study (NRA, 1992), to determine the job requirements of a foodservice manager in the year 2000. The panel for the study was selected from the Board of Directors of the National Restaurant Association and the Board of Trustees of the Educational Foundation of the National Restaurant Association. A number of other food service professionals supplemented the expert panel. The Delphi instrument design was open-ended. The panelists were given broad prediction categories, such as administration, finance, and human resources. The responses from this initial round led to the development of a structured Delphi

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instrument, which was designed in the form of statements. Various types of ranking scales were used. A total of 120 responses were returned, and the study sequence included two rounds.

The Delphi technique was used to forecast tourism in Hawaii to the year 2000 (Liu, 1988). The specific questions that the study sought to answer included visitor arrival numbers, percentage of domestic arrivals, market share, and growth-rate predictions. The study was unique in that it had two types of expert panels. One panel consisted of experts representing tourist “receivers,” such as hotel and restaurant managers. This panel consisted of 42 local tourism experts. The second panel consisted of tourist “senders,” such as travel agencies and tour operators. A total of 85 experts represented this panel. The first panel went through a two-round Delphi sequence, while the second panel was exposed to one round with a telephone follow-up.

The Delphi technique was applied at a Fortune 500 company to make future cash flow estimates to help with capital budgeting decisions concerning a new product. In this case, a modified version of the Delphi technique was used (Ang, Chua, & Sellers, 1979). The expert panel consisted of 15 members associated with the development of the new product (including the inventor). They were drawn from diverse departments, which included corporate market research, market research, product development and application, and corporate treasury. The Delphi sequence was terminated after round three due to lack of participant interest.

The Delphi technique was used in a study to make long-term predictions in the electronics industry (Johnson, 1976). The study was conducted in the electronics division of Corning Glass Works. Three panels were selected for the study, each representing an

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expertise in the electronics industry such as consumer electronics, industrial electronics, and government electronics. Each panel had 15 members. The questions on the instrument were multiple choice and were divided into four categories. Category 1 dealt with growth rates, Category 2 with changes expected by end users, Category 3 with changing the use of a particular product class, and Category 4 with new and different uses of the product class. The Delphi sequence went through three rounds.

The Delphi technique was used to create a framework to identify the political and environmental issues faced by multinational hotel chains in newly industrialized countries in Asia (Kim & Olson, 1993). The study divided the political environment into four categories—law and regulation, administrative, judicial, and lobbying. The experts on the panel represented various fields such as multinational hotel chains, trade associations, governments, educational institutions, and industry law firms. The panel consisted of 20 members. Round one of the questionnaire was open-ended, and the participants were asked to list events within the political categories identified. Round two and three had a structured, Likert-scale questionnaire.

The Delphi method was used to identify and assess the environmental impacts of tourism projects (Green, Hunter, & Moore, 1990). The panel of 40 experts included planners, tourism officers, civil engineers, economic-development personnel, and residents. The study involved a general preliminary survey to identify the major impacts of tourism projects. It was followed by a structured questionnaire designed as a checklist of possible impacts stemming from tourism. The data were summarized for respondents in the form of ranking the impacts, mean overall significance of the impact, and standard deviation.

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Tersine and Riggs (1976) have summarized the wide-ranging uses of the Delphi technique. These include studies to explore a firm's future external environment and to analyze evolutionary product lines. The Delphi technique has been used to predict likely inventions, new technologies, and product applications. In retailing, the Delphi technique has been used to indicate future changes in department stores. Finally, Tersine and Riggs state, "Delphi has become a multiple-use tool, and has proved to be an effective method of forecasting future events in both business and government."

#### Analysis of Delphi Studies Reviewed

An analysis of the various Delphi studies reviewed reveal the following key features:

1. The Delphi technique has been used in a wide variety of industries, disciplines, and subjects, and focuses primarily on future predictions.
2. The range of experts used in the panel has also varied, from as high as 900 to as low as 7, the number used in the first Delphi study.
3. The number of rounds in the study (including the first general questionnaire round) has ranged from 3 to 5.
4. The questionnaire design has primarily included event statements, some form of Likert scale, ranking, checklists, multiple-choice questions, and probability-of-event-occurrence questions.
5. Most of the studies used a form of descriptive statistics to analyze the data, such as mean, median, standard deviation, and inter-quartile range.

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6. Some studies have also combined interviews and telephone discussions as part of the rounds.

### Design of the Current Delphi Study

The current study was designed after reviewing the literature on Delphi studies, reading texts outlining the Delphi technique and procedures, and discussing the Delphi technique with researchers who have used the technique as well as with users and participants in Delphi studies.<sup>1</sup> Finally, a select group of study participants for the current study were consulted prior to designing the study. The final design was based on the original technique but adapted to suit the current participants and the overall purpose of the current research.

### Purpose of Step 3 (Current Delphi Study)

The purpose of the current Delphi study was to make long-term predictions into the years 2000 and 2005 about the structure, performance, and capital needs of the lodging industry. For the same period, the study was designed to determine the availability of capital and the role of financial institutions in providing capital to the lodging industry. The specific predictions that the Delphi study made were divided into five categories.

Each category asked:

In the years 2000 and 2005, what will be:

1. The economic, regulatory, and competitive environment of financial institutions?
2. The structure of the lodging industry?

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<sup>1</sup> Dr. Rod Rudolph recently finished a Delphi study on future competencies of hospitality graduates. I discussed his experience with the technique. I also consulted with one of his study participants, Dr. Raymond Schmidgall, about his experience.

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3. The operating and investment performance of the lodging industry?
4. The lodging industry's need for capital?
5. The role of financial institutions as suppliers of capital to the lodging industry?

#### Relationship of Step 3 to Steps 1 and 2

The historical and current perspective provided by the secondary research conducted in Step 1 was helpful in identifying the issues, designing the Delphi research instrument, and providing available background information to the Delphi participants. This was further confirmed by the interviews conducted in Step 2 of the research. Both Steps 1 and 2 provided knowledge essential to identifying some of the financing issues, terminology, and measures of performance used in the study. Steps 1 and 2 also created initial contact with potential participants and verified the practicality of the Delphi technique with the potential group of participants.

#### Delphi Study Procedures

The Delphi technique for this study was conducted by using a sequential procedure:

1. Development of the Delphi study problem
2. Selection and management of the expert panel
3. Development of the Delphi instrument
4. Administration of the Delphi sequence
5. Statistical analysis of the Delphi feedback.

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A brief explanation of each of these steps follows.

*1. Development of the Delphi Study Problem.* The Delphi study problem grew out of the theoretical construct that organizations are impacted by their environment. The search for an application of this construct resulted in the detailed historical review of changes in the environment of financial institutions as suppliers of capital and the lodging industry as a user of capital. A historical review, a current evaluation of the environment, and detailed discussions with graduate faculty and industry experts revealed an uncertain future scenario for financing the lodging industry.

*2. Selection and Management of the Expert Panel.* The literature on the Delphi technique does not indicate a specific method for selecting an expert panel. However, in order to prevent the selection of a biased panel, one of the panel selection guidelines is that the researcher should not directly select the panel. Instead, it is suggested that the names of the panel members should be recommended and nominated by a third party. These initial panel members can, in turn, recommend other participants. Both of these approaches were used when selecting the panel for this study.

It is also important to note that this stage of the research involved not only selecting the expert panel, but coming up with ideas to properly “manage” the panel. These ideas were designed to keep the panel interested in the research and to help the author develop a close working relationship with the participants.

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Before approaching the task of selecting a panel of experts for the current Delphi study, the following basic criteria were established for defining the ideal expert for the Delphi panel:

- a. The expert should have a broad-view understanding of the financial-services industry and the lodging industry, with a specific expertise in at least one area of the financial-services industry, such as banking, investment banking, finance company, life insurance company.
- b. The expert should be either in the top management/ownership ranks in his or her organization or work closely with top management/ownership personnel in the organization.
- c. The expert should be directly or indirectly involved with making financing decisions for his or her organization, including lending or investing decisions.
- d. The expert should have experienced at least two real estate financing cycles.
- e. The expert should have an interest in the results of the published research.
- f. The expert should be accessible.

*Panel Selection Process.* The selection criteria required that the experts chosen be mature, experienced, senior industry executives. The ideal group from which to draw experts—a group whose membership comprised all the above stated criteria—was IREFAC (the Industry Real Estate and Financial Advisory Council). IREFAC is a select group of 35 high-level financial and lodging industry executives and consultants. The author was introduced to this group through the chief financial officer of the American Hotel & Motel Association. After a series of letters, telephone discussions, and a meeting, his office he was convinced of the relevance of the proposed research. A letter of invitation was sent from the AH&MA office to 25 IREFAC members, informing them of

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the proposed study and requesting their participation. As a result of these efforts, 12 members of IREFAC agreed to be part of the expert panel.

In addition, three academicians with expertise in hospitality financing were added to the initial list. They were all recommended, based on discussions with individual members of the Association of Hospitality Financial Management Educators (AHFME).

The next step was to send each participant a letter, thanking him or her for participating. This mailing contained a cover letter, a brief description of the research, a description of the Delphi technique, a formal acceptance form, and a form asking the participant to recommend other potential participants, (see Appendix D at the end of this study for a copy of this mailing). The mailing was sent as first class mail with a stamped, self-addressed envelope. This was followed up with a phone call in an attempt to start a formal relationship with this initial group.

A total of 15 recommendations for additional participants were received, based on the initial mailing to the 15 participants (12 IREFAC members and 3 academicians). Each person on the recommended list was called to determine his or her eligibility and interest in participating in the proposed research. Based on initial screenings and the availability of these prospective participants, 10 were sent a letter of thanks and a description of the proposed research. As with the first 15 participants, these ten participants were asked to fill out a formal acceptance form and a form asking them to recommend other potential participants.

As a result of the second-round mailing, 15 more experts agreed to participate in the research, bringing the a total to 40 participants who had agreed to take part in the study (see Figure 2 for an illustration of the selection process) and, at this juncture, each

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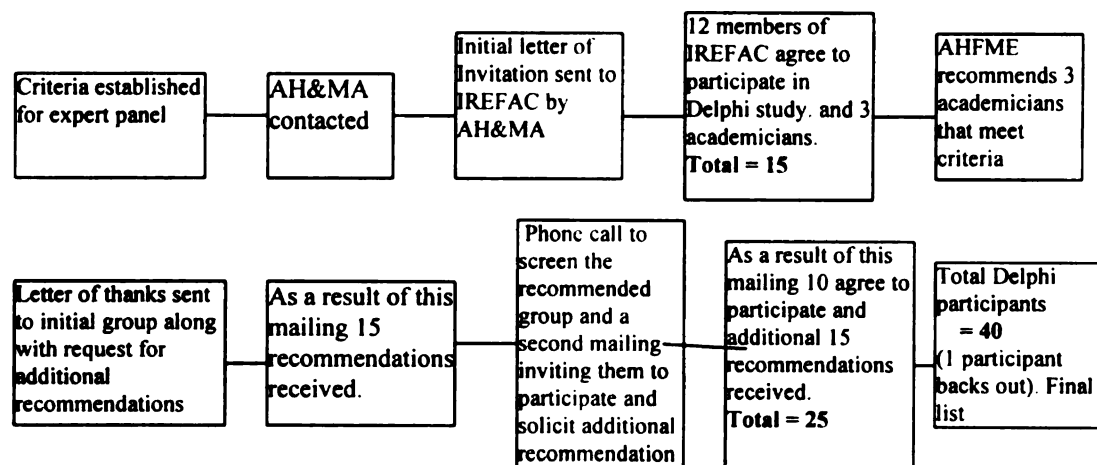
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participant had received a personalized letter and a phone call. Furthermore, interviews conducted in the qualitative research (step 2) of this study, offered an opportunity to meet ten Delphi participants. In consultation with graduate faculty, it was determined that 40 would be a manageable number for this study. A few additional participants were added, based on recommendations received at a later date. However, because some people had to drop out, the final panel consisted of 39 experts (see Table 1 for a breakdown of these participants according to expertise).



**Figure 5. DELPHI PARTICIPANT SELECTION PROCESS**

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**Table 1**

**PROFILE OF INSTITUTIONS AND ORGANIZATIONS REPRESENTED ON  
THE DELPHI PANEL**

CATEGORY	PARTICIPANTS
Academic Institution	3
Consulting Company	5
Mortgage Banker	1
Real Estate Broker	2
Acquisition Fund	1
REIT	2
Conduit	2
Investment Bank	5
Money Center Bank	2
Finance Company	3
Life Insurance	2
Investment Advisor	4
Lodging and Financial	2
Management Company	2
Franchisor	1
Lodging Chain	2
Total	39

*Managing the Panel.* Between the time that the initial 15 Delphi participants agreed to participate and the official start of the study, approximately seven months had lapsed. During this period, it was important to keep in touch with the study participants, in order to maintain their interest. Various opportunities were used to keep in touch with the group and improve the author's relationship with the participants. Some of these are listed below:

1. An invitation to make a presentation at the IREFAC meeting New York offered an opportunity to meet many of the participants.
2. Some participants were met during the personal-interview step (Step 2) of the study.

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3. An invitation to the UCLA investment conference (January, 1998) in Los Angeles offered an opportunity to meet new participants and renew the interest of participants who had already agreed to participate in the study.
4. The participants were each sent a Christmas and New Year's card.
5. Many of the participants were involved in pilot testing of the questionnaire.

3. *Development of the Delphi Instrument.* The initial information related to the development of the Delphi instrument was gathered in Step 1 of the research. This secondary review of the literature on financial institutions and the lodging industry helped to identify the historical and current issues and events related to the environment of financial institutions and the financing of the lodging industry. In the same way, interviews conducted in Step 2 of the study resulted in identifying concerns, issues, and events from experts about lodging industry finance and the role of financial institutions in providing capital. This information helped to operationalize the study by identifying specific variables to include in the Delphi instrument.

Preliminary work for the development of the Delphi instrument also was completed at the AHFME and IREFAC presentations in New York. The presentations, while giving an overview of the study, also allowed for comments from the audience on the overall study design and any issues or events they felt should be included in the study. AHFME is made up of hospitality faculty who teach financial management courses, and, as noted previously, IREFAC is made up of senior financial and lodging industry executives.

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Using information from the previous research and from consultations with financial management faculty and executives, an initial list of issues was developed. Next, the organizer of the 1998 UCLA investment conference was contacted and a special meeting was set up for the Delphi participants attending the conference. Each participant was mailed a letter informing them of the Delphi study (Round 1) meeting at the UCLA investment conference. The purpose of the meeting was to discuss key issues and questions to be included in the study. Five participants attended the meeting. A packet of information about the study was distributed at the meeting. This included an initial list of issues and questions. The participants were asked to make changes or additions to this list. They participated in a discussion for approximately 30 minutes. Some decided to take the packet with them and mail it back rather than complete it on site.

During the two-day conference, many other Delphi participants were contacted and given the Round 1 packet. They were asked to make comments and additions to the initial list of issues and questions. Overall, 15 participants contributed in this round either by attending the meeting or mailing in their comments. Each made valuable comments about and suggested additions to the preliminary list of issues and questions to be included in the study. This stage of the questionnaire development was the equivalent of Round 1 in a traditional Delphi study. In a traditional Delphi study, Round 1 starts with the participants receiving a blank sheet of paper on which they are asked to write issues, questions, and events that should be included in the study. Given the nature of this expert panel (very busy senior-level executives for the most part), it seemed best (as was done in this study) to modify Round 1 by providing members of the panel with a list and asking them to make additions and comments to this initial list.

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Once this phase of the questionnaire development was complete, a more structured questionnaire was formulated, using comments from Round 1. The main features of the questionnaire were as follows:

A. The questionnaire was divided into five categories, to coincide with the objectives of the study. It focused on the following five central questions.

In the years 2000 and 2005 what will be:

1. The economic, regulatory, and competitive environment of financial institutions?
2. The structure of the lodging industry?
3. The operating and investment performance of the lodging industry?
4. The lodging industry's need for capital?
5. The role of financial institutions as suppliers of capital to the lodging industry?

B. Each of these categories included a series of questions pertaining to that category. The questions asked the respondents to make predictions for the years 2000 and 2005.

C. The format of the various questions in each category yielded the following type of data:

- a. **Nominal:** This was in the form of Likert-type scales such as: Very favorable to Very unfavorable, Strongly agree to Strongly disagree, Much higher to Much lower. Two questions required the participants to select from multiple choices provided.
- b. **Ordinal:** This was in the form of rank-order questions.

- c. **Interval/Ratio:** This was in the form of whole numbers, percentage, averages, and ratios.
  - d. **Open-ended questions:** This required respondents to make predictions on specific issues.
- D. Where available, historic information was provided as background for answering the question. For example, if the participants were asked to predict occupancy percentages, previous year occupancy percentages were provided. Furthermore, a compendium of information (see Appendix A) accompanied the questionnaire. Where appropriate, participants were referred to the compendium as a suggested reference.
- E. Each questionnaire was accompanied by a set of general instructions, and brief instructions were provided at the beginning of each question. See Appendix E at the end of the study for a copy of the complete questionnaire.

Once a draft copy of the questionnaire was prepared, it was pilot-tested with the assistance of five Delphi participants and four non-participants. Pilot testing included two mailings. The first mailing was returned with extensive comments. After these changes were incorporated, a second mailing was sent to a smaller group (selected from the pilot testers) that agreed to help the researcher fine-tune the instrument. After the second mailing, the changes made were reviewed with the research advisor before being finalized.

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4. *Administration of the Delphi Sequence.* The finalized questionnaire was mailed as Round 1 to 35 Delphi participants.<sup>2</sup> The package consisted of an attractive questionnaire, with spiral binding and a glossy color cover. The questionnaire was entitled “Lodging Capital Markets into the next Millennium: Years 2000 and 2005.” The entire questionnaire had a report-like feel to it. A compendium of background information accompanied the questionnaire. This was also spiral bound and had a glossy color cover. The compendium was entitled, “A Compendium of Useful Information for Delphi Participants” (see Appendix A). The compendium contained the following sections:

1. Preface
2. Overview of study
3. Sources of information for the compendium
4. Explanation of a Delphi study
5. The Delphi research process
6. Background information categorized into five sections, to match the questionnaire
7. Standard definitions of mortgage financing terminology
8. Appendix with additional information

Included in the same package was a cover letter and a self-addressed envelope. A business mailing envelope was used, marked “priority mail.” The envelope also had a red sticker entitled “Delphi Study: Lodging Capital Markets: Years 2000 and 2005.” The address was typed on a mailing label. The entire package was designed to have an important and official look.

Each participant received a phone call within one week of the mailing to ensure that they had received the questionnaire. Two packets had to be mailed again, due to

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<sup>2</sup> Initially, a total of 39 people agreed to participate in the study. However, by the time the study started, five participants had dropped out.



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changes of address. Phone calls were made periodically to prompt and remind those who had not mailed back the questionnaire.

A total of 25 questionnaires were received at the end of the first round. This represented a 71 percent response rate. One questionnaire was returned empty, as the participant did not feel comfortable making such long-term predictions. Of those who did not respond to the first round mailing, four said that their schedules did not permit them to participate, five stated that they could not participate in this round but would do so in the next round, and one could not be reached. The total participant “mortality” rate at the end of the first round was ten.

Round 2 was mailed to 31 respondents after summarizing the results from Round 1. This questionnaire included three new columns, the summarized median response, the summarized inter-quartile range, and a column for the respondents’ revised predictions. The mailing package was identical to the previous round, with the exception of the compendium of information. Each participant was called within one week of the mailing of this round. Two participants did not receive the questionnaire and were mailed new packages. Two reminder phone calls were made to prompt speedy returns.

A total of 20 responses were received at the end of Round 2. This represented a 64.5 percent rate of response. A majority of those who did not respond said that their schedules did not permit them to participate. The various reasons cited included job changes, international travel, and company restructuring. One even wrote back: “Getting married, sorry could not finish”! The total participant “mortality” rate at the end of the second round was 11.

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5. *Statistical Analysis of the Delphi Feedback.* The questionnaire responses were analyzed using SPSS, statistical package. The summary statistic used for the analysis was the median, to indicate the midpoint response. The dispersion statistic used for the analysis was the inter-quartile range, to indicate the middle 50 percent of responses to each question. Question 1B used percentages as a measure of summary statistics. Three questions were open-ended and asked for participant views and opinions. These were transcribed to maintain the descriptive nature of their predictions.

#### Reliability of the Delphi Method

What is the probability that two equally expert Delphi panels will provide significantly different forecasts for the same event? Martino states, "This is a possibility, but if it happened often, Delphi would be a useless method of forecasting" (Martino, 1983). He also states that Dalkey, one of the original proponents of the Delphi technique, investigated this problem. He did this by treating first-round responses as a population, from which he drew samples of various sizes. Medians were obtained for each question and then correlations calculated between the median and the true answer. The results indicated that the mean correlation increased with panel size, such that as the panel size approached 11, the correlation was higher than 0.7. Martino states, "These results indicate that a panel of 15 members, if truly representative of the expert community on some topic, is unlikely to produce forecasts that differ markedly from those of another equally expert panel of the same size" (Martino, 1983). Therefore, since the current study used a panel of more than 15 members, we can feel relatively confident in the study's findings.

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## **Chapter 4**

### **A REVIEW OF THE STRUCTURE AND PERFORMANCE OF THE U.S. LODGING INDUSTRY**

A review of the U.S. lodging industry from the early part of this century to its current form reveals a number of changes in the structure of the industry and its operating performance. Starting as a fairly homogenous industry primarily made up of owner operators, the industry has evolved into a multi-product and micro-segmented industry. Large corporations, international in their scope, now dominate the industry. The pace and direction of the industry's growth is resulting in a consolidated industry, with fewer companies controlling a larger percentage of hotels.

This chapter discusses the significant events and issues in the environment of the lodging industry and their impact on the structural changes in the lodging industry from the early part of the twentieth century through the 1990s. This chapter especially focuses on structural changes in the lodging industry from 1990 to the present period (1996–1998). The 1990s started in a recession, and, by most accounts, the economy is currently (1998) at its peak or speedily approaching a peak in the current growth cycle.

In the framework of organizations and their environments, the lodging industry is the customer component (user of capital) for financial institutions, which are the suppliers of capital. Therefore, any study intended to predict future changes in the role of financial institutions as suppliers of capital to the lodging industry must first build on systematic understanding of the nature, scope, and characteristics of the industry to which capital is being supplied. Therefore, this chapter provides a historical review of events

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and issues in the environment of the lodging industry and their impact on the industry's structure, operating performance, and investment performance. The chapter answers the following research questions:

1. *What events and issues in the environment have impacted the structure of the lodging industry from the early twentieth century to the current period?*
2. *What have been the structural changes in the lodging industry from the early twentieth century to the current period?*
3. *What have been the changes in the operating and investment performance of the lodging industry from the early 1990s to the current period?*

## **The Structure of the Lodging Industry: Early Period to the 1980s**

### **Early Period**

Individual luxury hotels have existed in the United States since the early to mid-1800s. These hotels are characterized by their distinctive architecture. Hotels such as the Palmer House in Chicago, the Brown Palace in Denver, the Palace in San Francisco, the Astor House in New York City, and the Maxwell House in Nashville are examples of these early American hotels. These hotels were built to create distinctive landmarks in a city. As noted by Gomes: "Hotels built along the lines popularized by Rogers [famous hotel architect Isaiah Rogers] were not geared entirely to the needs of visiting dignitaries and traveling salesmen; they were the embodiment of civic pride and the center of business and social life of the communities in which they were located" (Gomes, 1985).



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The role of hotels in this early period is further illustrated in the observations of Boorstin: “In England the railroads were the pioneers, but in America first-class hotels appeared even before the railroads. They were built for the purpose of attracting railroads, along with the settlers, newspapers, merchants . . . and all the other paraphernalia of metropolitan greatness . . . .” Boorstin goes on to say that the “hotel mania” of the late 1800s led to grandiose projects that were built disproportionate to their surroundings (Boorstin, 1958). In many ways, this conviction that “supply creates its own demand,” which fed the proliferation of hotels, has become part of the psyche of hotel developers and has been carried into the current period. This is particularly evidenced in major U.S. and international cities that attract large convention hotels by offering investment incentives.

During the late 1800s and early 1900s, resorts and spas catering to the affluent traveler flourished, as railroads increased the mobility of Americans. Saratoga Springs in New York, The Broadmoor in Colorado Springs, the Ponce de Leon in St. Augustine, and The Hotel Del Coronado in San Diego are examples of such facilities.

The first hotel chains made their appearance with Conrad Hilton’s purchase of eight hotels during the 1920s. Due to the highly leveraged nature of these acquisitions, in 1929 (when the stock market crashed) the chain suffered losses. However, by 1935, earnings from other investments helped Hilton salvage some of his hotels. During the same period, Ernest Henderson founded what was later to become the Sheraton hotel chain (1937). Companies such as these took advantage of the depressed real estate market during this period and convinced bankers and private investors to work with them and aggressively pursue the acquisition of hotel portfolios.

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With the onset of World War II, labor, capital, and materials were diverted to the war effort and all types of construction or renovation of facilities came to a virtual standstill. Ironically, this was also a period of high demand for hotel rooms, because of the movement of troops and other personnel associated with the war effort.

### **Post World War II: 1945 to 1950**

The modern lodging industry had its genesis in the period following World War II. However, the structure of the industry during that period bears little resemblance to the hotel industry of today. In 1948, hotels with fewer than 50 rooms dominated the industry. They represented about 85 percent of all hotel establishments and 40 percent of total room supply. Almost all hotels were independently owned and operated; not even five percent belonged to a hotel chain (Winfrey, 1996). As noted in Table 2, the size of the industry has increased dramatically since 1948, as the number of rooms in the industry grew from 1,854,044 in 1948 to 3,525,000 in 1997. This indicates a total growth of 1,671,000 rooms, which is 90 percent above the 1948 levels. However, from 1948 through 1996, the number of properties declined from 55,569 to 47,000, a negative change of 8,569 properties or a decline of 15.4 percent.

An analysis of Table 2 also indicates that, compared to 1933, when large luxury hotels prevailed, from 1948 to the mid-1960s the average number of rooms per hotel declined. This is primarily due to the increase in the number of small motels during this period. However, extending the analysis to the current period reveals that the average

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hotel size has more than doubled from 1933 to 1996, due to the growth of chains with larger commercial and convention hotels.

**Table 2**  
**PROFILE U.S. LODGING PROPERTIES 1933–1997**

	1933	1935	1939	1948	1958	1963	1967	1972
Properties	29,462	38,670	41,508	55,569	70,535	64,276	65,579	58,688
Rooms	1,361,287	1,438,494	1,604,236	1,854,044	2,118,777	2,385,930	2,101,500	2,223,600
Avg Size Hotel	46	37	39	33	30	37	38	38
Avg room rate\$	N/A	N/A	3.37	5.40	9.91	11.22	15.78	20.64
Occupancy %			61.9%	85.0%	68.0%	62.0%	62.0%	59.0%

	1977	1981	1987	1993	1994	1995	1996	1997
Properties	51,861	54,135	44,500	45,000	45,000	46,000	47,000	N/A
Rooms	2,198,700	2,497,700	2,730,000	3,300,000	3,285,000	3,332,000	3,424,000	3,525,000
Avg Size Hotel	42	46	50	73	73	72	73	N/A
Avg room rate\$	30.34	50.75		60.53	62.86	65.81	69.66	75.16
Occupancy %	66.0%	63.0%	62.0%	69.0%	64.7	65.5	65.2	64.5

Source: American Hotel & Motel Association, *Trends in the Hotel Industry* (PKF Consulting; Coopers & Lybrand).

The post World War II period (1945–1950) represented a time when travel in the United States became increasingly popular. An improving economy, shorter workweeks, increased disposable income, construction of highways, and improvements in automobile and air travel stimulated this trend. However, the shortage of material and capital during the war years resulted in an aging hotel product. Thus, this period saw a significant amount of updating and replacing of old hotels, and the building of new ones, after years of neglect because of the Depression and the war.

A new type of highway-oriented hotel, called the “motel,” began to appear in large numbers in the 1950s. This was in response to the burgeoning number of

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automobile travelers. Table 3 indicates the percentage shift in the number of establishments from hotels to motels from 1939 to 1977. These early motels were small “no-frill” facilities, with very limited amenities. As the number of motels grew, competition with hotels became heated. Motels started to offer more amenities and started to resemble hotels, while hotels started to lower room rates to compete with motels. As a result, the distinction between the two segments started to erode.

**Table 3**  
**DISTRIBUTION OF HOTELS BY TYPE OF ESTABLISHMENT**

Year	Hotel Percentage	Motel Percentage
1939	67.4	32.6
1948	53.4	46.6
1954	45.7	54.3
1958	41.4	58.6
1963	35.3	64.7
1967	36.0	64.0
1972	23.8	76.2
1977	24.2	75.8

Source: *Hospitality in Transition*. Albert J. Gomes, 1985.

### **The 1950s and 1960s**

#### **The Birth of Franchising**

One of the major drawbacks of motels and hotels during the 1950s was that their services were not standardized. As a result, hotel guests did not know what type of product to expect when checking in. This nonstandardization of the hotel product was first recognized as a problem and rectified by Kemmons Wilson, who founded Holiday Inn in 1952. He is credited for introducing the concept of a standardized hotel product. The Holiday Inn concept revolutionized the lodging industry by introducing a motel with



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standardized service, a recognizable name, and moderate prices (Rushmore, 1992). A result of the success of this concept was that Wilson was able to expand his chain by offering franchises to prospective investors. Thus, the concept of franchised lodging properties started with Holiday Inn and was later adopted by Howard Johnson, Ramada, Marriott, Hyatt, and Radisson in the late 1950s and early 1960s. Today, virtually every hotel company is involved in some form of franchising. Besides offering a standardized product, the franchising concept also provides a vehicle to expand lodging chains at a much faster rate than if each property had to be purchased. As a result, the 1950s and 1960s saw a large increase in room supply.

#### Growth through International Expansion and Strategic Alliances

In the 1960s, U.S. hotel chains such as Intercontinental Hotels and Hilton Hotels began to expand their operations into South America and Europe. Lodging chains also expanded through vertical integration. Trans World Airlines (TWA) purchased Hilton International (1967), United Airlines purchased Westin Hotels, and American Airlines started to acquire hotels under the “Americana Hotels” name. This strategy was spurred by the belief that accommodations and transportation companies are synergistic and therefore more viable as one company. Later divestitures indicated that this strategy did not have the intended outcome.

#### Impact of the Highway Act and Changing Demographics

Other factors during the 1950s and 1960s that influenced the rapid increase in the supply of hotel rooms include the passage of the Interstate Highway Act of 1956, which laid out

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a blueprint for the establishment of a network of national highways. On the demand side, population growth and in migration, the increase in household formation, rising incomes, increases in leisure time, and business development in the suburbs resulted in more travel. An indirect impact of increased business activity was the emergence of the meeting and conventions market, which resulted in the creation of convention hotel products such as the New York Hilton in 1963 (Winfrey, 1996).

### The Early Role of Tax Law Changes on Growth and Development

A final factor that influenced hotel supply during this period was a change in income tax laws in 1954 that allowed accelerated depreciation. This change resulted in the development of new hotels to take advantage of the tax benefit provided by the new depreciation method, which allowed hotel developers to take larger depreciation in the early years of their investments. A major drawback of this type of investing was that, in order to keep up the high depreciation and interest deductions, new properties had to be added continuously to an investor's portfolio, which sometimes resulted in poor investment choices (Rushmore, 1992). The change in income tax law resulted in hotel development decisions that were not dictated by the economics of hotel operations but by the tax savings offered by hotel real estate ventures. Similar "tax-driven" supply increases were to plague the hotel industry later in the century.

### **The 1970s**

The increase in hotel room growth of the 1960s continued into the early 1970s. Many of the chains established in the 1950s and 1960s started to carve a niche in the budget

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segment of the industry. These companies were now established as franchisors and used the franchising vehicle to aggressively establish critical mass.

Financing was readily available in the early 1970s, especially through mortgage REITs (Real Estate Investment Trusts). Rushmore states, “These high-leverage finance companies were created to allow small investors to participate in real estate mortgages and equities. Wall Street quickly accepted the concept, and soon billions of dollars were made available to finance real estate projects. Many lenders became so overwhelmed with new money that their underwriting procedures broke down . . .” (Rushmore, 1992).

The net result of aggressive franchising policies and readily available capital was overbuilding and the development of hotels in poor locations. National occupancies dropped to 59 percent in 1972 (see Table 2).

The supply/demand imbalance put pressure on lodging companies to find new ways to grow. Since they were not able to grow by increasing demand for their product, chains started to pursue multiple market segments and offer more than one brand, so they could target more than one type of customer. Thus, the lodging industry chains were introduced to the concept of market segmentation, which has continued to the present period. “The advent of market segmentation marked the maturation of the lodging industry into its present form” (Ader & Lefleur, 1997).

The bubble burst in 1973, with the Arab oil embargo and the subsequent energy crisis. Annual hotel occupancies plummeted due to decreased travel, and many marginal properties were foreclosed. This was followed by a recession in 1975.

The late 1970s was a period of rough equilibrium between supply and demand. New construction was constrained because of the recent losses incurred by lenders on

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hotel properties. A combination of higher demand during the 1977–79 period, coupled with high inflation, resulted in escalating average daily rates (ADR). Between 1977 and 1980, ADRs increased at a compounded annual rate of 16.8 percent (Ader & Lefleur, 1997). As a result of high inflation, interest rates were raised, which increased the cost of borrowing. Developing new hotels became expensive. With a reduction in new room growth and a continued increase in demand, the late 1970s saw an increase in occupancy from 63.9 percent in 1975 to 72.6 percent in 1979 (PKF, *Trends in the Hotel Industry*).

## **The 1980s**

The 1980s were a turbulent period for the hotel industry. The decade started with a building boom as a result of three complementary factors: tax incentives for real estate investment, availability of capital, and product segmentation.

### Tax Incentives and Capital Availability

Beginning in 1981, the passage of the Economic Recovery Tax Act (ERTA) made investment in commercial real estate very attractive. ERTA cut corporate, individual, and capital gains taxes. Furthermore, by changing the depreciation rules, it made investment in commercial real estate—including hotels—profitable on an after-tax basis. In addition, the rules of taxation allowed passive investors (such as those in a limited partnership) to offset income generated in other activities by losses incurred by their participation in these limited partnerships. This resulted in the formation of syndicated limited



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partnerships to take advantage of these tax benefits. Thus, capital flowed to finance the lodging industry for “non-economic” (non-cash-flow generating) deals.

On the debt side, the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) and the Garn-St. Germain Depository Institutions Act of 1982 deregulated the savings-and-loan industry. This allowed it to make commercial loans for the first time. As a result, a massive infusion of debt capital flowed to the lodging industry through the hands of inexperienced lenders. Many loans made by savings-and-loan institutions were made with minimal underwriting standards. Flannery & Flannery (1990) describe the impact of this legislation on hotels: “Many S&Ls entered the bull market for development of real estate. As they competed to place loans, they began to fund marginal projects. The underwriting standards of some of the more venturesome S&L’s making loans to the hotel industry became less stringent and loans were made that had insufficient regard for the substantial risks involved in hotel development.”

In 1986, the Tax Reform Act (TRA) was passed. It took away the previous tax benefits of commercial real estate investment. Depreciation schedules were increased to 31.5 years, the investment tax credit was repealed, and earned income could no longer be sheltered by passive investment losses. Many of the hotels that had been built to take advantage of the tax laws were now exposed because of their uneconomical capital structure (very high leverage) and inadequate debt coverage. This resulted in many hotel owners defaulting on their loans; many savings-and-loan institutions that had overextended themselves into commercial real estate became insolvent. This was known as the “S&L Crisis,” which will be discussed in detail in the next chapter.

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During the period from 1983 to 1987, as noted in Table 4, the annual growth of room supply was more than four percent each year, and in 1987 it was over seven percent. Demand could not keep up with the frenzied pace with which new hotels were being added. Hotel operators competed by slashing room rates.

**Table 4**  
**U.S. LODGING INDUSTRY**  
**Growth in Room Supply (1968–1989)**

Year	Percent change from prior year
1968	2.1%
1969	2.1
1970	1.9
1971	1.8
1972	2.1
1973	5.2
1974	4.8
1975	2.3
1976	2.1
1977	2.1
1978	0.8
1979	1.8
1980	1.9
1981	2.0
1982	2.0
<b>1983</b>	<b>4.3</b>
<b>1984</b>	<b>4.8</b>
<b>1985</b>	<b>4.7</b>
<b>1986</b>	<b>4.4</b>
<b>1987</b>	<b>7.2</b>
1988	3.8
1989	3.7

Source: Smith Travel Research; Coopers & Lybrand.

### Product Segmentation

The final factor that fueled the over-development scenario was that the market segmentation strategy adopted by hotel chains evolved into “product segmentation.” With the increase in competition, chains saw that the only way to grow was by creating new products. In the words of one management consultant, “Proliferation of new products has been overdone by lodging companies, which dreamed up more concepts than there are

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real and discernible market segments” (Trice, 1992). These products were being created by franchisors who realized that the creation of certain critical mass is important for franchise-brand awareness.

*Transactions*, a research report by Hotel Motel Brokers of America (HMBA), summarized the situation correctly. It states: “In retrospect, the rationale for the 80s hotel construction boom is easy to see: franchisors created new products for developers to build; lenders had capital to lend; and developers could acquire capital on ‘soft’ terms with construction profits financed as part of the package” (HMBA, 1991).

During the 1980s, the only truly new hotel products created were the extended-stay and all-suite products. The all-suite product was based on the theory that many business travelers do not use facilities such as meeting, banquet, and restaurant space. By eliminating this space and providing additional space in the guestrooms by converting them into suites, a hotel would provide more value to its guests. The extended-stay product was designed to target a traveler who stays in an area for long periods, either due to relocation or extended projects. The facilities in these hotels resemble a residential atmosphere, so much so that checking into an extended-stay hotel does not involve going to the front desk. Furthermore, the layout of the guestrooms is more like a mini-apartment or studio.

Although not a completely new product, the “Microtel” may be considered the 1980s’ version of the original budget motels of the late 1950s. Just as motels did in the 1950s, motels in the 1970s and 1980s that started as budget properties began to add amenities, due to competitive pressures, and eventually moved up into the mid-price



category. Microtels filled the vacuum thus created. They are smaller and less expensive to construct than other motels, yet provide all the basic amenities.

Pannell Kerr Forster (PKF) has created a classification scheme for the lodging industry based on development criteria (see Table 5). By the 1980s, hotels were being developed on the basis of price, function, location, market served, and distinctiveness of style. From Table 5, it is clear that by the 1980s the industry had evolved from the simple dichotomy of hotels vs. motels (characteristic of the 1960s) into its present structure consisting of multiple products. The impact of the profusion of hotel products will be discussed later in this chapter.

**Table 5**  
**TYPES OF HOTELS BY FIVE DEVELOPMENT CRITERIA**

<b>Price</b>	<b>Function</b>	<b>Location</b>	<b>Market served</b>	<b>Distinctiveness of style or offerings</b>
<b>Budget/Economy</b> Rooms-only, little public space; no food and beverage	<b>Convention</b> Large; 500 + guest rooms; extensive public space and meeting space	<b>Downtown</b> High rise structures; attached parking; wide mix of facilities and amenities	<b>Executive Conference Center</b> Secluded settings; less than 300 rooms; small meeting rooms; audio visual facilities and variety of recreation facilities	<b>All-Suite</b> Larger than normal guest rooms; living and sitting areas separate; minimum public space; facilities equipped for extended stay
<b>Middle-Market</b> Wider range facilities and amenities	<b>Commercial</b> Functional guest rooms, ample work area; small meeting and conference rooms; limited recreation	<b>Suburban</b> Low to mid-rise structures; surface parking; meeting and banquet facilities	<b>Health Spa</b> Catering to market looking for specific need such as weight loss, or hedonistic experience. Staff consists of a variety of trained professionals such as dietitians, therapists, and counselors	<b>Historic Conversion</b> Well known historic buildings and landmarks renovated or converted to hotels
<b>Luxury</b> Upscale décor and furnishings; concierge service; high quality public space; higher than average employee to guest room ratio		<b>Highway</b> Low rise structures; surface parking; exterior corridors; some have outdoor pools	<b>Resort</b> Emphasis on recreation. Extensive food and beverage and banquet. Settings are picturesque	<b>Hotels in MXD's</b> Mixed use developments consisting of hotels, retail and other attractions.
		<b>Airport</b> Adjacent or attached to airports; Efficient and functional.		

Source: PKF Consulting



### Impact of Management Contracts on the Lodging Industry's Structure

The 1980s also saw the rise of management contracts in the lodging industry. Although the history of management contracts in the lodging industry can be traced back to the 1960s and 1970s, they were not as prevalent during those periods. Owners generally operated their own hotels.<sup>1</sup> Charles A. Bell points out that, while there were less than 22 management contracts in 1970, this increased to 182 in 1975, and by 1980 “there were too many to count” (Bell, 1993). The primary reason for this growth was the increase in passive investors that owned hotels during this period to take advantage of the hotel real estate tax benefits discussed earlier in this section.

The introduction of the management contract presented a fundamental change in the structure of the lodging industry; management contracts separated lodging ownership from its management. Ownership represents the real estate component while management represents its business component. Hotel companies realized that the hotel business was really a hybrid of two businesses, real estate and lodging:

Hotel companies began selling ownership of existing hotels to, and developing new projects with, investment groups who sought the benefits of real estate ownership, but who had no interest or expertise in hotel operations. In return, hotel companies kept long-term management contracts, giving them operational control over the properties for a stipulated management fee. The arrangement could either include the right to use a brand name along with the management services (example: Marriott), or include just management services (example: Interstate), with the brand provided by a third-party franchiser (example: Choice or HFS) (Ader & Lefleur, 1997).

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<sup>1</sup> Although not all owners did. Another common method of operating hotels in the 1950s and 1960s was via total property leases. Davis (1997) states: “Essentially, a total property lease is an agreement between a hotel company and hotel owner whereby the hotel company leases the hotel.” The lease terms were based on some variable percentage of revenue.

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## **The Structure of the Lodging Industry: 1990 to the Present**

### **Impact of the Recession on the Lodging Industry**

As the lodging industry entered the 1990s, it was severely impacted by a national recession. The excess hotel building of the 1980s resulted in a dramatic increase in hotel rooms. An overbuilt industry faced declining demand for rooms, due to a reduction of overall travel as a result of the Persian Gulf War (1990–91) and an economic recession. As shown in Table 6, national occupancies bottomed out at 61.8 percent in 1991. Due to the oversupply of rooms, hotels had to reduce room rates, which further impacted profitability. Table 6 also shows the heavy losses suffered by the hotel industry during this period—net losses of \$5.7 billion in 1990 and \$2.8 billion in 1991.

**Table 6**

#### **ANALYSIS OF LODGING INDUSTRY PERFORMANCE (1990–1992)**

<b>Yr</b>	<b>Supply % Chg</b>	<b>Demand % Chg</b>	<b>Occ</b>	<b>% Chg</b>	<b>ADR*</b>	<b>% Chg</b>	<b>RevPAR*</b>	<b>% Chg</b>	<b>GOP*</b>	<b>Fixed Charges</b>	<b>Profits \$Billions</b>
<b>1990</b>	3.2%	1.9%	63.5%	(1.1 %)	\$57.96	2.9 %	\$36.82	2.9 %	25.5%	32.1%	-5.7
<b>1991</b>	1.4	(1.3)	61.8	(2.6)	58.08	0.2	35.91	(2.5)	27.4	29.7	-2.8
<b>1992</b>	0.7	1.9	62.6	1.3	58.91	1.4	36.87	2.7	29.5	26.5	0.0

Source: Smith Travel Research

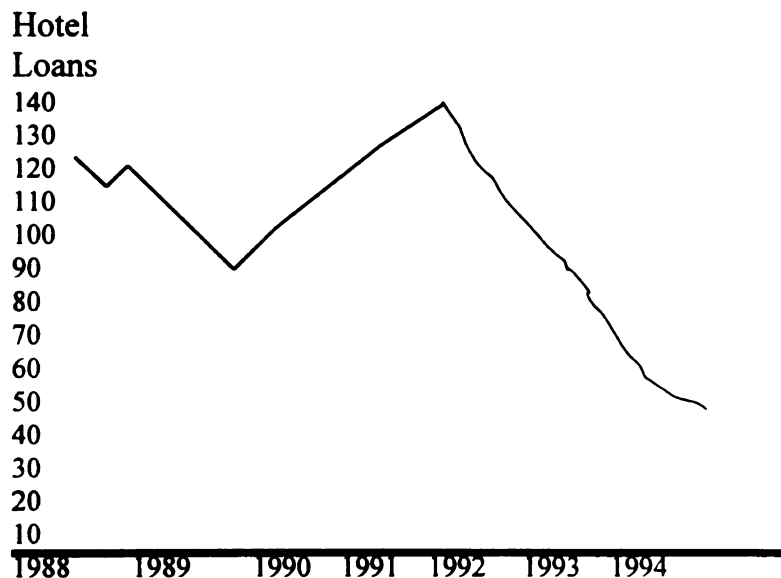
\*ADR = Average Daily Rate

\*RevPAR = Revenue Per Available Room

\*GOP = Gross Operating Profit

## **Increase in Loan Delinquencies**

To further compound the problem, many of the loans made in the 1980s were now coming due. The structure of these loans required a large lump sum payment at the end of the loan term. This type of financing structure is known as a “bullet loan.” The consequence of the negative economic environment facing the hotel industry in the early 1990s was an increase in the number of non-performing loans, leading to an increase in foreclosures. As noted in Figure 6, the number of delinquent loans increased dramatically during the period from 1990 to 1992. After 1992, as loans were restructured, new loans were cut back, and the overall performance of the lodging industry started to gradually improve, the amount of foreclosures began to decline.



Source: American Council of Life Insurance.

**Figure 6. HOTEL LOAN PERFORMANCE (Number of Foreclosures)**

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The direct result of these non-performing hotel loans led to the virtual elimination of new hotel capital to the industry from traditional financing sources such as commercial banks, life insurance companies, and savings-and-loan institutions. This vacuum was filled by two sources of capital to the lodging industry (introduced below and to be discussed in detail in the next chapter).

On the debt side, public money financed the hotel industry with the use of Commercial Mortgage-Backed Securities (CMBS). CMBSs packaged loans into debt securities, which were then sold to passive investors. The genesis of CMBS as an indirect form of hotel ownership started as early as 1992, when the Resolution Trust Corporation (RTC) needed to sell nonperforming hotel loans. Many of these nonperforming loans were bundled as securities and sold by investment banks.

Besides public money, private equity capital also financed the lodging industry during the period of capital scarcity, primarily through professional real estate investors forming joint ventures with investment banks and partnerships with management companies (HMBA, 1994). Many of these groups were formed in 1991–1992 to purchase the distressed loan pools from RTC and large regional banks, insurance companies, and pension funds, which at this time were selling their hotel portfolios. Some of this capital earned the moniker of “Opportunity Funds” or “Vulture Funds,” as these funds purchased properties at a discount with the purpose of repositioning them and selling them later at a profit.

## **Reduction of Hotel Values**

The oversupply of hotel rooms during this period also impacted the value of hotel real estate, which reached rock bottom in 1993 (see Table 7). Many hotel properties that were taken back by the lender in a foreclosure or were part of the REO portfolio (Real Estate Owned) of savings-and-loan institutions were acquired by the Resolution Trust Corporation (RTC) and sold at discounted prices. The majority of the sellers during this time were financial institutions.

**Table 7**  
**AVERAGE SELLING PRICE OF HOTELS**  
**1987–1994**

YEAR	AVERAGE SELLING PRICE PER ROOM
1987	\$20.713
1988	\$23.630
1989	\$20.688
1990	\$21.539
1991	\$18.400
1992	\$18.741
1993	\$17.411
1994	\$19.068

Source: Hotel Motel Brokers of America (HMBA).

## **Lodging Industry Recovery**

The lodging industry gradually began to recover in 1992. Hotel occupancies increased to 62.6 percent. This was the result of a 1.9 percent increase in demand and only a 0.7

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percent increase in room supply. Financing was still difficult to find, as lenders were still trying to dispose of their hotel real estate.

As this recovery continued, the lodging industry was once again profitable in 1993 and hotel values started to increase in 1994, reversing the doldrums of the previous three years. This was done primarily by restructuring their debt load, re-financing their loans at lower rates, increasing their equity contribution, and purchasing hotels at discounted rates, which further reduced debt service (Mandelbaum, 1994). Furthermore, management companies improved the operating performance of hotels by instituting tighter controls (see Table 8).

**Table 8**  
**OPERATING AND CAPITAL STRUCTURE RATIOS**  
**U.S. LODGING INDUSTRY**  
**1990-1996**

YEAR	EMPLOYEES PER 100 ROOMS	DEPARTMENTAL EXPENSES	INTEREST EXPENSE
1990	78.5	45.0%	14.0%
1991	77.5	36.6	12.0
1992	75.5	36.2	10.0
1993	75.0	37.0	8.0
1994	74.5	35.1	7.5
1995	75.0	34.2	7.0
1996	75.2	33.2	7.0

Source: Coopers & Lybrand. Smith Travel Research

### **Introduction of REITs as a New Way to Own Hotels**

The major buyers of hotel real estate during this period of recovery in the mid 1990's were Real Estate Investment Trusts (REITs). RFS Investors, Inc. made a successful REIT

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initial public offering in August 1993. With the exception of a brief slowdown at the end of 1994, REITs have continued to the present period as major owners of hotel real estate. The formation of equity REITs started a period of large-scale public-equity financing of the hotel industry. Thus, from 1993 onward, investment banks and large money-center banks increased their role as financial intermediaries supplying capital to the lodging industry. The organizational structure and role of REITs in reshaping the current hotel industry is discussed in detail in the next chapter. Table 9 lists all of the hotel REITs in 1993 and 1994.

**Table 9**  
**EQUITY REITs**  
**August 1993–December 1994**

REIT	Market Capitalization \$ Millions	Total Hotels	Limited Service	Full Service	All Suite Extended Stay
R.F.S Hotel Investors	370.4	34	25	5	4
Felcor Suite Hotels	123.6	7	0	0	7
Equity Inns	109.5	17	12	3	2
Winston Hotels	70.6	11	1	0	0
Innkeepers USA	39.1	7	5	1	1
Jameson Inns	23.3	15	15	0	0
Humphrey	21.8	8	8	0	0
Total	758.3	99	76	9	14

Source: Coopers & Lybrand.

### **Consolidation of the Lodging Industry**

The U.S. lodging industry in the 1990s is characterized as a mature industry. A mature industry is one in which growth has slowed down. Maurice Robinson of KPMG Peat

Marwick states that “the lodging industry is a mature industry, where top brands have been fighting for market share for years. Segmentation or ‘nichemanship’ is mostly the result of the battle for ‘shelfspace.’ Consolidation or cannibalization is the growth strategy most often utilized in these mature industries, once growth in demand for the product levels off” (Robinson, 1996).

Growth in the 1990s for hotel companies is different from the growth experienced in the 1960s, when growth came through franchising and vertical integration (United Airlines and Westin, for example). Now, as Robinson states, the growth strategy is consolidation. Increasing access to capital through public-equity and debt markets fuels this growth. Other factors, such as the improved performance of the lodging industry (and consequent inflation of stock prices), economies of scale, strategic fit, and globalization, are also contributing to the increased merger and acquisition (M&A) activity.

Steve Bollenbach of Hilton Hotel states, that M&A activity is inevitable and will continue to grow: “In a unit-expansion business, the only way you can expand your company is by acquiring properties. Today it is cheaper to acquire than build them. . . . There is plenty of product to buy because the bulk of the construction done in the 1980s and the product controlled by Japanese investors have come into the market” (Wood, 1997).

As noted in Table 10, M&A activity increased from 1 deal in 1992 to 15 in 1996 and 1997. In 1997 the total M&A activity announced was valued at \$23.5 billion (Shroders & Co., 1998). Some of the most notable hotel deals of 1997 are listed in Table 13. As Table 11 shows, the major acquirers of hotel companies in 1997 were REITs, as

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REITs accounted for ten out of the 15 M&A deals in 1997. This trend continues into 1998.

The consolidation of the lodging industry is changing the structure of the industry in many ways. The following are some of the major impacts of the trend toward consolidation:

1. Consolidation is resulting in a larger number of hotel rooms being controlled by fewer companies.
2. Although it is not evident as yet, consolidation also has the effect of reducing competition, as the number of lodging companies diminishes.
3. The surviving hotel companies are growing larger in size. Because of this, the industry as a whole should become more efficient and have more access to capital. At the same time, many industry observers are presently asking the question, how big is too big?

**Table 10**  
**MERGERS AND ACQUISITIONS**  
**1991-1997**

YEAR	1991	1992	1993	1994	1995	1996	1997
M&A	-	1	7	9	10	15	15
Spinoffs	-	-	-	1	3	2	

Source: National Hotel Realty. Smith Travel Research.

**Table 11**  
**LARGEST LODGING DEALS IN 1997**

Acquirer	Target	Deal Size (Millions)
Starwood (REIT)	ITT	\$13,748
Promus	Doubletree	1,704
Patriot American (REIT)	Interstate	2,142
Starwood (REIT)	Westin	1,570
Patriot American (REIT)	Wyndham	773
Marriott International	Renaissance	908
Patriot American (REIT)	Carnival	485
Starwood (REIT)	HEI	327
Sunstone (REIT)	Kahler	322
Patriot American (REIT)	WHG	266
Extended Stay America	Studio Plus	296
Boykin Lodging (REIT)	Red Lion Inns	271
Patriot American (REIT)	Cal Jockey/Bay Meadows	239
Prime Hospitality	Homegate	132
Wyndham	Clubhouse	130

Source: Securities Data Corp.

4. As each hotel company grows, it acquires multiple brands and types of products and thus becomes more diversified. Many large hotel companies are either acquiring or merging with firms that operate casinos. Companies such as Cendant, which started as a lodging company (Hospitality Franchise Systems), no longer operate only hotels. They have diversified into car rental, real estate, marketing, and insurance businesses. Some consolidations, such as the Doubletree/Promus merger, are examples of brand consolidation. Promus did not have an upscale, full-service brand, and Doubletree did not have mid-scale brands. Together, they cover a wider range. Furthermore, Doubletree was strong as a management company, while Promus's strength was in its

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brand. Other major hotel companies undergoing portfolio diversification include Hyatt, Marriott, Westin, and Four Seasons.

5. Besides lodging companies acquiring each other, they may be acquired by companies and become part of a conglomerate. Bass Plc., a conglomerate based in the United Kingdom, added Intercontinental Hotels to its growing umbrella of firms. Bass Plc. also owns Holiday Hospitality—formerly known as Holiday Inn Worldwide. The new combined company was renamed Bass Hotels and Resorts. Other examples include La Quinta, which was acquired in 1998 by Meditrust, a non-hotel REIT.
6. It is also expected that the newer, consolidated hotel companies will put money into renovating many of their hotels that are approaching the end of their economic lives. As Greg Spevok, a Vice President at Bear Stearns, notes, “By having a mass of properties, you are spreading that CapEx [capital expenditure] over a much greater base. And you are gaining efficiencies in construction trades and in ordering replacement materials” (Wood, 1997). Furthermore, Bjorn Hanson, a Partner with Coopers & Lybrand, states, “Collective purchasing for greater discounts, technology investments, shared central costs, and marketing synergy should have a positive impact on the profitability and effectiveness of these consolidated companies to compete in the mature lodging industry” (Hanson & Vo, 1998).
7. The consolidation trend is also resulting in the acquisition of U.S.-based hotel firms by foreign companies. By the same token, as a result of consolidation, U.S. companies are gaining access to foreign markets. The acquisition of Renaissance by Marriott International will give it access to markets such as Vietnam, China, and Indonesia.

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8. Finally, growth and consolidation is also occurring via strategic alliances, such as those between a REIT and a management company. This type of alliance fuels future growth by combining the capital acquisition potential of a REIT with the management company's operational expertise to manage the growing portfolio of hotels. Furthermore, alliances of this nature impact the ownership structure of the lodging industry.

Many experts predict that, after the hotel-company "equals" have finished merging, the next wave of mergers will be of large hotel companies acquiring smaller ones. According to Bjorn Hanson, these will be "survival mergers," because the operating environment will make it very difficult for small hotel companies to match the marketing or financial clout of the large ones. According to Paul Nussbaum, chairman of Patriot American (a REIT), "We'll see smaller capitalized companies—especially those that have a higher cost of capital—become targets of larger firms. As securitization increases, growth companies will continue to acquire non-growth companies" (Wood, 1997).

### **Globalization of the Lodging Industry**

The lodging industry in the 1990s is becoming increasingly global. Many U.S. lodging companies are gaining a foothold in foreign markets by buying companies that have a global presence. Foreign companies are acquiring U.S. hotel companies as well. Tables 12 and 13 give an idea of the increasing globalization of the lodging industry in the 1990s.

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**Table 12**

**MULTINATIONAL PRESENCE OF THE LARGEST CORPORATE HOTEL CHAINS**

HOTEL CHAIN	NUMBER OF COUNTRIES
Accor	70
Best Western	69
Inter Continental	69
Holiday Inn Worldwide	65
ITT Sheraton	62
Marriott International	51
Forte Hotels	50
Hilton International	49
Carlson Hospitality Worldwide	42
Choice Hotels International	40
Club Mediterranee	40
Hyatt Hotels	37
Grupo Sol	25
Westin Hotels & Resorts	23
Park Plaza International Hotels	20

Source: Hotels: Giants Survey 1997.

As shown in Table 12 Accor, a French hotel chain, has a presence in the largest number of countries (70 countries). However, it is interesting to note that there is not much difference in the global distribution of the top five multinational hotel chains, all having a presence in from 62 to 70 countries. This is indicative of the intense competition between the multinational hotel chains; when one chain opens a hotel in a particular country, another usually follows suit.

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**Table 13****INTERNATIONAL CORPORATE HOTEL CHAINS RANKED BY COUNTRY**

<b>RANK</b>	<b>HEADQUARTER COUNTRY</b>	<b>ROOMS</b>	<b>HOTELS</b>	<b>AVERAGE HOTEL SIZE (Rooms)</b>
1	USA	2,643,899	20,715	128
2	FRANCE	387,980	3621	107
3	GREAT BRITAIN	237,310	1267	187
4	JAPAN	152,109	613	248
5	SPAIN	135,462	805	168
6	GERMANY	80,151	660	121
7	HONG KONG	42,671	99	431
8	CANADA	40,354	144	280
9	SWEDEN	26,485	150	177
10	SINGAPORE	24,156	79	305
11	SOUTH AFRICA	22,834	179	128
12	INDIA	21,196	137	155
13	THAILAND	20,522	81	253
14	AUSTRALIA	19,062	106	180
15	SWITZERLAND	12,664	50	253
16	ITALY	12,142	62	196
17	FINLAND	12,058	77	157
18	HUNGARY	11,618	73	159
19	MEXICO	10,603	45	236
20	CHINA	10,354	42	246
21	POLAND	10,100	47	215
22	BAHAMAS	8,031	37	217
23	NORWAY	5,700	47	121
24	DOMINICAN REPUBLIC	5,690	22	259
25	GREECE	4,945	20	247
26	SYRIA	4,620	16	289
27	TUNISIA	4,443	18	247
28	CYPRUS	4,343	29	150
29	IRELAND	3,821	23	166
30	NETHERLANDS	3,788	28	135
31	DENMARK	3,721	17	219
32	INDONESIA	3,494	21	166
33	CUBA	3,486	34	102
34	BRAZIL	3,329	18	185
35	PORTUGAL	3,156	15	210
36	AUSTRIA	2,964	22	135
37	TURKEY	2,290	9	254
38	ISRAEL	2,190	8	273
39	JAMAICA	2,180	9	242
40	UAE	2045	14	146
41	KOREA	2000	3	667
Total		4,034,635	29,461	137

Source: Adapted from Hotels: Giants Survey 1997. Based on the top 200 corporate chains.

While noting the growth of multinational hotel chains from various regions of the world, it is important to keep a few facts in mind. As noted in Table 13, in terms of overall scope, the multinational hotel chains originating from the United States still maintain a leadership position. However, chains from various parts of the world are increasingly challenging the market share of U.S. multinational hotel companies. A study of 110 firms, conducted by Sumit Kundu as part of his research on the globalization of the hotel industry, indicates that North American and European firms account for 80 percent of multinational hotels, Asian firms account for 17 percent of the total rooms (Kundu, 1995). His study indicates that of the 139,000 rooms in Asia operated by multinational chains, approximately 73 percent are operated by multinationals from North America and Europe. On the other hand, only 22 percent of the total multinational hotels in the United States are operated by Asian multinationals. It is clear that even though the picture is not as one sided as it was in the 1960s and 1970s, multinationals from the West still have a stronger presence in the Orient than the Oriental multinationals do in the West.

However, even though multinationals may originate from a certain part of the world, they may be owned by an entity from another country. For example, in 1981 Intercontinental Hotels (U.S. company) was sold to Grand Metropolitan Plc in the United Kingdom and then later (in 1988) purchased by the Saison Group, a Japanese company (Gee, 1994). In 1998, Intercontinental Hotels was sold again to Bass Plc from the United Kingdom. In this manner, even though the brands of non-U.S. multinational hotel companies may not be strong enough to compete with older and easily recognizable U.S. brands, they are entering the U.S. market by purchasing U.S. hotel chains.



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## **Growth of Lodging Brands**

The market segmentation of the lodging industry in the 1980s reached its culmination in the 1990s. Between 1980 and 1996, 113 new brands were introduced in the lodging industry (Coopers & Lybrand, 1997). Segmentation occurs when hotel companies feel that the opportunities for expansion in their existing stratum of business are not sufficient to maintain or increase growth at a desired level. As these segments become saturated, thereby limiting growth potential, chains create a new “product,” targeted at another segment, so they can try to continue their growth. “As a result of the far-reaching segmentation of brands and the complex interweaving of ownership and management, the hotel industry has reached a stage of brand confusion. Consumers, investors, and even people in the industry find it difficult to define any hotel company’s character or ‘personality’” (Coopers & Lybrand, 1997).

Today, 64 percent of all U.S. lodging properties with 20 rooms or more are affiliated with one of the nearly 180 lodging brands ( Coopers & Lybrand *Directions*, 1997). The “brand map” shown in Table 14 provides an idea of the different lodging industry tiers and a sampling of brands in each of the lodging segments.

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**Table 14**

**A MARKET SEGMENTATION MAP OR BRAND MAP  
(A Selection of Hotel Chains and Market Segments)**

Chain	Lower range economy	Upper-Range Economy	Middle-Range Full Service	Upper Range Full Service	Luxury	All Suite	Other
Choice	Sleep Inn Econolodge Friendship	Comfort Inn Rodeway Inns	Quality Inns	Clarion Hotels		Comfort Suites Quality Suites Clarion Suites	
Doubletree			Doubletree Club	Double tree Hotels		Guest Quarters	
Forte	Thriflodges	Travelodge	Travelodge Hotels	Exclusive Hotels		Travelodge Suites	
Hilton			Hilton Garden Inns	Hilton Hotels		Hilton Suites	
Holiday Inn		Holiday Inn Express	Holiday Inns	Crowne Plaza Holiday Inn Select			Sunspreet Resorts Crowne Plaza Resorts
HFS	Super 8	Park Inns Days Inn Wingate Hojo Inn Ramada Limited	Howard Johnson Ramada Inns		Ameri Suites		
Hyatt				Hyatt Regency	Grand Hyatt Park Hyatt	Hyatt Suites	Hyatt Resorts Hyatt Vacation Clubs
ITT Sheraton			Four Points	Sheraton Hotels	Luxury Collection	Sheraton Suites	
Marriott		Fairfield Inns	Courtyard by Marriott	Marriott Hotels	Marriott Marquis	Residence Inn Marriott Suites	Marriott Timeshares
Promus		Hampton Inns				Embassy Suites Homewood Suites	
Wyndham			Wyndham Garden				Wyndham Resorts

Source: PKF Consulting.

Table 15 indicates the increase in the introduction of new brands in the 1990s. This has further added confusion to the structure of the lodging industry which, in the minds of many, has created more brands than clearly discernible products. In 1995 and 1996, a

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total of 25 new brands were added to the lodging industry. Many of these are either new brands, “relaunchings” of brands whose development was stalled due to the capital crunch of the early 1990s (HMBA *Transactions*, 1995).

**Table 15**  
**NEW HOTEL BRANDS**  
**1991–1997**

Product	1991	1992	1993	1994	1995	1996	Ytd 3 <sup>rd</sup> Qtr 1997
Limited Service	-			1		4	
Full Service	2	1	3	1	5		1
Extended Stay		2	-		2	6	2
All Suite	1	1	-	1	3	5	
Luxury	1	-	-				
Total	4	4	3	3	10	15	3

Source: National Hotel Realty; Smith Travel Research.

A review of trends in hotel construction also reveals that there is a relationship between the number of room starts (number of rooms opened in a particular year) and the introduction of new brands (see Table 16). Periods of new hotel construction are also periods when capital is available. The period from 1980 to 1982 was a period of few room introductions and not many new hotel brands. From 1983 to 1986, the total number of brands increased rapidly as capital availability resulted in a surge of hotel building activity. From 1987 to 1989 most of the new brands added were in the all-suite segment. By 1990 the industry was overbuilt and the capital “spigot” was shut off. As construction slowed down, so did new brand introductions from 1990-1993. Most of the new brands added in the most recent period from 1994-1996 were in the limited service and extended-stay segments.

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**Table 16**  
**BRAND INTRODUCTIONS AND ROOM STARTS**  
**(1980–1996)**

YEAR	ROOM STARTS	NEW BRANDS
1980	12500	1
1981	12500	1
1982	30000	3
1983	148000	13
1984	175000	16
1985	100000	9
1986	125000	11
1987	75000	6
1988	100000	9
1989	112500	10
1990	49000	5
1991	49000	4
1992	22000	4
1993	9000	3
1994	30000	3
1995	112500	10
1996	112500	15

Source: Coopers & Lybrand; Smith Travel Research; National Hotel Realty.

### **Chain versus Independents (Growth of Franchise and Management Companies)**

The direct result of the proliferation of lodging brands is that the industry has become more organized and dominated by large chains, which is reflected in changes in the chain versus independent share of room demand. In 1980, the independents commanded 45 percent of the room demand; in 1997, they only commanded 30 percent. Based on room conversion tracking by Smith Travel Research, in the past four years 64,000 rooms have been converted from independent to chain status (Smith Travel Research, 1997).

The increase in brands is influenced by a number of factors, such as the changing demographics of travelers who prefer recognizable products, the conversion of independents to brands, the availability of capital to construct new hotels, the physical



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aging of hotel products from the 1970s and 1980s, and the international expansion of U.S. lodging companies (HMBA *Transactions*, 1995).

As the lodging industry grew in size, diversity, and complexity, the need for professional management also increased. While many of the management companies in the early 1990s were “workout” specialists with short-term objectives, in the mid to late 1990s only strong management companies willing to align their interests with owners survived. Mirroring the diversity of hotel products offered in the lodging industry, these management companies started to specialize and target specific segments. A survey of top management companies conducted by *Hotel Motel Management* (March 2, 1998) indicated that these companies manage a wide range of hotel sizes, from an average hotel size of 63 rooms to an average hotel size of 615 rooms. The size of the average hotel managed by the top 25 management companies is 168 rooms.

### **Growth of New Product Types in the 1990s**

In the 1990s, the lodging industry structure changed in yet another way. The existing companies started to diversify into new types of “lodging” and “entertainment” products. For some of the companies, the diversification efforts started in the 1980s but were stalled due to lack of capital. However, since the mid-1990s (considered to be the period when the lodging industry started to recover), many of these new types of lodging and entertainment products have seen varying degrees of growth. Three of these new products are briefly discussed in the following sections.

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### Vacation Ownership/Timeshare

The timeshare industry has its origins in Europe and was first introduced to the United States in the 1960s. However, for many years the industry remained small and fragmented. Furthermore, due to marketing abuses in the 1970s, the industry fell into disrepute and stagnated. The regulation of the industry in the 1980s created a level of professionalism, and the industry has experienced an annual growth rate of 15 to 17 percent over the last decade (Mutkowski & Maher, 1997). Other factors that contributed to the growth of the vacation ownership/timeshare industry include an increase in consumer confidence, an improvement in quality of physical product and service, and an increase in the number of brands entering the industry (thus increasing the level of awareness via increased overall promotion investment). Table 17 shows that many traditional hotel companies have diversified into the timeshare segment, which has started to pose a competitive threat in many locations.

**Table 17**

#### **MAJOR VACATION OWNERSHIP AND TIMESHARE COMPANIES**

Companies	Resorts	Owners/Members
<b>PURE PLAY COMPANIES</b>		
Signature Resorts, Inc	69	175,000
Fairfield Communities, Inc	15	160,000
Vistana, Inc	6	68,000
Trendwest Resorts, Inc	19	45,000+
Silverleaf Resorts, Inc	9	Approx 32,000
Vacation Break, U.S.A.	5	Approx 20,000
<b>LODGING &amp; ENTERTAINMENT COMPANIES</b>		
Marriott International	32	Approx 100,000
Hilton Hotels Corp	18	43,000
Westin Hotels & Resorts	1	Na
Four Seasons Hotels, Inc	1	Na
Hyatt Hotels	1	Approx 1,600
Promus Hotels Corp	3	7,900+
The Walt Disney Co.	4	25,000+
<b>TIMESHARE EXCHANGE COMPANIES</b>		
RCI International (subsidiary of HFS)	3,109	2.2 Million+
Interval International	1,461	Approx 750,000

Source: BT Alex Brown Incorporated Research.

Worldwide sales in 1996 for the vacation ownership/timeshare industry were \$5.5 billion (BT Alex Brown, 1997). In addition to the factors just cited, the increasing affordability of vacation intervals and the availability of onsite financing have fueled the industry's growth. With the increasing involvement of branded hotel companies in the vacation ownership/timeshare industry and the demographic shift of U.S. households, the vacation ownership/timeshare industry is expected to grow steadily.

### Gaming and Casinos

One of the ways that entertainment, as part of the hotel product, has manifested itself is with the emergence of casino hotels. The liberalization of gaming laws in many states and the increasing demand for entertainment by a growing segment of travelers has resulted in the expansion of many traditional hotel chains into the casino business. Casino properties vary in size, from mega-resorts such as the 6,000-suite Bellagio casino hotel just constructed in Las Vegas to small hotels adjacent to Native American Indian casinos. Hotel chains have entered the casino business primarily through the ownership of casinos, and recently through franchising. Hospitality Franchise Systems was the first to introduce a nationally franchised casino brand (HMBA *Transactions*, 1995).

A testimony to the importance of gaming to the lodging industry is the growth in casino revenues. In 1982, the total gaming revenue for the industry was \$4.2 billion. This increased to \$19.1 billion in 1996—an increase of 355 percent (Castro, 1997).

The synergy created by combining casinos and hotels creates a larger and much more attractive travel product. The casino is the primary product, which the traveler purchases, and the hotel brand provides recognition and the necessary distribution

network (national reservations and sales). Although Las Vegas and Atlantic City are the primary gaming destinations in the United States, this model (combining hotels and casinos) is being rapidly adopted throughout the country.

### Extended-Stay

The extended-stay hotel segment had 366 properties with 43,000 rooms in 1995; by 1997, the extended-stay segment had grown to 754 properties with more than 85,000 rooms (Shroders & Co., 1998). Extended-stay hotels are a step up from all-suite hotels, which were introduced in the 1980s. As U.S. companies started to use outsourcing as an acceptable form of doing businesses, the need for extended-stay accommodations increased, because more and more consultants worked on projects away from their homes. These hotels “provide a residential atmosphere by offering larger, apartment-type guestrooms with separate living and sleeping areas, full kitchens, and exterior entrances” (Lee, 1997).

Besides a radical change in the physical shape of a typical guestroom, the extended-stay lodging product also impacted the industry’s overall structure because of differences in its basic operation. The average length of stay in extended-stay hotels for a typical guest is close to ten days, as opposed to two days in a regular hotel. As a result, extended-stay hotels do not have as high a level of fluctuation in room demand as do traditional hotels. This has resulted in much higher occupancies (75.7 percent for 1997) and higher room rates (\$73.20 for 1997) than those of traditional hotels (Shroders & Co., 1997). The overall change in the business format has also reduced operating costs and



increased profitability ratios. A profile of current extended-stay brands is shown in Table 18.

**Table 18**  
**EXTENDED STAY HOTEL BRANDS**  
**1997**

<b>Brand</b>	<b>Hotels</b>	<b>Rooms</b>
Residence Inn	254	30,013
Extended Stay America	114	13,678
Homestead	69	9,260
Villager Lodge	73	6,034
Homewood	52	5,364
Studio Plus	65	4,783
Summerfield	29	3,782
Suburban Lodge	26	3,476
Hawthorn	26	3,171
Candlewood	20	2,101
Sumner	17	2,001
Homegate	6	787
Woodfin	6	739
Crossland Suites	6	719
Inn Town Suites	5	682
Sierra	6	591
Mainstay	4	386
Townplace	2	184

Source: Smith Travel Research.

Other emerging products that are expected to impact the lodging industry's structure include the involvement of the lodging industry in the acquisition and management of retirement communities. Marriott International is leading the industry in this area. With an aging U.S. population, this industry segment is expected to grow.

As the industry consolidation continues, it is expected that lodging companies may acquire affiliated enterprises in order to offer a total travel package, not just lodging. Cendant (formerly HFS) is leading the way in this area, with the acquisition of car rental, timeshare, and other travel-related companies (Standard & Poor's Lodging and Gaming Survey, 1997).



## **Organizational Forms in the Lodging Industry**

Although many hotels are individually owned (as sole proprietorships), the organizational form of most large hotel organizations is either a C-Corporation, Limited Partnership, Real Estate Investment Trust (REIT), or Limited Liability Company (LLC). Limited Partnerships were more prevalent in the period from 1981 to 1985, when many were formed to participate in hotel ownership for the tax advantages. Since 1993, equity REITs have been actively acquiring hotel properties, and many hotel companies (C-corps) are either management companies, owners of hotel real estate or hotel brands. Table 19 outlines the major characteristics of the five lodging organizational forms.

A survey conducted by PKF Consulting in 1993 (see Table 20) shows that partnerships were the dominant form of hotel ownership in 1993, followed by individuals and hotel companies. Hotel REITs were just beginning in 1993 and therefore represent a small percentage. However, a recent report by Frank Nardoza, a Hospitality Consulting Partner at KPMG Peat Marwick, indicates that “the buying binge that has been occurring recently in the lodging industry has left large concentration of hotel assets in the hands of relatively few major portfolio investors. Several new industry giants have emerged with portfolios valued well in excess of \$1 billion. This new breed of owners consists of well capitalized hotel companies, REITs, pension funds, and investment funds” ( Nardoza, 1996).

**Table 19**

**ORGANIZATIONAL FORMS IN THE LODGING INDUSTRY**

Business Form	Characteristics	Advantages
Limited Partnership	<ul style="list-style-type: none"> <li>♦ It is a hybrid between a general partnership and a corporation.</li> <li>♦ At least one general partner who manages the affairs of the partnership and at least one limited partner who acts as a passive investor</li> <li>♦ Used in many cases in the hotel industry where the general partner is a real estate developer and limited partners are passive investors.</li> <li>♦ A favored organizational form prior to the TRA of 1986, due to favorable tax treatment.</li> </ul>	<ul style="list-style-type: none"> <li>♦ Limited Partners are a good source for raising equity capital.</li> <li>♦ Liability of limited partners limited to extent of their investment.</li> <li>♦ Prior to the Tax Reform Act of 1986, Limited partnerships offered tax advantages.</li> <li>♦ Even in the present tax environment, the partnership does not pay income tax.</li> </ul>
C-Corporation	<ul style="list-style-type: none"> <li>• A legal, taxable entity chartered by a state and/or federal government and owned by stockholders</li> <li>• C-corps may be franchisors, chain or independent management companies, owners/operators, on non-REIT owners</li> </ul>	<ul style="list-style-type: none"> <li>• Fewer regulations with respect to structure, earnings distribution and asset sales relative to REITs</li> </ul>
S-Corporation	<ul style="list-style-type: none"> <li>• It is a corporation with tax advantages of a partnership and limited liability of a corporation.</li> <li>• Maximum number of shareholders 35</li> <li>• May have only one class of outstanding shares</li> </ul>	<ul style="list-style-type: none"> <li>♦ Limited Liability</li> <li>♦ Easy transferability of shares</li> <li>♦ Centralized management</li> <li>♦ No double taxation</li> </ul>
Limited Liability Company (LLC)	<ul style="list-style-type: none"> <li>• An entity formed under state law to conduct a business or investment activity</li> <li>• LLC's can limit liability more effectively than a limited partnership and is less restrictive than a S corporation. As a result it is becoming an increasingly important organizational form for hotel real estate ownership.</li> </ul>	<ul style="list-style-type: none"> <li>• No double taxation</li> <li>• Limited Liability</li> <li>• No limits on number of owners (unlike S corporation)</li> <li>• Can limit liability more effectively than a limited partnership</li> </ul>
Real Estate Investment Trust (REIT)	<ul style="list-style-type: none"> <li>• A publicly traded company that raises equity through an initial public offering or private formation transaction.</li> <li>• Structured to lease its owned hotel assets to a tenant and receive rent based on a percentage lease arrangement.</li> <li>• Income increases are derived from increases in lease income resulting from higher hotel revenues and via acquisition of additional hotel assets.</li> <li>• Because of the requirement to distribute 95 % of taxable net income, an equity REIT must grow through external capital sources.</li> <li>• To access external capital sources, REITs establish a line of credit with a lending institution and typically borrows 40-50 percent of the value of the hotel asset.</li> <li>• REITs are exempt from corporate income tax if they comply with specific regulations such as :               <ol style="list-style-type: none"> <li>1. Distribute 95% income as dividends.</li> <li>2. No fewer than 5 individuals can own more than 50% of the REIT.</li> <li>3. Minimum of 100 investors</li> <li>4. At least 75% of gross income from rent of real property.</li> <li>5. At least 75% of asset must be real estate.</li> </ol> </li> </ul>	<ul style="list-style-type: none"> <li>♦ Exempt from corporate income taxes if meet specific requirements.</li> </ul>

Source: Bear Stearns & Co., Inc.

A recent study reported in the December 29, 1997, issue of *Forbes* magazine (see Table 21) for commercial real estate as a whole is consistent with Nardoza's analysis mentioned in the previous section. Partnerships are not as important as corporations, the latter owning 43 percent of U.S. commercial real estate. REITs, at 3.6 percent, have a higher percentage of ownership than financial institutions and institutional investors. Even though as a percentage of the total ownership REITs are still small, their growth from \$17 billion in commercial real estate assets in 1992 to \$142 billion in 1997 tells the true story of their growing role in the commercial real estate industry (Locker, 1997).

**Table 20**  
**WHO OWNS AMERICA'S HOTELS?**

OWNER	PERCENTAGE
Partnership	40%
Individual	19
Hotel Company	17
Joint Venture	8
Other	6
Insurance	3
Bank	2
Pension Fund	1
REIT	1
S&L	1
Construction Co	1
Government	1

Source: *Trends*, by PKF Consulting, 1993.



**Table 21**

**OWNERS OF U.S. COMMERCIAL REAL ESTATE**

OWNER	AMOUNT (\$)	PERCENTAGE
Corporations	\$1.7 Trillion	43.1%
Partnerships	1 Trillion	25.6
Not for profit	411 Billion	10.5
Government	234 Billion	6.0
REITs	142 Billion	3.6
Institutional Investor	128 Billion	3.3
Financial Institution	114 Billion	2.9
Other	104 Billion	2.6
Individuals	96 Billion	2.4

Source: *Forbes*, December 29, 1997.  
Original source, AEW Capital Management.

**Shifts in the Lodging Industry Room Supply: 1990s**

There are currently over 3.5 million hotel rooms in the U.S. lodging industry. From an investment perspective, it is important to understand that the supply of hotel rooms is not homogeneous. The lodging room supply may be differentiated either by the price segment, product type, location, or region. As such, an analysis of the changes in the lodging room supply is important in any study of capital flows, because it is indicative of the type of products financed and the locations and regions to which capital is being attracted. The series of tables that follow analyzes the characteristics and trends of the U.S. lodging industry's room supply in the 1990s.

### Change in Net Room Supply, U.S. Lodging Industry (1990–1997)

Table 22 shows the total net change in room supply from 1990 to 1997 for each of the hotel price segments. It is clear that “Midscale w/o F&B” and the “Economy” segments have added the most rooms to the inventory, through a combination of construction and conversion activity. Much of the new construction in the 1990s was a result of the aging of the limited-service hotels, most of which were constructed in the 1970s and were at the end of their economic lives in the 1990s. (Economic lives for limited-service hotels range from 15 to 20 years [Winfrey, 1996]). “Upscale” and “Budget” hotels were the next highest in terms of rooms added. “Independent” and “Midscale with F&B” have actually reduced their inventory, primarily by converting out of these concepts.

**Table 22**  
**NET ROOM CHANGE**  
**By Chain Segment 1990–1997 (March Ytd) (000s)**

Segment	Net Room Change (B+C)	Net Rooms Constructed (B)	Net Room Conversions (C)
Upper Scale	43838	42924	914
Upscale	63909	37891	26018
Midscale with F&B	-6705	21605	-28310
Midscale w/o F&B	156794	118667	38127
Economy	132121	97514	34607
Budget	19335	17410	1925
Independent	-66393	6089	-72482

Source: Smith Travel Research.

### Distribution and Change in Room Supply by Price Segment

Table 23 shows changes in share of room supply by each of the price segments. Although independents represent the largest percentage of hotel rooms, they have been losing their market share. This is primarily through conversions to branded properties. The “Upper Scale” and “Upscale” segments have remained steady in their share of supply. The “Midscale with F&B” segment is losing popularity and has shown a reduction in supply,

while “Midscale w/o F&B” experienced the highest rate of growth during this period. The economy segment has shown a slight increase, while the budget segment a minor reduction in share.

**Table 23**  
**CHANGE IN SHARE OF ROOM SUPPLY BY SEGMENT**

SEGMENT	1990 Percentage	1994 Percentage	1997 Ytd March Percentage
Upper Scale	12.6	12.3	12.5
Upscale	6.5	7.0	7.4
Midscale with F&B	21.5	20.8	19.6
Midscale w/o F&B	4.8	6.6	8.5
Economy	9.9	10.8	12.2
Budget	7.0	7.2	6.8
Independent	37.7	35.3	33.0
Total	100%	100%	100%

Source: Smith Travel Research.

#### Profile of Hotel Development

Table 24 shows the number of new hotel properties and rooms opened from 1991 to the third quarter of 1997. As is evident, the rate of development doubled in 1996 and 1997 compared to 1991 and 1992. This is in part the result of the increasing availability of capital in the past few years. The average size of a new hotel opened in 1997 was 93 rooms, as compared to 83 rooms in 1994. This is indicative of the increasing popularity (in part, due to a perception of overbuilding in the limited service segment) of larger full-service hotels and the financial community’s ability to finance such projects.

**Table 24**  
**DEVELOPMENT OF NEW HOTELS**  
**1991–1997**

YEAR	1991	1992	1993	1994	1995	1996	Ytd 3 <sup>rd</sup> Qtr 1997
Properties opened	475	394	410	540	799	1054	945
Number of Rooms opened	51197	36547	39750	44838	64092	91150	84754
Avg size of new hotels	108	93	97	83	80	87	93

Source: National Hotel Realty; Smith Travel Research.

Relationship Between Room Supply by Price Segment and Location

Room supply may also be analyzed by price segment and type of location.

As noted in Table 25, most urban hotels are either luxury, upscale, or mid-price.

Suburban hotels tend to be upscale, mid-price, or budget. Airport hotels are clustered mainly around the upscale or mid-price segments, while highway properties are mostly low priced. Not surprisingly, resort hotels are mostly luxury or upscale.

**Table 25**  
**DISTRIBUTION OF LODGING ROOMS BY PRICE SEGMENT AND**  
**LOCATION**  
**1997**

SEGMENT	Urban	Suburban	Airport	Highway	Resort
Luxury	35.1%	9.5%	12.0%	1.7%	23.8%
Upscale	28.5	23.2	25.2	16.6	42.8
Mid-Price	20.1	28.4	34.5	27.3	17.4
Economy	6.9	17.2	15.2	22.5	7.0
Budget	9.4	21.7	13.2	31.8	9.4
Total	100.0%	100.0%	100.0%	100.0%	100.0%

Source: Smith Travel Research.



### Distribution of Room Supply by Location (1990 and 1998)

Table 26 shows the distribution of lodging room supply by location. As can be seen, suburban and highway locations currently have the highest share of hotel rooms in the United States. This is indicative of the move of businesses from central business district locations (CBDs) to the suburbs and the continued use of the automobile by most travelers as the primary travel method.

**Table 26**  
**PERCENTAGE OF ROOM SUPPLY BY LOCATION**  
**1990 and 1998**

LOCATION	TOTAL ROOMS (1990)	SHARE OF ROOMS	TOTAL ROOMS (1998)	SHARE OF ROOMS
Urban	485,658	15.9%	518,634	14.4%
Suburban	995,675	32.7	1,243,815	34.6
Airport	219,310	7.1	244,865	6.8
Highway	982,946	32.2	1,158,669	32.2
Resort	364,679	12.0	427,527	12.0
Total	3,048,268	100.0%	3,593,510	100.0%

Source: Smith Travel Research.

### Distribution of Room Supply by Region

Lodging industry room supply may also be analyzed by its regional distribution. As shown in Table 27, the largest share of hotel rooms in the United States (24 percent) is located in the South Atlantic region. The Pacific, Mountain, and East North Central regions follow, with shares of 16, 12, and 11.9, respectively. The New England area, with 4 percent, has the smallest number of hotel rooms.

**Table 27****GEOGRAPHIC DISTRIBUTION OF ROOM SUPPLY BY REGION**

REGION	ROOMS January 1998	Share of Rooms	ROOMS January 1997	Share of Rooms	STATES
New England	142,989	4.0%	140,151	4.0	ME,NH,VT,MA,RI,CT
Middle Atlantic	307,701	8.6	301,147	8.7	NY,NJ,PA
South Atlantic	860,843	24.0	827,646	24.0	DE,MD,DC,VA,WV,NC,SC ,GA,FL
East North Central	425,966	11.9	407,044	11.8	OH,IN,IL,MI,WI
East South Central	228,921	6.4	216,356	6.2	KY,TN,AL,MS
West North Central	247,298	6.9	236,148	6.8	MN,IA,MO,ND,SD,NE,KS
West South Central	367,149	10.2	350,364	10.1	AK,LA,OK,TX
Mountain	436,006	12.0	417,889	12.1	MT,ID,WY,CO,NM,AZ,UT, NV
Pacific	576,637	16.0	566,044	16.3	WA,OR,CA,AK,HI
Total	3,593,510	100.0%	3,462,789	100.0%	

Source: Smith Travel Research.

As noted in Table 28, 1997 showed growth rates of room supply in most regions from 3.4 to 5.7 percent. The New England, Pacific and the Middle Atlantic regions exhibited relatively slow rates of growth. The New England area, which experienced negative growth rates in the early part of the decade, is now experiencing small increases in room supply. A similar story prevails in the Middle Atlantic region. The West South Central region also had negative growth rates in the early part of the decade but has recently exhibited larger than average growth rates. Although the South Atlantic region has the largest share of rooms, it experienced very slow rates of growth in the periods from 1991 to 1996.

**Table 28**

**PERCENTAGE CHANGE IN ROOM SUPPLY BY REGION  
1990–1997**

Year	New England	Middle Atlantic	South Atlantic	East North Central	East South Central	West North Central	West South Central	Mountain	Pacific
1990	3.5%	3.7%	3.4%	4.0%	2.8%	2.5%	0.8%	4.5%	3.1%
1991	1.5	2.1	1.8	1.4	0.9	0.7	-0.6	1.2	2.2
1992	-0.3	0.4	0.5	0.9	0.8	1.6	-0.1	0.5	1.3
1993	-0.6	-0.6	0.2	0.4	0.4	1.6	0.4	0.7	0.4
1994	-0.3	-0.1	0.9	0.5	2.3	2.7	1.0	3.1	0.0
1995	-0.1	0.4	0.9	1.2	4.0	2.1	1.7	2.3	0.2
1996	0.0	0.3	1.9	2.1	4.2	2.3	4.3	4.0	0.6
1997	.6	1.7	3.4	4.1	5.7	4.5	4.9	4.5	1.2

Source: BT Alex Brown Inc and Smith Travel Research.

**Profile of Lodging Transactions, Average Selling Price, and Market Values of Hotels in the 1990s**

Changes in the average selling price and market values of hotels are also factors that impact the flow of capital to the lodging industry. Although the total number of hotels sold does not exhibit a remarkable change from the early 1990s to the present, the change in average selling price has more than doubled. This is an indication that most of the sales in the early 1990s were of the distressed sales type discussed earlier in the chapter, while the current sales are more truly reflective of market value. Table 29 presents the changes in the profile of hotel transactions from 1991 to the third quarter of 1997. During this period, the average selling prices more than doubled (reaching \$79,925), which indicates a solid recovery for the industry. Table 29 also clearly shows that large hotel transactions (over \$10 million) have also increased, and equity REITs, which were nonexistent in the early 1990s, are continuing to amass a larger and larger portfolio of hotels.

**Table 29**  
**PROFILE OF HOTEL TRANSACTIONS**  
**1991–1997**

YEAR	1991	1992	1993	1994	1995	1996	Ytd 3 <sup>rd</sup> Qtr 1997
<b>Hotels Sold</b>	593	559	527	570	581	597	392
<b>Avg selling price per room (\$)</b>	33.887	32.449	31.024	45.475	53.087	66.433	79.295
<b>Sales greater than \$10 Million</b>	47	62	54	96	128	211	147
<b>Hotels in REIT portfolios</b>	-	-	10	123	286	503	1927
<b>Other transactions</b>	12	11	14	56	97	232	269

Source: National Hotel Realty, Smith Travel Research, and the Conference Board.

**Table 30**  
**LODGING INDUSTRY MARKET VALUES**  
**(Per Room)**

Segment	1990 (\$)	1991 (\$)	1992 (\$)	1993 (\$)	1994 (\$)	1995 (\$)	1996 (\$)	1997 (\$)
Luxury	74.161	61.907	69.652	71.092	90.136	113.051	126.947	137.905
Upscale	42.949	39.392	47.488	49.562	65.026	77.320	83.576	94.106
Midscale	34.953	36.294	42.119	45.946	52.038	62.952	64.775	70.194
Economy	29.572	26.245	27.784	28.085	29.498	35.367	36.121	36.411
Budget	25.400	21.818	22.679	22.998	27.498	33.003	34.797	37.168

Source: Hospitality Valuation Services. Note: the changes in the hotel values are different from those shown above, as they are from a different source. However, the trend is nevertheless the same.

## **Operating Performance of the Lodging Industry in the 1990s**

### Summary of Operating Performance of U.S. Lodging Industry

Table 31 summarizes the operating performance of the U.S. lodging industry from 1990 to 1996. Ever since demand caught up with supply and finally exceeded it in 1992, room

Table 31 summarizes the operating performance of the U.S. lodging industry from 1990 to 1996. Ever since demand caught up with supply and finally exceeded it in 1992, room rates, occupancies, and profits have been steadily improving in the lodging industry. The lodging industry recorded a profit of \$12.5 billion in 1996, after operating at a deficit at the beginning of the decade.

**Table 31**

**ANALYSIS OF U.S. LODGING INDUSTRY PERFORMANCE**

Yr	Supply % Chg	Demand % Chg	Occ	% Chg	ADR	% Chg	RevPA R	% Chg	GOP	Fixed Charges	Profits \$Billions
1990	3.2%	1.9%	63.5	(1.1	\$57.96	2.9	\$36.82	2.9	25.5	32.1%	-5.7
			%	%)		%		%	%		
1991	1.4	(1.3)	61.8	(2.6	58.08	0.2	35.91	(2.5	27.4	29.7	-2.8
				)				)			
1992	0.7	1.9	62.6	1.3	58.91	1.4	36.87	2.7	29.5	26.5	0.0
1993	0.3	1.7	63.5	1.4	60.53	2.8	38.42	4.2	30.5	23.3	2.4
1994	1.0	3.0	64.7	1.9	62.86	3.8	40.70	5.9	36.2	22.8	5.5
1995	1.2	1.7	65.1	0.6	65.81	4.7	42.83	5.2	37.0	19.8	8.5
1996	2.1	2.3	65.2	0.2	69.66	5.9	45.47	6.2	38.2	18.3	12.5

Source: Smith Travel Research.

Analysis of Operating Performance by Price Segments

The operating performance of the lodging industry can be further analyzed by each segment. When comparing the growth of the individual segments, the mid-price segment, and particularly the upscale and luxury segments have been performing better in recent years than the economy and budget segments of the industry. <sup>2</sup>Demand growth for these segments has been weak in the last few years. While demand for economy hotels grew by 1.8 percent in 1996 from the previous year, budget hotels actually experienced reduced demand for the same period. Equity analysts at BT Alex Brown feel that this weakness

life. Furthermore, they feel that the introduction of the mid-price segment, which is much newer, offers a higher price-value relationship to the customer. The strength of the overall economy has also allowed many companies to afford higher-priced rooms for their executives, which benefits occupancies at upscale and luxury hotels. Finally, it is felt that the lower-tiered segments are becoming overbuilt, which increases competitive pressures and further dampens occupancies.

### **Investment Performance: The Commercial Real Estate Industry and the Lodging Industry**

It is important to consider the investment performance of the lodging industry and the commercial real estate industry together . As the supply of capital to the lodging industry is determined, to a large extent, not only by the industry's investment returns, but also by the investment returns of alternative real estate investments and the overall trend in the commercial real estate sector.

Table 32 shows the total returns for five commercial real estate sectors, based on the Russell NCREIF index of total returns. Most institutional investors use this index when comparing sector returns. All sectors show strong returns in 1995–1997, with R&D and the office sector showing the highest returns. (The lodging industry returns are not analyzed by NCREIF.)

**Table 32**

**TOTAL RETURN BY PROPERTY TYPE AND TOTAL INDEX  
1990–1997**

Year	Office	Retail	R&D	Warehouse	Apartment	NCREIF (Classic)
1990	(1.05)	5.96%	1.04%	2.44%	5.80%	2.30%
1991	(11.44)	(1.84)	(5.62)	(2.94)	(1.82)	(5.58)
1992	(8.00)	(2.23)	(8.78)	(2.43)	1.72	(4.26)
1993	(3.93)	4.84	.83	(1.52)	8.72	.27
1994	3.88	6.00	5.75	8.5	12.07	6.38
1995	7.16	3.99	11.25	12.70	11.66	15.95
1996	13.34	4.85	18.18	12.79	11.53	10.29
1997	17.35	8.39	26.00	13.76	12.76	13.74

Source: National Council of Real Estate Investment Fiduciaries (NCREIF).

The National Association of Real Estate Investment Trusts (NAREIT) tracks all REITs and composes an index of total returns. Table 33 shows that REITs in general have performed well in the last few years. NAREIT started to track lodging REITs as of 1997. Lodging REITs' total returns were much higher than the overall REIT returns in general.

**Table 33**

**TOTAL REIT RETURNS  
1990–1997**

Year	All	Equity
1990	(17.35)%	(15.35)%
1991	35.68	35.70
1992	12.18	14.59
1993	18.55	19.65
1994	0.81	3.17
1995	18.31	15.27
1996	35.75	35.27
1997	18.86	20.26

Source: NAREIT. (NAREIT reported a total return of 30.09% for lodging REITs in 1997.)

Positive operating results for the commercial real estate industry as a whole and the lodging industry in particular have also been good for lodging stocks. Tables 34 and

35 show positive returns for lodging stocks as measured by the AH&MA Lodging Property Index and the BT Alex Brown Lodging Index, respectively.

**Table 34**

**AMERICAN HOTEL & MOTEL ASSOCIATION  
LODGING PROPERTY INDEX**  
(Total Returns)

<b>Year and Quarter</b>	<b>Total Return</b>
1995 Q4	5.9%
1996 Q1	6.36
1996 Q2	9.33
1996 Q3	8.05
1996 Q4	9.37
1997 Q1	9.25
1997 Q2	8.94
1997 Q3	14.08

Source: Lodging Property Index: Industry Real Estate Advisory Council of the AH&MA;  
and the Cornell University School of Hotel Administration.

**Table 35**

**BT ALEX BROWN LODGING INDEXES**  
(Total Returns)

<b>Index</b>	<b>Year End 1997</b>	<b>Total Return 52 Weeks As of (10/31/97)</b>
Lodging Index (Large Cap)	33.9%	38.8%
Small-Cap Lodging Index	12.6	10.4
Lodging C-Corp Index	33.4	42.8
Extended Stay Index	-47.5	-6.8
Lodging REIT Index	28.3	57.5

Source: BT Alex Brown Incorporated Research  
And FactSet Research Systems, Inc.

Table 36 outlines a lodging stock index tracked by Shroders & Co. This index, which was started in 1982 with a base of 100, rose to 220 in 1990. The recession in 1991 brought the index down to 75 and recovery did not take place until 1994. In 1997, the index reached 200, which neared its 1990 peak of 220.



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**Table 36**

**SHRODERS LODGING INDEX  
1982–1998**

YEAR	INDEX
1982	100
1983	125
1984	140
1985	125
1986	145
1987	150
1988	145
1989	150
1990	220
1991	75
1992	75
1993	80
1994	150
1995	150
1996	150
1997	200
1998	175

Source: Shroders & Co. Inc.

Note: The stock index values are as of January of each year.

The index consists of 11 public companies (including Starwood, a REIT). The public companies are a combination of upscale, mid-price, and economy hotel companies.

## **Conclusions**

This chapter has discussed the evolution of the structure of the U.S. lodging industry from the early part of the 20<sup>th</sup> century to the late 1990s. Over this time, the structure of the lodging industry has changed in many ways. The industry has become much larger as measured by the number of rooms, more diverse and heterogeneous in terms of the types of products offered and ownership structure, more geographically dispersed in terms of the distribution of hotels both domestically and globally, more complex in terms of its overall organizational forms (REITs, C-corps, Limited partnerships), more sophisticated in terms of its operations (Management contracts, Franchising), more segmented in terms

of the overall markets served, and more consolidated as measured by the increasing presence of larger hotel chains.

This evolution of the lodging industry from simplicity to sophistication and complexity has taken place in the context of a changing environment. The events and issues in the environment of the lodging industry which have impacted the structure of the industry have been changes in the overall economy, tax laws, demographic shifts, changing tastes and preferences of its customers, technological changes, competition, financial innovation and availability of financing.

Historically, the availability of financing to the lodging industry has had a direct impact on changes in the supply of hotel rooms and therefore on its operating and investment results. The lodging industry started the 1990s facing an economic recession and was very overbuilt. The excessive lending of the 1980s resulted in major supply demand imbalances, which resulted in an unprofitable industry. As capital was shut off, the demand caught up with supply and the lodging industry returned to profitability. As the industry became attractive once again to the financial community, capital became available once again from the mid 1990s to the current period (1997-1998). The future performance of the lodging industry and sources and availability of capital are the subject of the Research Questions addressed in the Delphi study and reported and discussed in chapter 7.

## **Chapter 5**

### **FINANCING HOTEL INDUSTRY GROWTH AND DEVELOPMENT**

The last quarter of the twentieth century has seen profound changes in the way the lodging industry is financed. As these changes occurred, the role of the financial-services organizations that provide capital to the lodging industry has also been transformed. This chapter seeks to answer the following research questions:

- 1. What have been the current needs for which capital has been used by the lodging industry?*
- 2. What have been the key events that have impacted the availability of capital to the lodging industry from the 1970s to the current period?*
- 3. What financing trends have impacted the lodging industry from the 1970s to the current period?*
- 4. What has been the role of individual financial institutions as suppliers of capital to the lodging industry in the twentieth century?*

### **The Need for Capital by the Lodging Industry**

The previous chapter chronicled the lodging industry as it evolved from a simple homogeneous industry owned and operated largely by individuals to a micro-segmented industry owned largely by corporations. The industry now consists of real estate,

management (management contracts), and marketing components (brands), organized in various legal formats and owned by various entities ranging from individuals to institutions.

During this progression from a simple to a complex and mature industry, the lodging industry's need for capital has changed. This section will summarize the changing needs for capital by the lodging industry during selected historical periods. The factors that have changed how capital has been used by the lodging industry over the years can be placed into three categories: business cycles, hotel products, and hotel owners.

### **Business Cycles**

During the last 25 years of the lodging industry, the need for capital was determined to a large extent by the stage of the lodging industry's business cycle during each historical period. A cyclical stage in which supply exceeded demand for rooms characteristically resulted in lower property values, which resulted in lower acquisition costs per room. The opposite was the case during the growth or peak stages of the business cycle.

During each historical period, the purpose for which capital was used in the lodging industry also varied. When acquisition costs started to exceed construction costs, more capital was applied toward the construction of hotels. Whereas in other periods, when the hotel product was beginning to age, capital was applied toward renovation or conversion. During periods when property values declined, capital was used for opportunistic types of investing. As hotel markets became saturated and growth rates

slowed down, capital was used to open up new markets (globalization) or to create new brands and further segment the market. When competitive pressures increased (as is true in the current period), mergers and acquisitions were the dominant use of capital. Table 37 outlines the ten largest public fund raisers from 1991 through 1996 and how the capital raised was used.

**Table 37**  
**TEN LARGEST PUBLIC FUND RAISERS**  
**1991–1996 (1<sup>st</sup> Qtr)**

Company	Type	Funds raised (\$mm)	Percentage of funds raised	Primary Purpose
Host Marriott	C-Corp	1,591.5	15.5%	Acquisition hotels domestic and intl
HFS Inc	C-Corp	1,388.2	13.6	Acquisition of hotels and diversification strategy
Marriott Corp	C-Corp	975.0	9.5	Corporate purposes prior to spin-off of Host Marriott
Marriott Intl	C-Corp	600.0	5.9	Corporate purpose
Felcor Suites	REIT	521.1	5.1	Acquisition of all suite hotels
John Q Hammons	C-Corp	504.6	4.9	Construction of mid market and first class hotels in secondary markets
La Quinta Inns	C-Corp	468.9	4.6	Expansion and renovation of existing hotels and repayment of debt.
Trump Hotels and Casinos	Gaming	460.5	4.5	Expansion of Trump casino and construction of riverboat casino
RFS Hotel Investors	REIT	367.1	3.6	Acquisition of hotels.
Patriot American	REIT	350.5	3.4	Acquisition of hotels in business and tourist destinations.
All others		3,012.8	29.4	
<b>Total</b>		<b>\$10,240.2</b>	<b>100.0%</b>	

Source: National Hotel Realty.

Source: Patrick Ford, "Who Has the Money?" *Lodging Hospitality*, May 1996, p. 32.

## Hotel Products

The hotel products that attracted capital were also different in different historical periods. In the 1960s, for example, with the growth of franchising (predominately associated with highway properties), the major use of capital was for franchised highway hotels. During

the period of suburban growth (the 1960s and 1970s), airport and suburban hotels gained popularity and hotels were not built or acquired in center-city locations. Later, as the market became more segmented, hotel financing was used for a variety of different hotel products. Hotel companies that licensed brands needed capital for maintaining existing brands and developing new brands. A detailed review of changes in the various hotel brands during different historical periods was discussed in the previous chapter. Most brand introductions were part of a hotel company's strategy to create "brand equity," which is the intrinsic value associated with a brand that is successfully positioned, is differentiated from competitors, and has a distinct image (Dev, Morgan, & Shoemaker, 1995).

Demographic shifts also dictated regional growth and use of capital. The South Atlantic region currently has the highest share (24 percent) of the total room supply, but in the 1950s, the Mid-Atlantic and East North Central regions had the highest percentage of hotel rooms.

A survey by Hotel Partners (a mortgage broker) shows the range of different types of hotel products funded by lenders today (see Table 38).

**Table 38**

**TOTAL AMOUNT FUNDED BY PRODUCT TYPE (January–June 1997)**

PRODUCT	PERCENTAGE FUNDED
Full-Service	52%
Limited-Service	19
Resort	17
Luxury	8
Extended-Stay	3
Convention	1

Source: Hotel Partners Capital Group.

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The current emphasis on full-service and resort properties is easy to understand. As Thomas R. Engel of ERE Yarmouth states, “We continue to believe that unique, more difficult to reproduce, full-service hotels and resorts—wherever they may be located—offer the best investment potential for investors” (Wood, 1997). On the other hand, limited-service hotels have attracted capital mainly due to lower-per-room investment of capital.

During the lodging industry’s current period of recovery (1993 to the present), three new travel/entertainment product types have created a need for capital in the lodging industry. These are briefly discussed in the following sections.

#### Gaming Properties

Gaming activity is the primary driver of hotel room growth in Las Vegas, the city with the largest concentration of hotel rooms in the United States. Table 39 shows the growth in hotel rooms ( and thus need for capital) in Las Vegas from 1987 to 1997. The rooms in the city have almost doubled (to 105,000) in the past ten years. (Recent reports on Las Vegas gaming indicate worries about overbuilding, which has raised the specter of uncertainty in future earnings and may lead to a reduction in future growth levels.)

**Table 39**

**GROWTH OF HOTEL ROOMS IN LAS VEGAS  
1987–1997**

YEAR	HOTEL & MOTEL ROOMS	PERCENTAGE CHANGE
1997	105,000	6.0%
1996	99,072	10.0
1995	90,046	1.7
1994	88,560	2.9
1993	86,053	12.5
1992	76,523	(0.5)
1991	76,879	4.3
1990	73,730	9.4
1989	67,391	9.8
1988	61,394	4.9
1987	58,474	3.5

Source: Las Vegas Convention and Visitors Bureau, and Christina Binkley, "Gamble on Las Vegas Hotel-Casinos May Not Pay Off," *Wall Street Journal*, April 1, 1998.

The growth and popularity of gaming has also led to a large number of consolidation transactions. In 1996, mergers and acquisitions valued at over \$5 billion occurred (see Table 40).

**Table 40**

**MAJOR GAMING MERGERS AND ACQUISITIONS  
1996**

BUYER	TARGET	VALUE(\$MM)
Hilton Hotels Corp.	Bally Entertainment	\$2,000 MM
ITT Sheraton Corp.	Caesars World Inc	1,696
Circus Circus	Gold Strike Resorts	576
Sun Intl Hotels Ltd.	Griffin Gaming	210
Boyd Gaming	Par-a Dice Gaming	175
Investor	Sahara Hotel & Casino	150
HFS Inc.	National Gaming Corp	80
Sigman Family Trust	Aladdin Hotel & Casino	80
Circus Circus	Hacienda Hotel & Casino	80
<b>Total</b>		<b>\$5,047.00</b>

Source: Coopers & Lybrand.

### Vacation Ownership/Timeshare Properties

Due to the rapid growth of the vacation ownership/timeshare industry and the increasing presence of hotel brands, this industry sector's performance has been improving. This improvement has attracted publicly raised capital to the industry. Debt and equity capital raised for vacation ownership companies exceeded \$750 million in a recent 15-month period (BT Alex Brown Research, 1997). The industry's need for capital has been mainly for growth through consolidation and for funding new product ideas, such as the "urban timeshare" (timeshare properties in major metropolitan areas).

### Extended-Stay Properties

The all-suite hotel segment, introduced in the 1980s, has expanded to include the extended-stay segment. A recent study by Anderson Consulting forecasted that the extended-stay segment will be the fastest growing type of hotel product during the next five years (Cline & Rach, 1997). Construction activity in the extended-stay segment included 249 hotel projects (27,235 rooms) in 1997. This represents 25 percent of the lodging industry's total room construction for 1997 (Shroders & Co., Inc., 1997).

### **Hotel Owners**

As the ownership structure of the industry changed from individuals owning hotels to various institutional and corporate owners, the need of capital changed as well, because of the different capital structures of each of these investing entities.

Among the current buyers of individual hotels and hotel portfolios, REITs have been the most active buyers from the mid-1990s to the current period (early 1998). Starwood Lodging Trust, Patriot American Hospitality, and Felcor Suites are three REITs that have led the pack.

Hotel companies may buy hotels for their own portfolio or for an investment partner. Companies such as Host Marriott, Hilton Hotels, Doubletree Hotels, Capstar Hotels, Bedrock Partners, and Hyatt are included in this category (Robinson, 1996).

Certain investment funds, primarily representing pension funds, have also been active buyers of hotel properties since 1996. Prudential, Equitable, Colony Capital, and AEW are examples from this group.

Foreign corporations and high-net-worth buyers also have been buying hotels, including His Royal Highness Prince Waleed Bin Talel (Kingdom Holdings), Regal Hotels, CDL Hotels, and other Asian hotel companies (Robinson, 1996).

Lodging industry investors from the mid to late 1990s have had diverse strategic rationales for investing in the industry, based on a survey conducted by Anderson Consulting (Summers, 1996). Approximately two-thirds of investors surveyed emphasized the need to upgrade and reposition their hotels via brand conversions. Acquisitions favored new development, as existing facilities were still priced lower than new developments. This scenario, however, is currently approaching equilibrium.

Changes in the ownership structure of lodging firms have had an impact on the various investment alternatives in the lodging industry. A study by John B. Corgel and Jan deRoos (1997) outlined a classification scheme to evaluate the various

investment alternatives. Each of these investment alternatives may have a different need for capital:

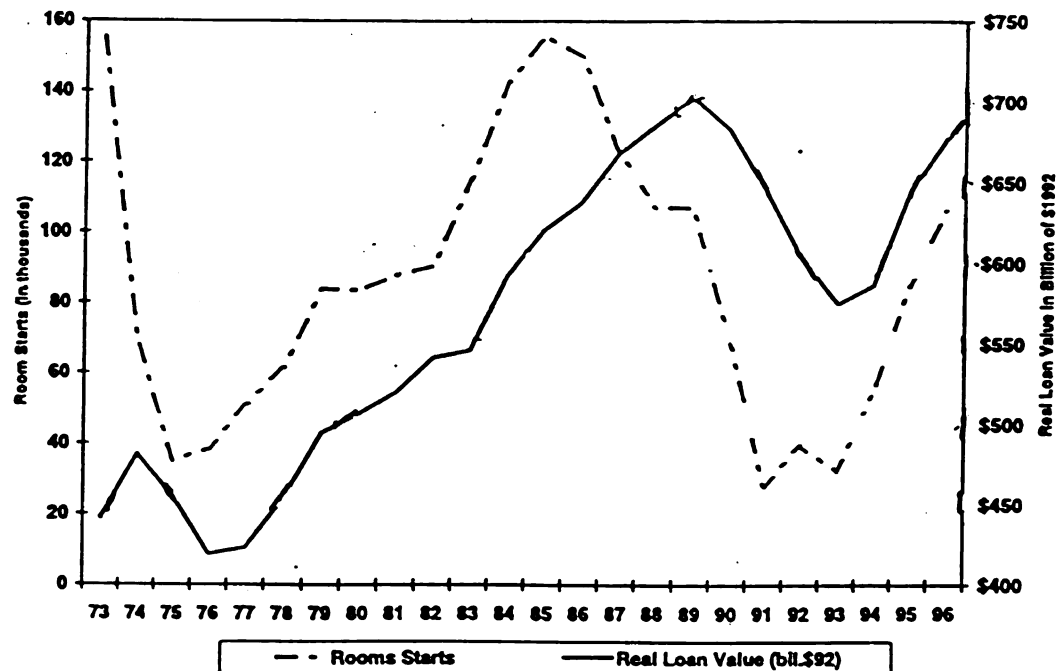
1. *Lodging firms that behave as stocks.* These include franchisors such as HFS or Choice. Their main income source is through the selling of brands. This group also includes management companies such as Hyatt Hotels or Marriott International. They derive most of their income from operating hotels that others may own.
2. *Lodging firms that behave as real estate.* These include companies such as C-Corps like CapStar Hotels. Additionally, REITs such as Patriot American would be in this category.
3. *Lodging firms that behave like hybrids.* Some companies, such as Hilton Hotels, may own property, manage it for others, and sell franchising rights.

### **Key Events Impacting the Availability of Lodging Capital and Financing Trends: 1970s–Current Period**

Over the past 25 years, various events have had an impact on the availability of capital to the lodging industry. Furthermore, the financing of the lodging industry in the 1990s is very different from how it was financed in the 1960s or 1970s. This section analyzes the key events that had an impact on the availability of capital for the lodging industry. This section also looks at financing trends from the 1970s to the current period.

One of the important reasons for analyzing capital availability is noted in Figure 7, which illustrates that the availability of capital has a close relationship with room starts

(one measure of lodging industry growth). For example, convenient access to capital through the mortgage REITs of the early 1970s pushed room starts in 1973 to 155,400 (see Figure 7 ). Conversely, in the early 1990s, as capital availability tightened, room starts declined.



Source: Coopers & Lybrand ; Smith Travel Research; WEFA group. Adapted from *Lodging Almanac* by Bear Stearns (1997).

**Figure 7. U.S. LODGING INDUSTRY ROOM STARTS COMPARED WITH AVAILABILITY OF CAPITAL**

## The 1970s

### Introduction of Mortgage REITs

During the late 1960s, as investors were not able to achieve adequate returns from stocks, they looked to real estate as a hedge against inflation. An efficient means of investing in real estate that developed during this period is known as the real estate investment trust

(REIT). The REITs that financed the real estate boom of the early 1970s were mortgage REITs (as opposed to the equity REITs of the 1990s, which will be discussed later).

Mortgage REITs are essentially lenders, and in the early 1970s they were responsible for providing first and second mortgages, construction and development loans, and joint venture loans for hotel development. These REITs raised capital by selling shares to the public, issuing commercial paper, and borrowing from banks. It is estimated that between 1969 and 1972 the REIT industry sold securities worth \$1 billion to \$2 billion each year (Decker, 1997).

An advantage of these lending institutions over traditional lenders was that they were relatively unregulated. As the spread of rates at which they made their loans and their own cost of capital increased, their share prices showed dramatic increases in the early 1970s. The national recession of 1974 destroyed the mortgage REITs because, as their cost of borrowing increased, they were unable to get adequate returns on their loans and, as the REITs became unprofitable, they were unable to attract investors to buy their shares. This problem was further exacerbated by the highly leveraged nature of the mortgage REITs; in some cases their debt-to-equity ratio was as high as 4:1 (Arnold, 1994). From a peak of 200 REITs in 1974, their number was reduced to less than 100 by the end of the decade (Robinson, 1996).

#### Overbuilding in the 1973–74 Period

In the early 1970s, mortgage REITs kept developers supplied with capital for development. As a result, the supply of rooms showed a large increase during this period.

In addition to the REITs, commercial banks, savings-and-loan associations, and other lending institutions made loans that exceeded prudent levels.

A study by Laventhol & Horwath during this period summarizes the effects of overbuilding when the environment changed (Laventhol & Horwath, 1975):

During 1973–1974, overbuilding in the hospitality field was aggravated by several unexpected factors. First, the energy crisis reduced travel. Second, developers were hit with staggering construction cost increases and cost overruns. Third, interest rates went up. With soaring costs crimping their profits, many developers had decided to wait for the widely predicted lowering of long-term interest rates. Accordingly, many projects were undertaken without long term mortgage commitments, and certain lenders flush with cash—notably REITs—did not discourage the practice. The Federal Reserve Board, however, in an attempt to dampen the country's rampant inflation, began to tighten the money supply and interest rates reacted appropriately (went up), catching builders with high-cost long-term financing, or—worse—none at all. Fourth, as the recession started to take hold, consumer confidence began to wither and demand for real estate projects of all sorts evaporated.

Because of this hostile environment, lenders became owners of non-performing lodging properties. Loan write-offs continued to increase. REITs started to fail due to their over-leveraged position. Besides REITs, other lenders also suffered losses on commercial real estate and hotel loans.

## **The 1980s**

### The Savings-and-Loan Crisis

Until the early 1980s, savings-and-loan institutions or S&Ls primarily financed housing through traditional mortgages at fixed interest rates for the duration of the loan. These



long-term loans (30 years) were primarily funded by short-term deposits. Moreover, regulations at this time (based on Regulation Q: A regulation of the Federal Reserve for depository institutions) imposed interest-rate ceilings on these deposits. Under conditions of stable interest rates this is not a problem, but if interest rates rise above the interest rate on the mortgage loans, a negative spread results for the institution. This is what happened from 1979 to 1982, when the Federal Reserve radically changed its monetary policy by targeting bank reserves rather than interest rates in an attempt to lower the rate of inflation (Saunders, 1994). Due to this restrictive monetary policy, there was a surge in interest rates, with rates on T-bills rising to as high as 16 percent.

This increase in short-term rates and the cost of funds had two effects on S&Ls. First, as they were saddled with fixed-rate, long-term home mortgages, their earnings spread became negative, as their cost of funds was higher than what they were receiving from the interest on home mortgages. Second, due to Regulation Q, which restricted the interest rate they could pay on deposits, they were at a competitive disadvantage from the newly emerging money-market mutual funds, which paid a much higher market rate. The result of this was disintermediation or loss of depositors and hence erosion of their capital base.

In an attempt to counter this problem, Congress set into motion the deregulation of depository institutions by passing the Depository Institutions Deregulation and Monetary Control Act (DIDMCA, 1980) and Garn -St. Germain Act of 1982. These two acts expanded the deposit-taking and asset-investment powers of S&Ls. They were now able to offer deposits at higher rates of interest and make consumer and commercial loans through adjustable-rate mortgages.

For many institutions, deregulation made them safer and more diversified. However, for a significant number of S&Ls, whose earnings and shareholder capital were being depleted in traditional lines of business, it meant the opportunity to take more risks in an attempt to return to profitability (Saunders, 1994). As a result, many S&Ls made high-risk loans—acquisition and development loans and construction loans on “location-oriented businesses” such as hotels, resorts, golf courses, and fast-food restaurants (Arnold, 1994). At first the deregulated climate improved the profitability of the industry. However, in 1984, a regional economic crisis began to unfold in Texas, as crude oil prices began to fall, which caused enormous declines in real estate values. This crisis spread to other parts of the nation. National delinquency rates on mortgages increased from 2.1% in 1983 to 5% in 1986 (Hayes, 1993). Hindsight has shown that this loss of asset quality by the S&Ls was caused by the regulatory environment, which permitted them access to new areas in which they had no experience. The FSLIC (the insurer of S&Ls) accentuated this risk-taking behavior because it did not peg its insurance premium to the risk profile of the S&L, nor did it close down capital-depleted institutions.

Abundant capital from S&Ls along with the tax incentives provided by ERTA (the Economic Recovery Tax Act of 1981) resulted in a massive hotel construction boom. The Tax Reform Act of 1986 (TRA) took away the previous benefits accorded by ERTA. As Arnold (1994) states:

“The passage of TRA had an instantaneous and devastating effect on the real estate industry. Construction for many types of real estate (including hotels) virtually halted. Default rates increased to record levels. In many cases, it became apparent that many thrift institutions, lacking experience in making real estate and construction loans, had accumulated portfolios with such a large percentage of bad loans that default was inevitable.”

To rectify the situation, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989. The two main tasks of this act were to once again regulate S&Ls (by establishing strict capital standards) and to establish the Resolution Trust Corporation (RTC), which was designed to take over failed S&Ls and dispose of their assets.

#### Growth of Real Estate Limited Partnerships (Syndications)

Prior to the passage of the Tax Reform Act of 1986, real estate limited partnerships were a popular way to raise capital. This was primarily done through the process of syndication. In a syndicate, a group of investors pool their capital for investment in real estate (Tarras, Abrams, & Whitman, 1997). Two primary types of syndicate structures were commonly used: a single-class syndicate, in which each investor receives a pro rata ownership interest in the syndicate for a one-time investment in cash; and a multi-class syndicate, in which investors own different classes of shares. Prior to the passage of TRA, syndicate structures were set up mainly as a tax sheltered way to invest in hotel real estate. This advantage was taken away as a result of the Tax Reform Act in 1986.

### **The 1990s**

#### Capital Scarcity (1990–1993)

Excess room inventory, the declining value of hotel real estate, the inability of hotels to meet debt service, the S&L debacle, and a national recession all combined to shut off funding for hotel projects in the early 1990s. In particular, traditional lenders such as commercial banks, life insurance companies, and S&Ls stopped lending on hotel

projects. A survey of lenders in 1990 by Hospitality Valuation Services (HVS, summer 1990 news release) indicated that only 33 percent of lenders would consider new hotel loans. The remaining lenders stated that new hotel loans were too risky. These lenders did not plan to return to hotel lending in the near future. This was a period when lenders were more concerned with disposing of the non-performing hotels that they were forced to acquire, or working with hotel owners to restructure their loans.

The investment climate during the early 1990s is reflected in an investment survey conducted by PKF Consulting during this period (Slay, 1993). (Table 41 summarizes the results of the survey.) The survey indicates the increased risk of a hotel investment, which is reflected in higher interest rates, capitalization rates, debt coverage ratios, loan-to-value ratios, return requirements, and other investment and lending criteria. It should be noted that, although by 1992 interest rates had come down, hotel loans were still difficult to obtain. Since capital was difficult to obtain, investors had to use more of their own equity to secure loans, which lowered loan-to-value ratios.

The true nature of the real estate “credit crunch” during 1992–1993 is summed up in a research newsletter by Grubb & Ellis, a real estate advisory firm: “The truth seems to be that the crisis in real estate finance, where it exists, is not a crisis born of a shortage of loan funds. Instead it is one of confidence, on the part of both lenders and buyers, in the integrity of investment real estate in a severely overbuilt market” (Grubb & Ellis Research Report, 1993).

**Table 41**

**INVESTMENT CRITERIA  
(1986–1992)**

	1986	1988	1990	1992
Overall Cap rate	10.90%	11.10%	10.20%	11.90%
Discount rate (IRR)	13.80%	14.60%	15.0%	16.0%
Holding period (yrs)	9.3	8.8	9.6	8.4
Debt Coverage Ratio	1.30	1.30	1.30	1.60
Income Growth rate	4.00%	4.40%	4.80%	3.80%
Expense Growth rate	4.30%	4.30%	4.70%	3.60%
Interest Rate	10.1%	11.6%	11.5%	8.9%
Loan to Value	72.5%	73.6%	69.0%	67.4%

Source: PKF Consulting.

Alternative Sources of Financing

From 1990 to 1993, when traditional hotel financing sources curtailed their lending, alternative sources of financing emerged to partially fill in the gap and also take advantage of the depressed values of hotel real estate. Finance companies, charging very high rates of interest, were the main providers of capital. Even they provided financing only on existing properties. Foreign commercial banks were still providing financing (Taninecz, 1990).

However, three new sources of financing emerged during this period:

1. Opportunity funds
2. Evolution of the secondary mortgage market, the securitization of commercial (including hotel) real estate, and the creation of new financing structures (CMBSs, CMOs, and REMICs)

### 3. Equity real estate investment trusts (equity REITs)

These sources are discussed in detail in the following sections. The latter two have continued to the present period and revolutionized the way in which hotels are financed.

*Opportunity Funds.* Opportunity funds are still loosely defined in the hotel real estate industry. However, Richard G. Carlson, of Deloitte & Touche (a consulting firm), defines them as “a source of capital that has a contrarian investment focus on under-performing properties and loans” (Carlson, 1997). Investment banks are the source of most of these funds, but in some cases the source of these funds may be a company with an opportunistic focus. These entities acquire under-performing hotel properties (or other forms of real estate) and loans, with the purpose of turning around the investments through repositioning, restructuring, or updating, and then waiting for the market to improve. The long-term objective of these funds is to buy properties at rock bottom prices or at times when capital is scarce, hold the investments for a few years, and then sell them at much higher prices, thus reaping huge profits on the assets.

Many opportunity funds started in 1990 when the Resolution Trust Corporation was disposing of the real estate assets of failed S&Ls. The majority of their early acquisitions occurred during the period from 1990–1992, generally considered to be the bottom of the real estate cycle. Many of these assets included individual hotels and portfolios of hotels. Although it is difficult to ascertain the exact amount invested specifically in hotel properties (because most funds invest in multiple forms of commercial real estate), there were over 40 major funds, whose combined capital of over

\$16 billion that was either placed or committed (Carlson, 1997). Investors in these funds may include institutions (such as pension funds) or high-net-worth individuals. The high yields (20 to 25 percent) and the passive nature of the investment are the primary motivations for investors in these funds.

As the non-performing assets of the RTC were depleted, opportunity funds either disbanded or change their strategic focus to properties in other countries. For example, an article in the *Wall Street Journal* stated that many opportunity funds (also known as “vulture” funds) are currently taking advantage of the real estate crisis in Japan (Sapsford, 1998). E&Y Kenneth Leventhal, a U.S.-based consulting firm, estimates that about \$20 billion in U.S. money has already been invested in bad loans and distressed property in Japan. Many of these distressed properties include golf courses, hotels, and “pachinko” (a form of pinball machine) arcades (Sapsford, 1998).

Some examples of opportunistic investing that went directly to the hotel industry can be seen in Table 42.

**Table 42**

**OPPORTUNISTIC INVESTMENTS IN THE HOTEL INDUSTRY**

YEAR	INVESTOR	ACQUISITION	VALUE
1992	Ashford Financial and Fisher Family	143 hotels from RTC	\$380 Million (57 percent discount)
1993	Colony Capital, Hilton Hotels and Pan Global	Hyatt Regency Waikoloa (1,241 room resort)	\$55 Million (85 percent discount)
1993	KSL Recreation (Created by Kohlberg, Kravis and Roberts the LBO firm)	La Quinta Resort and PGA West	\$276.4 Million (57 percent discount)
1993	Morgan Stanley Real Estate Fund	Carmel Valley Resort and Doral Telluride Resort & Spa. Red Roof Inns	N/A
1994	Ashford Financial, Fisher Family and George Soros	14 Howard Johnsons and 3 full-service hotels	N/A
1994	Interstone Partners (JV between Interstate Hotels and Blackstone Group)	3 Full Service Hotels	N/A
1994	Starwood Capital	Interests in 8000 rooms	N/A

Source: Robert G. Harp, “Opportunistic Investors are Bullish on the Hotel Industry.” *National Real Estate Investor*, September 1994, pp. 90–93.

Although not categorized strictly as opportunity-fund purchases, many well-known hotel companies participated in the purchase of distressed hotel properties in the early 1990s. Companies such as Richfield, Hostmark, Ramada, and Radisson participated in RTC sales. Promus in particular started some of its well-known brands, such as Embassy Suites, by purchasing portfolios of distressed properties and then repositioning them (Qickel, 1994). Richfield Hotels, a management company that had its beginnings in the early 1990s, is another example of a well-known hotel company that purchased hotels at distressed prices, especially from the RTC. Management companies like Richfield were known as turnaround or “work-out” specialists, as they bought (or managed) distressed hotels and positioned them for resale in a few years. In the case of Richfield, the investment capital was provided by its parent company in Hong Kong, Regal Hotels International Holdings.

Generally speaking, opportunity funds are not currently very active as a funding source in the hotel industry. Those that still exist have been transformed into some form of acquisition fund, because as the prices of hotel real estate continue to rise, the opportunities to purchase at deep discounts have been reduced.

*Securitization of Commercial (Hotel) Real Estate and New Financing Structures.* A major change in the way that commercial real estate in general and hotel real estate in particular is being currently financed is the linkage of the originators of mortgage loans with the broader capital markets. Colloquially this is also stated as the linkage of “Main Street with Wall Street.” This linkage started with the development of a secondary market for real estate. Until the 1970s, when a bank or another financial institution originated a loan



it was held on its balance sheet until the loan was paid off. The secondary market in real estate began when lenders in a particular geographical area, who had more available capital than demand for it, bought mortgages from lenders in geographical areas that had a shortage of capital. This secondary market received further impetus when the RTC ( in the early 1990s) acquired failed S&Ls and banks and sold off non-performing mortgages.

The development of the secondary real estate market received its greatest boost in the 1970s, when federal government agencies such as the Federal National Mortgage Association (FNMA or Fannie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and Government National Mortgage Association (GNMA or Ginnie Mae) began purchasing mortgages from lenders and issuing mortgage-backed securities to investors. Investors were mainly attracted to these securities because of the default guarantees provided by these government agencies. The involvement of the federal government on such a large scale played a big role in establishing the secondary mortgage market.

In these early secondary real estate markets, the mortgage originators sold whole loans to either other institutions (such as banks or life insurance companies) or to one of the three government-sponsored enterprises (FNMA, FHLMC, or GNMA). In the 1970s this direct-sale program, as it was known, was further extended by the creation of mortgage-backed securities. “This was the beginning of one of the most important developments in real estate lending that has occurred since the invention of the mortgage itself—the securitization of mortgage debt” (Arnold, 1994).

“Securitization” is a process by which an asset, such as a mortgage, is standardized into individual units, such as shares. An investor in these shares is a partial

owner of a large pool of mortgages. The direct-sale program started to revolutionize mortgage lending by letting the mortgage originator remove mortgages off its books and sell them to another party. However, the creation of securities carried the revolution to greater heights by converting the mortgage instrument into a packaged product, which could then be sold in an organized market just like a stock or bond.

The securitization of real estate is part of the new advances in finance called “financial engineering.” John Finnerty defines financial engineering as follows: “Financial engineering involves the design, the development, and the implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in finance” (Finnerty, 1988). The key words in the definition include *creative* and *innovative*. This type of creativity was first seen in the creation of products such as the swap, zero coupons bonds, junk bonds, and—in the case of the securitization of real estate—the first mortgage-backed securities.

As stated by Arnold (1994), there are four principal advantages of securitization:

1. *Small investment.* Securitization reduces the amount of capital that an investor needs to invest in the asset, therefore giving small investors (the public) access to the mortgage market.
2. *Diversification.* Since the entity issuing the security can pool a large number of mortgages to “back” the securities, the risk exposure of the investors is reduced, due to diversification.

3. *Liquidity.* Real estate has always been maligned due to its illiquid nature. The creation of debt securities (such as stocks in a corporation) enables investors to buy and sell these units in an organized market.
4. *Flexibility.* More advanced structures of mortgage securities create various classes of these securities to suit the risk/return preferences of different investors.

Since they were first started, mortgage-backed securities have evolved into very efficient and flexible financial products. The following sections identify the most common type of mortgage-backed securities and briefly explain their structure. Many of these mortgage-backed securities had originally packaged home mortgages but have since evolved to include commercial mortgages, including hotel mortgages. In fact, mortgage-backed securities are also known as commercial mortgage-backed securities.

*Mortgage-Backed Securities.* There are two types of mortgage-backed securities (MBSs): pass-through securities and mortgage-backed bonds. A pass-through security represents a pool of mortgages. Owners of this security earn a pro-rata share of principal and interest which is “passed through” to them. Many of the investors of these securities include institutions such as pension funds, insurance companies, bank trust departments, and mutual funds. In the case of mortgage-backed bonds, originators (such as banks or mortgage companies) use pools of mortgages to issue bonds to investors. Like corporate bonds, mortgage-backed bonds pay interest on a semiannual basis and all principal at maturity.

The main difference between a pass-through security and a mortgage-backed bond is that, with a pass-through security, the principal and interest are being amortized over

the life of the security, so upon maturity the investor has already received the full payment of principal and interest. In the case of mortgage-backed bonds, interest is paid semiannually, but the principal is paid to the bondholder at maturity. Besides the difference in payment structure, they are similar in that they are collateralized by pools of mortgages.

These early financial instruments suffered from two main drawbacks. First, they were single-class instruments, in that all investors shared the same return, because they held identical securities with identical cash flows and identical maturities (Marshall & Bansal, 1992). Second, borrowers have a tendency to prepay their mortgages in periods when interest rates are declining. As a result, the stated return of a pass-through security was sometimes much lower than actual returns. This was because “the investor who receives an unanticipated early return of his investment must shorten his horizon and reinvest at lower interest rates” (Duett, 1989).

*Collateralized Mortgage Obligations.* The drawbacks of MBSs were rectified by the creation of a new financial instrument called a “collateralized mortgage obligation” or CMO. The main advantage of a CMO is that it changed the security from a single-class financial instrument to a multi-class instrument. This added flexibility made CMOs a more attractive form of mortgage-backed security. The first CMO was created by First Boston in 1983. Each CMO issue is divided into various classes of securities known as “tranches.” The cash flow that each tranche receives is based on a predetermined plan. It is possible to consolidate all prepayment and interest risk into one segment of the issue (for example, “Class A”). Therefore, investors with a higher tolerance for risk may purchase this type of security. There are an infinite variety of CMOs, ranging from “plain

vanilla” types, in which cash flow from the underlying pool of mortgages is distributed in a sequential order, to more complex structures, such as stripped CMOs. In a stripped CMO, the principal and interest are divided among two classes unequally. For example, one class may receive all of the principal and the other class all of the interest (Fabozzi & Modigliani, 1992).

Like MBSs before them, CMOs suffered from some drawbacks. A CMO is not considered to be a “pass-through” security and is therefore treated like a bond. This added considerable debt to the balance sheets of the issuing institutions. To alleviate this problem, issuing institutions (such as investment banks) placed these securities in a trust. The trust structure created adverse tax consequences for the issuer, as the IRS taxed these grantor trusts as they would a corporation (Duett, 1989).

*Real Estate Mortgage Investment Conduits.* Real estate mortgage investment conduits (REMICs) made their debut into the securitization arena after congress passed the Tax Reform Act of 1986. The major impetus for creating REMICs was the need to replace the trusts (because of their inherent tax problems) previously used to create CMOs (Scherrer & Bolick, 1997). The creation of the REMIC essentially made a CMO-like product (that is, a multi-class security), but with the added advantage of providing flow-through tax treatment.

Some experts explained it this way: “Under the 1986 tax law, a REMIC is a tax entity (not necessarily a legal form of organization such as a corporation or partnership) that can be created by simply selecting a REMIC tax status and maintaining separate records relative to the mortgage pool and management of funds related to the pool” (Bruggeman & Fisher, 1993). As such, “issuers can ‘sell’ mortgage assets to the REMIC,

which then can issue multi-class securities (like CMOs). The main difference between CMOs and REMICs is that CMOs are bonds backed by mortgages, while REMICs are simply entities that facilitate the securitization of pools of mortgages” (Scherrer & Bolick, 1997). Simply stated, a REMIC is a CMO without its tax disadvantages.

“In summary, by providing for REMICs, a tax-exempt conduit has been created by Congress through which CMOs may be issued. This allows for the creation of mortgage-backed securities with multiple maturity classes. This should provide more choices to more investors and hence broaden the participation by investors in mortgage-related securities” (Bruggeman & Fisher, 1993).

*Real Estate Investment Trusts (REITs).* The securitization of real estate was one of the solutions to the problem of scarcity of capital for commercial real estate in general and hotels in particular during the early 1990s. Selling debt securities (CMBSs and CMOs) to the broader public market increased the flow of capital to the lodging industry. On the equity side, another solution to the scarcity of capital during this period was offered by the reemergence of real estate investment trusts (REITs). The equity REITs of the 1990s were different from the mortgage REITs of the 1970s, however. While both mortgage REITs and equity REITs sell shares to individuals and institutions, the former were akin to banks (because they used the funds to make loans), while equity REITs are akin to corporations, because they are investment vehicles that use the funds to acquire or construct hotels. The role of REITs was briefly discussed in the previous chapter. However, the growing importance of REITs as a new type of hotel owner and the

increasing pace at which they are currently acquiring hotel companies and properties requires an in-depth discussion of equity REITs in this section.

The modern equity REIT can trace its development back to the Real Estate Investment Trust Act of 1960. The congressional sponsors of the 1960 legislation used the growing success of the mutual fund industry as a model for attracting capital to the real estate industry. The equity REIT structure was designed to be a “mutual fund” for real estate. Those with not enough means to buy real estate could nevertheless participate in the real estate market by buying shares in an equity REIT.

The New York Institute of Finance (1988) states:

“A REIT may be a corporation, business trust, or association primarily developed to own or finance real estate. As with most corporations, a board of directors or trustees elected by shareholders sets policy and arranges the day-to-day operation of the REIT by professional managers or advisors. Persons with real estate experience, such as real estate brokers or mortgage bankers, organize many REITs. They may also be organized by commercial banks or insurance companies.”

Once legally organized, an equity REIT begins its existence by issuing shares of stocks. To purchase properties, equity REITs sell securities to institutional investors, issue commercial paper, and borrow from banks. Traditional equity REIT investments include the purchase of office buildings, apartments, shopping centers, warehouses, and hotels. REIT shares trade on the major stock exchanges. This provides liquidity to the holders of REIT shares.

Besides being a type of mutual fund for purchasing real estate and being organized like a corporation, REITS are also intended to be a tax “conduit” or pass-through, according to section 856-60 of the Internal Revenue Code. This means that

REITs are exempt from corporate income tax as long as they distribute 95 percent of their income to their stockholders.

REITs as we know them today emerged in the early 1990s. Kimco Realty, a regional-mall REIT, was the pioneer in the field with its public offering in November 1991. In fact, the asset class that led the emergence of equity REITs was regional malls. As the operating performance of hotels improved, they became the next target for REITs (Lefleur, 1995).

RFS Hotel Investors was the first of the modern hotel-industry REITs, with its initial public offering in August 1993. Jameson Inns, Equity Inns, Winston Hotels, Felcor Suites, and Innkeepers USA followed in 1994. Starwood Lodging Trust in 1995. As of April 1998 there are 15 hotel REITs.

Arnold (1994) states that the resurgence of equity REITs in the 1990s can be traced to three primary motivations:

1. As the traditional financing sources such as banks, S&Ls, and insurance companies stopped funding commercial real estate (including hotels), a vacuum was created. As a result, real estate developers, managers, and owners saw REITs as a means to raise capital and finance growth.
2. The demand for REITs also came from institutional investors such as mutual funds and pension funds. These investors wanted to continue investing in real estate but needed an exit strategy. Securitization and investment in REIT shares provided the ideal solution.



3. The Tax Reform Act of 1986 took away the tax-shelter advantages of investing in commercial real estate (including hotels). At the same time, the tax shelter partnerships and syndicates that were formed prior to the passage of the act were no longer the ideal business format for investing in real estate. At the same time, there was an excess inventory of real estate, resulting in unprofitable operations and the eventual decline in the value of real estate (including hotels) by the early 1990s. During this period, many investors wanted to purchase hotels and other real estate because of their reduced values. Since traditional capital sources were not available, and the previously used limited-partnership formats were not suitable for raising capital, REITs became the vehicle of choice for raising capital to make real estate purchases. In fact, many of the early hotel REITs got their start by buying hotels in this overbuilt environment at 50 cents on the dollar.

Other attributes of REITs have made them an attractive vehicle for investing in real estate. These attributes include:

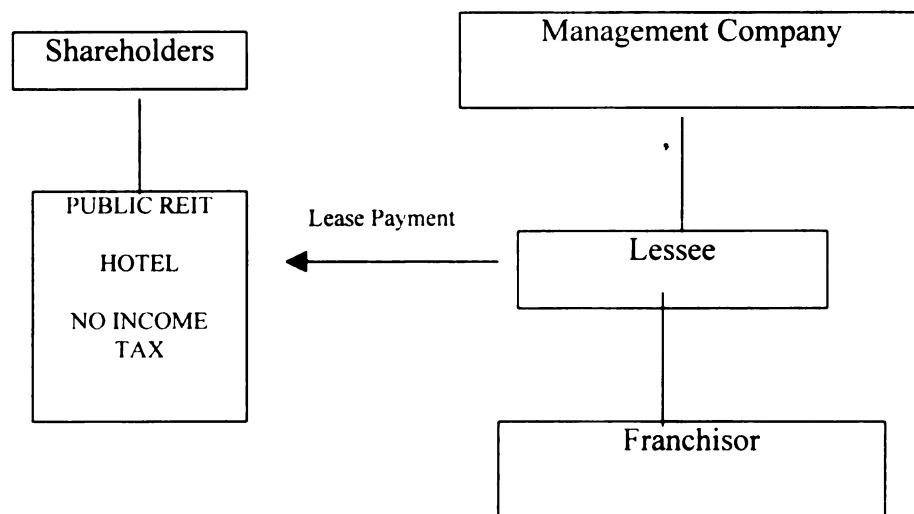
- ◆ The corporate character of the REIT (ownership takes the form of corporate stock).
- ◆ The liquidity of REIT shares and the ability to trade them.
- ◆ Diversification.
- ◆ Tax advantages (no corporate-level tax).
- ◆ Established state law regarding corporate governance.

- ◆ Flexibility—most REITs can operate in any state or city (banks and S&Ls may have restrictions related to expansion).
- ◆ Professional management.

Despite these advantages, REITs also have to face certain challenges. These include:

- ◆ Operating restrictions prevent REITs from participating in managing or sharing in the profits of a hotel.
- ◆ By imposing the 75 percent minimum-gross-income threshold, the business activities of REITs are restricted primarily to rents, mortgage interest, and the gains from the sale of real estate assets.
- ◆ REITs cannot own more than 10 percent of a tenant (in the case of hotels, the tenant is the hotel operator). Additionally, the sponsor of the REIT is restricted to 10 percent ownership of the REIT, if he also owns the management company.
- ◆ Operating losses cannot be passed to investors, which was formerly the case with syndication structures.
- ◆ As 95 percent of a REIT's income is distributed to the shareholders, it is continuously seeking capital through secondary stock offerings, issuance of convertible debentures, and bank borrowings. The danger is that if most of a REITs growth is fueled with externally generated funds (versus accumulated reserves), its continued performance and maintenance of stock prices determine the REIT's capital-raising success.

*Types of REIT Structures.* There are typically three forms of REIT structures. In the traditional structure, the REIT owns the real estate (hotels, apartments, and office buildings), and these are then leased to a lessee, who arranges management and franchise agreements. (See Figure 8 for a diagram of a traditional REIT structure.) In the case of hotels, the lessee usually was a private company owned by REIT management. However, recently many of these private companies have been sold (by the REITs) to non-related entities to avoid the inherent conflict between the public REIT and private lessee (Shroders & Co., Inc., 1997).



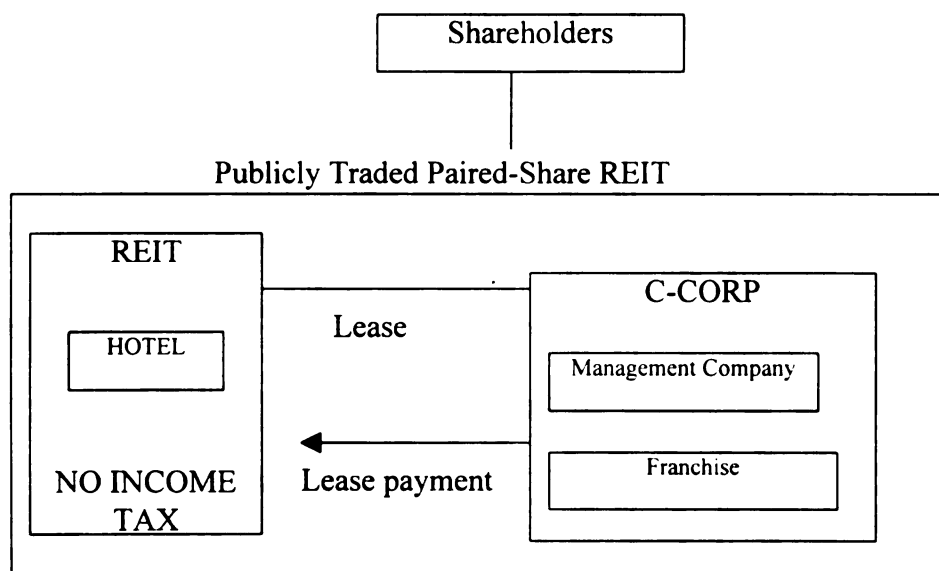
Source: Shroders & Co., Inc.

**Figure 8. TRADITIONAL REIT STRUCTURE**

A paired-share REIT pairs a REIT with a C-Corp (see Figure 9). This combined company is then traded as one. This integrated structure is advantageous to investors because the REIT leases the hotel properties to the C-Corp, which then is the operating

company and the franchisor; this structure avoids what is termed in the industry “leakage,” meaning loss of income due to the management contract and franchise agreement, which otherwise are typically given to another company. In a paired-share REIT, the leakage occurs but is recaptured by the C-Corp. “Since paired-share shareholders own an equal stake in both the REIT and the C-Corp, the profits foregone by the REIT flow back to the security holder via the C-Corp” (Shroders & Co., Inc., 1997).

As a result of the recent IRS Restructuring Bill passed by the U.S. Congress (August 1998) paired share REITs will not enjoy the tax advantages associated with its unique structure for future acquisitions. In anticipation of this announcement, Starwood Lodging (The largest lodging equity REIT) gave up its paired share status and converted to a tax paying C-Corp (Giovanetti, 1998). This is an example of the impact of regulatory changes on organizational structures.



Source: Shroders & Co., Inc.

**Figure 9. INTEGRATED PAIRED-SHARE REIT STRUCTURE**

Another REIT, similar to a paired-share REIT, is known as a paper-clip REIT.

The main difference between the two is that paired-share REITs trade the shares in the REIT and the C-Corp as one integrated share; a paper-clip REIT trades the shares in the REIT and the C-Corp separately (however, the REIT and the C-Corp have common management control). The latest example of a paper-clip REIT is Meristar Hospitality Corp., which was formed by merging Capstar (a C-Corp) and American General Hospitality (a traditional REIT) (Nozar, 1998). Paper-clip REITs are very new and do not have enough of an operating history to judge their success.

As competition increases, other types of creative REIT structures are evolving. For example, in a recent relationship between Promus (a management company) and Felcor (a REIT), the management company develops the hotel and then sells it to the REIT, but maintains the management contract and franchise agreement.

In the past four or five years, REITs have started to dominate the lodging industry as owners of hotel properties and companies. The superior performance of their stock and the tax advantages enjoyed by their structure have attracted public capital to fuel their growth. Table 43 outlines the lodging REITs and their acquisitions in 1997. However, a recent report by equity REIT analysts at Paine Webber reported that REIT stocks were down by about 19 percent in the first seven months of 1998 (Cruz, 1998). The direct impact of declining stock values for lodging REITs is that it is difficult for them to find financing to fuel their growth. To add insult to injury two of the largest lodging REITs, Starwood (now a C-Corp) and Patriot American, entered into a financial transaction known as equity forwards. In this transaction, a company may borrow funds from lending institutions, and pay back in stock. However, if the companies stock prices fall over the

term of the loan, they would either have to issue more stock to settle the loan or pay cash (Vinocur, 1998). This is the predicament that Patriot American is in today, which did 3 equity forwards. This REIT currently has short term bank debt of \$1.1billion and about \$300 million in equity forwards (Kirkpatrick, Templin & Martinez, 1998).

**Table 43**  
**BIGGEST REIT DEALS OF 1997**

ACQUIRER	TARGET	AMOUNT \$Millions
Starwood Lodging	ITT Corp	\$17,000.0
Patriot American Starwood Lodging	Interstate Hotels Westin Hotels	2,100.0 1,570.0
Patriot American	Wyndham Hotel Corp	1,100.0
Patriot American	Carnival Hotel and Resorts	485.0
Starwood Lodging	HEI Hotels	327.0
Patriot American	WHG Resorts & Casinos	300.0
Patriot American	California Jockey Club	238.0
Patriot American	Grand Heritage Hotels	22.0

Source: Coopers & Lybrand.

### **Summary of Recent Trends in Hotel Financing**

The 1990s have been a time of tremendous change with regard to financing the lodging industry. The decade began with a period of capital scarcity, due to the excesses of the 1980s. However, the latter half of the decade has seen a complete reversal of financing trends. Many of the key trends were discussed in depth in the preceding section and are summarized in the following paragraphs:

1. With the advent of securitization and the introduction of the REIT as a vehicle to raise capital, there was an abundance of capital available for the lodging industry until the end of 1997. Table 44 outlines the increasing availability of publicly raised capital from 1993-1997. This flow of publicly raised capital started to slow down in mid-1998.

**Table 44**  
**PUBLICLY RAISED CAPITAL**  
**(For the Lodging Industry)**  
**\$ Millions**

Source	1991	1992	1993	1994	1995	1996	Ytd 3 <sup>rd</sup> Qtr 1997
Non REIT IPO	0.0	140.7	0.0	159.5	738.2	1,310.4	<b>120.0</b>
REIT IPO	0.0	0.0	39.8	295.6	901.8	348.4	<b>0.0</b>
Secondary offering	289.0	0.0	663.3	597.5	1,125.8	4,503.2	<b>2,285.7</b>
Debt Offering	800.0	0.0	419.5	1,082.5	2,076.0	4,338.6	<b>2,211.9</b>
Total Flow of Public funds	1,089.0	140.7	1,122.6	2,135.1	4,481.8	10,500.6	<b>4,617.6</b>

Source: National Hotel Realty, Smith Travel Research, and the Conference Board.

2. In this current financing environment, where capital is available from both public and private sources, the financing environment may be described as one of conservative competition, between the various sources of capital. This is reflected in the changes in the lending terms in Table 45. While interest rates have declined from the mid 1990s as compared to the 1980s, lenders are conservative in terms of their debt coverage ratio and loan to value ratios, which are somewhat more stringent in the 1990s as compared to the 1980s.

**Table 45****HOTEL LENDING CRITERIA  
1986–1996**

	<b>1986</b>	<b>1988</b>	<b>1990</b>	<b>1992</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Debt Coverage Ratio	1.30	1.30	1.30	1.60	1.40	1.38	1.40
Interest Rate	10.1%	11.6%	11.5%	8.9%	9.9%	9.59%	9.10%
Loan to Value	72.5%	73.6%	69.0%	67.4%	68.0%	69.12%	69.70%

Source: PKF Consulting.

3. With the introduction of securitization, which is an extension of financial engineering or structured finance to the commercial real estate industry, many new and creative financial instruments have been introduced. The ultimate impact of these creative instruments is to bring flexibility to real estate investing, which makes investing in real estate appeal to a wider range of investors. Some of these new financial instruments and structures (CMOs, REMICs, and REITs) have been discussed earlier in the chapter.
4. With the introduction of securitization, a new organization—the rating agency—has entered the hotel-financing arena in the 1990s. One of the main reasons for the overbuilding of the 1980s was a breakdown in loan quality by the banks and thrifts. As each competed to make loans and earn up-front fees, their lending criteria began to be less strict, which resulted in poor-quality loans. The rating agencies are expected to prevent an excess flow of capital to the lodging industry, as they evaluate a potential issuer's credit quality (default risk) and assign a rating based on the issuer's business and market sector (hotel, regional mall, warehouse), management asset quality, and



other financial measures such as profitability, size, and leverage (Kirtland, 1995).

Therefore, it is expected that the securitization process and the role of the rating agencies will keep capital flows in check.

5. Financing of the hotel industry is changing from being merely mortgage lending to what is being called “credit-based financing” (Levy & Furman, 1997). In this lending environment, loans are more akin to corporate loans, in which the borrower is treated as a business. “Credit-based financing takes into account not just the value, cash flow, and risk profile of a single property, but rather the borrower’s overall credit, based on an evaluation of all the borrower’s assets and operations” (Levy & Furman, 1997).
6. Equity investors in the 1990s have been different from those in the 1980s. While limited partnerships and syndication were the dominant source of equity capital in the 1980s, the 1990s started with opportunity and acquisition funds buying depressed hotel real estate; from the mid to late 1990s hotel companies and REITs became the major source of equity capital. Today there are 39 public hotel companies (C-Corps) and 15 equity REITs that raised in excess of \$8 billion in equity capital in 1997 (Security Data Corporation, 1998). However, as of mid-1998 equity REITs started to lose their luster due to declining share prices, and legislation which took away the former tax advantaged status of paired share REITs.
7. The current lending and investing climate is not only positive but also characterized by alternative sources of capital. In the 1980s, the traditional lenders such as banks, thrifts, and life insurance companies were the dominant lenders. However, in the current environment, not only have these traditional lenders started to return but public capital markets have also become an additional major source of capital for the

hotel industry. These two lending sources are very different. The traditional lenders are portfolio lenders, in that they make loans or investments in hotel real estate and hold them in their portfolio. This type of participation is being increasingly replaced by the model in which investment banks raise capital by selling debt (CMBSs) and equity (shares of REITs or C-Corps) to the public or by doing private placements with large institutions.

However, it is important to note that when hotel financing moved from the traditional banks to the public capital arena (investment banks) it also became exposed to the various global changes in the capital markets. This became event when the economic turmoil in Asia and Russia this summer (1998) raised the return expectation of institutions that are the traditional buyers of commercial mortgage backed securities. As a result, investment banks that sell these securities to their customers, who are institutions, had to do so at a loss or a very thin margin. The net result of this was that investment banks stopped making new loans for hotel projects (Holusha, 1998).

It is interesting to note however, that when the public capital markets dried up this summer (1998) this presented opportunities to the traditional lenders, who stepped forward to fill the vacuum. This is an interesting change from financing earlier in the decade at which time when the traditional lenders stopped financing the lodging industry public capital markets filled the vacuum.

## **The Role of Financial Institutions as Suppliers of Capital to the Lodging Industry**

### **Types of Financial Institutions**

Typically, the financial institutions that have been and presently are sources of capital to the lodging industry include commercial banks, thrifts, life insurance companies, pension funds, and others. No authoritative information exists as to the amount of capital provided to the industry from each of these financial institutions. However, a survey conducted by PKF consulting (see Table 46) provides a general idea of the importance of each source of capital. This survey asked respondents to state the prime sources of financing to the hotel industry. Most respondents chose commercial banks. A variety of “other sources,” including investment banks and mortgage funds, were next. Insurance companies and pension funds were also cited as important sources of capital.

**Table 46**

### **WHO PROVIDES HOTEL FINANCING?**

<b>SOURCE</b>	<b>PERCENTAGE (Responding)</b>
Bank	58%
Other Source**	36.0
Seller	24.0
Insurance Company	24.0
Pension Fund	18.9
Savings & Loan	3.4

Source: PKF Consulting. Hospitality Investment Survey, 1996.

\*\* Other sources included investment banks, Small Business Administration loans, mortgage funds, conduits, and private equity.

A more authoritative source of information is the investment research department of ERE Yarmouth, a real estate advisory firm. Table 47 summarizes the change in the flow of capital, both debt and equity, experienced by the commercial real estate industry (this information was gleaned from past and present issues of ERE Yarmouth's research publication *Emerging Trends in Real Estate*). Clearly, commercial banks, pension funds, and life insurance companies are strong institutional sources of funds for commercial real estate. The role of thrifts has been steadily declining.

**Table 47**

**INSTITUTIONAL CAPITAL SOURCES  
COMMERCIAL REAL ESTATE**

	<b>1993</b>		<b>1994</b>		<b>1995</b>		<b>1996</b>		<b>1997</b>	
<b>Institution</b>	<b>Equity</b>	<b>Debt</b>	<b>Equity</b>	<b>Debt</b>	<b>Equity</b>	<b>Debt</b>	<b>Equity</b>	<b>Debt</b>	<b>Equity</b>	<b>Debt</b>
Commercial Banks	11.4%	43.3%	6.4%	39.8%	2.4%	39.7%	1.7%	40.2%	0.9%	41.0%
Life Insurance	19.6	26.0	20.6	25.0	21.1	20.3	21.5	20.2	15.3	18.1
Pension Funds	46.4	6.5	49.1	3.3	42.7	3.5	43.4	2.4	39.2	2.6
REITs	4.3	0.50	9.8	0.8	18.5	1.5	22.0	1.6	35.6	1.5
Thrifts	4.8	11.1	3.2	14.0	1.2	13.4	0.8	12.7	0.4	10.8
Foreign Investors	13.6	12.6	10.9	10.9	12.3	12.5	10.6	10.6	8.7	8.7
CMBS issuers						5.8		8.1	-	16.3
Other						3.4		4.2		1.0
<b>Total</b>	<b>\$258.8</b>	<b>\$915.3</b>	<b>\$262.66</b>	<b>\$918.56</b>	<b>\$235.55</b>	<b>\$992.55</b>	<b>\$254.4</b>	<b>\$1,024.0</b>	<b>\$320.6</b>	<b>\$1,130.2</b>
(Billions)										

Source: "Emerging Trends in Real Estate." Real Estate Research Corporation and Equitable Real Estate Investment Management inc. (1994–1997 issues).

The rest of this chapter will explore further the following major sources of capital for the lodging industry:

1. Commercial banks
2. Thrifts (savings-and-loan institutions)
3. Finance companies
4. Life insurance companies
5. Pension funds
6. Investment banks
7. Mutual funds

### Commercial Banks

Commercial banks were the traditional construction lenders to the lodging industry, particularly in the 1980s. However, the overbuilding of the 1980s resulted in large foreclosures and loan losses. As a result, banks virtually withdrew from the lending scene in the early 1990s. During most of that period, banks were involved in selling REO assets (distressed hotel properties acquired in foreclosure) at discounted prices.

Remembering the lessons they learned from the excessive lending activity of the 1980s, commercial banks started in 1995 to re-enter the hotel mortgage market, albeit with restrictive terms and higher underwriting standards. There are several reasons for their return to hotel lending:

- ◆ A reduction of mortgage delinquencies
- ◆ An improvement in the hotel industry's performance
- ◆ An improvement in the profitability of the banking industry
- ◆ An increase in the competition for loans

Since construction of new hotels is taking place on a limited scale, most of the construction loans are for smaller, limited-service properties. Otherwise, most of the financing provided by commercial banks is either for refinancing or buying existing hotels (Simon & Furbey, 1996).

The role of commercial banks has become wedded to the securitization process. The CMBS market allows banks to originate loans, earn origination fees and potentially servicing and bond administration fees (Gordon, 1997). The CMBS market also allows banks to earn fees associated with warehousing commercial mortgages.

### Thriffs

Thriffs include savings-and-loan institutions, savings banks, and credit unions. Savings-and-loan institutions started their association with the lodging industry after the passage of the acts that deregulated the S&L industry (the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn -St. Germain Act of 1982). As a result of these acts, S&Ls were able to expand their loan-making ability to include commercial loans, which began a period of large-scale (and, in many cases, irresponsible) lending to hotels and motels. Most of these loans were used for the construction of new hotels. This association ended with the savings-and-loan crisis described earlier in the chapter, the real estate crash from 1987 to 1992, and the passage of the Financial Reform, Recovery, and Enforcement Act of 1989. The stringent requirements of the re-regulation of the industry have effectively shut out thriffs from making any more loans to the lodging industry.

### Finance Companies

Due to the negative lending experiences of banks, thrifts, and life insurance companies, in the early 1990s these traditional lenders virtually stopped financing the hotel industry.

During this period, finance companies used this opportunity to expand their market share.

Finance companies such as GE Capital, Money Store, GMAC, and Finova may either be subsidiaries of large companies (such as GE Capital and GMAC) or may be separate entities (such as Finova and Money Store). Typically, these companies borrow funds in the open market and lend them at a higher rate.

Finance companies are quite flexible in the types of loans that they make to the hotel industry; loans include construction loans, permanent loans, and creative-deal loans to reduce lending risk. Finance companies are competitors with traditional lenders for various types of loans.

In many cases however, finance companies are “lenders of last resort,” providing high-risk financing. Overall, hotels are attracted to finance companies because of their relatively high loan-to-value ratios. They generally make loans in the \$5 million to \$25 million bracket (HMBA, 1996).

Finance companies also play a role in financing the hotel industry by participating in the secondary-mortgage market—buying commercial loans from banks and thrifts and then selling them for pooling, packaging, and securitization.

Many of the loans made by finance companies such as the Money Store are made in conjunction with Small Business Administration guarantees. Generally, these loans are for limited-service hotels and are under \$2 million.

### Life Insurance Companies

While in the 1980s commercial banks were the major providers of construction funds for the lodging industry, the fixed (and long-term) nature of life insurance company sources of funding made life insurance companies ideally suited to provide “take-out” or permanent financing. After construction is complete, a long period of cash flow begins that is expected to service the loan. Generally, borrowers are required to have a commitment for permanent financing before construction financing is approved. Life insurance companies generally do not get involved in small hotel projects; they are more likely to make loans or invest in hotel projects of more than \$10 million.

As the return requirements for life insurance companies changed in the 1980s, due to the inflationary climate and the need to offer variable annuity plans to the insured, life insurance companies started seeking investments that acted as inflation hedges and offered higher returns. Commercial real estate (including hotels) offered this type of investment opportunity. During the 1980s, life insurance companies became the major permanent lender to the lodging industry and entered into various joint venture and participating loan programs.

As of 1993, life insurance companies were the second largest holder of commercial mortgages, with 26 percent of the total debt outstanding (see Table 48). However, as in the case of banks and thrifts, the real estate crash hurt life insurance companies, and they started to withdraw from hotel lending and investing in 1992. In 1993, the loans outstanding were 12 percent lower than their peak in 1991. Furthermore, life insurance companies reduced their mortgage origination activity in 1993 by 43 percent from the previous year (American Council of Life Insurance Companies, 1994).



From 1993 through 1994, life insurance companies were primarily sellers of hotels in which they had an equity interest or held mortgages.

**Table 48**

**LIFE INSURANCE COMPANY MORTGAGE ORIGINATION  
First Quarter 1992 vs. First Quarter 1993.**

PROPERTY TYPE	1 <sup>ST</sup> Q 1992(000'S)	1 <sup>ST</sup> Q 1993 (000'S)	PERCENT POINT CHANGE
Apartment	233.340	274.517	17.6%
Office	553.567	488.546	(11.7)
Retail	551.632	436.057	(21.0)
Industrial	148.255	133.905	(9.6)
Hotel/Motel	118.951	67.363	(43.4)
Mixed Use	-	-	-
Other Commercial	60.807	35.910	(40.9)
Total	1,646,552	1,436,298	(12.7)

Source: American Council of Life Insurance Companies.

Insurance companies are now resuming hotel lending. A recent industry report states that: “a growing number of small life insurance companies are providing hotel loans but mostly for refinancing. Only a few, like Lincoln National Life and Jefferson Pilot, provide acquisition loans. Large life insurance companies will consider joint ventures, but only for top operators with leading franchise names and only for large, exceptional, first-class hotels” (Ford, 1996).

Although direct ownership of and mortgage lending for hotels on the part of life insurance companies is increasing at a slow rate, indirect ownership through the purchase of REITs and CMBSs has been increasing at a much higher rate. Even though the potential for higher yields is better with direct loans and investments, they also come with the negative aspects of lower liquidity, the need for specialized management of the

loans/investments on the part of the life insurance company, higher risk (due to less diversification), and higher risk-based capital requirements (Green, 1997).<sup>1</sup>

### Pension Funds

Pension funds are tax-exempt capital funds held by corporations, labor unions, and state or local governments. As a source of institutional capital, they represent the fastest-growing pool of funds and are expected to play a major role in financing the hotel industry (Tarras, Abrams, & Whitman, 1997).

Like life insurance companies, pension funds are long-term lenders and investors. However, most of their capital invested in commercial real estate is in the form of equity as opposed to debt (see Table 16). Their participation in hotel financing was in the form of investment in closed-end real estate funds. As the real estate market turned and property values started to decline from 1987 through 1993, pension funds suffered huge losses.

Recently, however, there has been an increase in pension-fund activity in hotel investments. Taylor (1996) states that “with an abundance of opportunities to buy hotels well below replacement costs, pension funds are once again pumping money into the lodging industry. Many of these funds are not just investing in hotel real estate, but in stock of publicly traded hotel REITs and hotel companies.” Pension funds are also beginning to look at partnership alliances with REITs to develop projects. The pension plan sponsors underwrite the project cost, and REITs acquire the properties (ERE

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<sup>1</sup>Risk based capital rules put into effect in 1993 by the National Association of Insurance Companies (NAIC) requires insurance companies to maintain a higher ratio of capital if they carry real estate loans on their balance sheet.

Yarmouth, 1997). Some of the more active pension-fund investors in the hotel industry include the pension plans of AT&T, General Motors Corp., Stanford University, and the employee retirement funds of Pennsylvania, Oregon, and Ohio (Martin, 1996).

Based on a recent report by ERE Yarmouth, about four percent of the pension-fund industry's total portfolio is allocated to real estate. It is difficult to determine how much of that is invested in hotels. The various ways in which pension-fund capital enters the hotel industry includes investment in stocks or CMBSs, direct investment in hotels, investment in equity funds that then invest in hotels,<sup>2</sup> investment in mutual funds that then purchase hotel stocks, and investment in guaranteed investment contracts (GICs) that are issued by life insurance companies (the GIC funds generated from life insurance companies may then be used to make hotel loans or investments). Discussions with industry executives indicated that pension-fund planners who are interested in hotels are not merely hotel real estate investors, but are also aligning themselves with hotel management companies by making investments in publicly or privately held hotel management companies.

The relatively small pension-fund investment in the hotel industry can be attributed to the tax burden that hotel income can generate. Pension funds are tax-exempt entities, but when investing in hotels they are subject to unrelated business taxable income because hotels are considered to be not just real estate but operating businesses as well.

On the other hand, a review of the literature indicates that pension funds are allocating more and more of their assets to non-core assets (hotels are included in this category), which are properties with a higher risk profile and therefore require specialized management. Cambon (1995) states: “The real estate market into which pension funds will invest during the rest of the decade will be very different from that of the decade of the 1980s. Continuing institutionalization of the \$3 trillion U.S. property-investment market will ultimately shift the ownership of the sector from the individual entrepreneur to large institutions.”

### Investment Banks

The history of investment banks’ involvement with the lodging industry can be traced to the early 1990s, when the Resolution Trust Corporation was entrusted with the job of selling defaulted loan portfolios. Investment banks accelerated the process when they began to securitize large portfolios of mortgages and sell them for the RTC. This single act jump-started the CMBS industry and hastened investment banks’ entry into the real estate business (Bergsman, 1997).

Having devised a way to securitize commercial real estate, the investment banking community’s involvement with financing the lodging industry became easier, particularly when investment banks found that many of the traditional lenders and investors had departed the market and that the lodging industry was in need of capital. Many hotel

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<sup>2</sup>Commingled hospitality funds is an example of an industry-specific equity fund. This was launched by Yarmouth Group (a pension-fund advisory firm), which will spend \$400 million to \$500 million on top-tier hotels and resorts. Other similar funds include a \$350 million fund by Equitable Real Estate Investment Management; and Prudential Real Estate Investors has Prisa and Prisa II, which are commingled funds with substantial hotel real estate investments.

companies and REITs raised capital through investment banks in the public capital markets (selling shares to individuals and institutions) to purchase hotel properties that were being sold during the early 1990s at fire-sale prices. This early involvement of investment banks with lodging companies included refinancing their debt in the public markets, structuring Initial Public Offerings (IPOs), financing mergers and acquisitions, and underwriting of equity issues of REITs and public hotel companies (HMBA *Transactions*, 1994). Later, as hotel real estate entered the CMBS market, investment banks were involved in underwriting and selling these various debt securities. The key contribution of investment banks to lodging finance is best stated in a recent article on the subject: “The highly fragmented lodging industry has historically been held in private hands in the United States, with only the major brands owned publicly. In the past four to five years, Wall Street has driven large-scale restructuring of the industry’s ownership base by providing a breakthrough to public capital” (McConnell & Summers, 1997).

From 1992 to 1994, investment banks raised over \$2.025 billion for the lodging industry in the public capital markets. During this period, 70 percent of the capital raised went to three firms: Hospitality Franchise Systems (a franchisor), RFS Hotel Investors, Inc. (the first hotel REIT), and Host Marriott, a hotel company that actively acquired single hotel assets (HMBA *Transactions*, 1994). There were primarily five investment banking firms involved in hotel underwriting during this period: Montgomery Securities, Smith Barney, Merrill Lynch, Nikko Securities, and Morgan Keegan.

Each investment bank is known for a certain specialty. For example, while Merrill Lynch is known for its strength in underwriting REIT issues (in 1997 it had 30 percent of the market share), Nomura dominates the CMBS market.

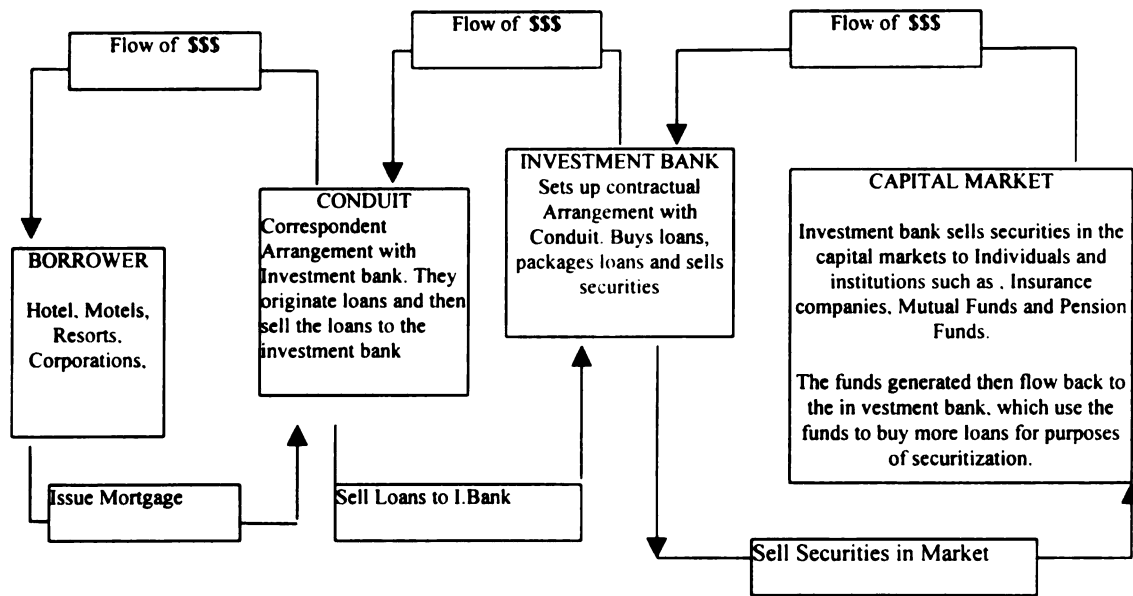
The level of involvement of investment banks with hotel lending varies from bank to bank. However, the increasing importance of the hotel sector is seen in the growing trend for investment banks to merge lodging and real estate groups into one department. For example, Bear Stearns has merged real estate, lodging, gaming, and leisure into one department, known by the acronym “Regal” (Bergsman, 1997). Also, as in the case of investment banks such as Nomura, Morgan Stanley, Goldman Sachs, and DLJ (Donaldson, Lufkin and Jenrette), their commitment to real estate is indicated by the creation of a real estate fund used for lending or equity investing.

In general, the role of investment banks with regard to hotel financing may be categorized into the following areas:

- ◆ Issuing initial and secondary public offerings for REITs and C-Corps
- ◆ Raising debt capital for hotel companies
- ◆ Advising on mergers and acquisitions
- ◆ Providing direct lending, either as mortgage loans or corporate loans
- ◆ Providing conduit services
- ◆ Financing opportunity/acquisition funds
- ◆ Providing construction loans (on a minor scale)

One of the largest growth areas for investment-bank lending to the hotel industry is their participation in “conduit” programs. Investment banks set up many conduits with licensed mortgage lenders, known as “correspondents.” The purpose of a conduit is to

originate loans and then sell them to an investment bank at a predetermined rate. The investment bank then packages the loans and sells them as a bond (security) in the capital market. This provides more capital to make more loans. The correspondent represents a “conduit” or path between the supplier of capital and the user. (See Figure 10 for a diagram showing how conduits work.) The major contribution of conduit programs has been to “connect Wall Street to Main Street.”



**Figure 10. CONCEPTUAL STRUCTURE OF THE CONDUIT ARRANGEMENT**

Increasingly, the relationship between opportunity funds and investment banking is becoming fuzzy. For example, the investment bank DLJ recently announced that it would team up with the Simon DeBartolo Group (a real estate developer) to form a partnership fund to develop entertainment-related real estate properties. Recently, Strategic Hotel Capital Inc., a partnership between Goldman Sachs and Security Capital Group, bought five luxury hotels from Prudential Insurance for \$549 million (Bergsman, 1997).

In the 1990s, investment banks have played a major role in not only financing the lodging industry but greatly influencing a change in its structure. Specifically, the role of public capital has impacted the lodging industry structure in four ways:



1. *Ownership structure.* Since the introduction of public capital in the 1990s, many private hotel companies have become public. There are currently 15 public equity REITs and over 40 public C-Corps that own hotels.
2. *Consolidation.* In order to maintain share prices, public companies need to continuously show improved financial performance. This has fueled the increasing merger and acquisition activity in the hotel industry. A recent industry report records 1997 merger-and-acquisition activity in the hotel industry at \$23.4 billion, involving 15 transactions (Shroders & Co., Inc., 1997).
3. *Capital structure.* The flow of public capital has resulted in a de-leveraging of the hotel industry. For example, investment banks for the hotel industry from 1995 to 1997 raised a total of approximately \$16 billion in public capital. The total debt issued was about 48 percent of the total capital raised (Securities Data Corp, 1997). To put this in perspective, in 1987 the total public debt issued was about 90 percent of the total capital raised (Securities Data Corp, 1997).
4. *Reorganization of corporate structures.* As stated earlier, public ownership requires a maintenance and growth in stock prices. Public markets reward companies with higher stock multiples if they take the real estate off their balance sheets.<sup>3</sup> Marriott is an example of how hotel companies are reorganizing to take this market reality into account. In 1996, Marriott created Host Marriott as the company to hold its real estate assets and Marriott International to operate the higher-growth operating side of the business (McConnell & Summers, 1997).

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<sup>3</sup>The debt loads and depreciation expense endemic to real estate ownership can erode earnings as the cyclical lodging market slows and rebalance.

### Mutual Funds

The role of mutual fund institutions as suppliers of capital to the lodging industry is difficult to measure, as they do not make direct investments in or direct loans for hotel real estate property. However, because of the vast pool of capital that they command, their role as financial intermediaries cannot be overlooked. Mutual funds were virtually nonexistent before 1970, but by 1997 mutual fund assets were valued at approximately \$4.2 trillion, with monthly cash inflows of about \$21 billion (Barry, 1997). About 15 to 20 percent of this cash inflow is from retirement plans. Each fund manager purchases a variety of securities, including those issued by lodging C-Corps and REITs, with the cash that flows in. Because of this financial clout, the role of mutual funds as suppliers of capital to the lodging industry is expected to become very important in the future.

The importance of their role in today's capital markets is summarized in the following statement: "When an investment banker wants to know whether it is a good time to launch a new company on the stock market, the first thing he now asks is whether [mutual] fund managers are expecting cash inflows from their customers. An entire cottage industry has evolved just to monitor the activities of Fidelity, the industry's behemoth, with over \$500 billion under management" (Barry, 1997).

## **Conclusions**

This chapter discussed the historical changes in the need for capital by the lodging industry on the basis of business cycles, changes in the type of hotel products and changes in the ownership structure of the lodging industry. The need for capital by various ownership entities for the various hotel products was not uniformly satisfied during different historical periods. The early 1970s and early 1980s were characterized as a time of excess capital availability induced by various changes in tax laws. This resulted in a period of overbuilding of hotels. In the late 1980s and early 1990s the reverse was true as capital was scarce and hotel growth was stunted. During this period, traditional financial institutions were replaced by alternative sources of financing in the form of opportunity funds, securitization and REITs.

As the lodging industry evolved in the 20<sup>th</sup> century, so did role of the various financial institutions that provided it financing. The role of individual financial institutions as suppliers of capital to the lodging industry was discussed in the second part of the chapter.

## **Chapter 6**

### **TRANSFORMATION OF THE FINANCIAL SERVICES INDUSTRY:**

#### **Regulatory, Competitive and General Issues Impacting the Environment of the Financial-Services Industry**

The present environment of the financial-services industry bears little resemblance to its environment in the decades after World War II. In the 1950s and 1960s, the financial-services environment was characterized by a high degree of regulation, segmentation of financial institutions, and low and stable interest rates—in short, it was a very stable environment. “Banking during this period was a straightforward business; financial decisions were relatively simple, and comparatively few choices were available. One caricature suggested that bankers adhered to a 3-6-3 rule: pay 3% for deposits, charge 6% for loans, and tee off at the golf course at 3:00 p.m.!” (Meerscham, 1991). During this period, the financial-services industry was primarily domestic, as regulations restricted the geographical and product expansion of these institutions. Competition between financial institutions was minimal, sources of funds for financial institutions were stable, and the cost of funds was low and stable. Public debt and equity markets were underdeveloped, with many SEC rules encumbering access to this capital source.

This stable industry started to transition in the 1970s to one characterized by change. The chief factors responsible for this were rising inflation and interest rates combined with changes in the regulatory climate of financial institutions. During this period, banks started to access the unregulated Eurodollar market for funds, rather than rely solely on depositors for funds. Furthermore, financial innovations to overcome the

restrictive regulatory climate were introduced. Negotiable certificates of deposit (CDs) were developed to overcome the interest rate restrictions imposed by Regulation Q.<sup>1</sup> Commercial paper as a source of funding was developed by corporations in this high-interest-rate environment, thereby bypassing the traditional financial intermediaries for funds. This period also saw the expansion of the corporate bond market, which hitherto was restricted only to well-known companies. This period witnessed the growth of money-market mutual funds. Investment companies offering these funds were not subject to interest-rate restrictions, as were commercial banks. Many bank depositors flocked to these funds, which promised higher rates of return. This resulted in the erosion of the asset base of traditional lending institutions such as commercial banks. By the end of the 1970s, the stable financial system of the 1950s and '60s was replaced with a “price-driven” system in which investment and lending decisions were based almost solely on the cost of funds.

These changes in the environment of the financial-services industry continued into the early 1980s, with the deregulation of savings-and-loan institutions (S&Ls). This loosening of regulatory controls, which expanded the lending powers of S&Ls, culminated in the savings-and-loan crisis of the late 1980s (discussed in Chapter 5). Subsequently, new regulations were imposed with the passage of the Competitive Equality Banking Act of 1987 and the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

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<sup>1</sup>The Federal Reserve Board's Regulation Q imposed interest rate ceilings on time and demand deposits offered by depository institutions such as commercial banks.

After a brief period of stability due to the re-regulation in the late 1980s, financial institutions are once again in a state of flux and find themselves in an environment marked by change, complexity, instability, innovation, and expansion. This has resulted in the breakdown of the traditional roles of financial institutions. The future role of financial institutions as suppliers of capital to the lodging industry will depend to a large extent on how these institutions adapt to the current environment. Issues such as the future sources of capital, the future cost of capital, the future availability of capital, and how capital will be accessed in the future can be more successfully explored once one understands the various changes currently taking place in the regulatory, competitive, and general environment<sup>2</sup> of financial institutions.

This chapter begins by briefly discussing the nature of financial markets and the role of financial institutions in the flow of funds. This is followed by an analysis of the current regulatory, competitive, and general environment of the financial-services industry.

## **Financial Markets**

Financial markets are a central part of the financial system of a nation's economy.

Financial systems consist of a "collection of markets, institutions, laws, and regulations through which bonds, stocks, and other securities are traded, interest rates determined, and financial services produced and delivered around the world" (Rose, 1995). Financial

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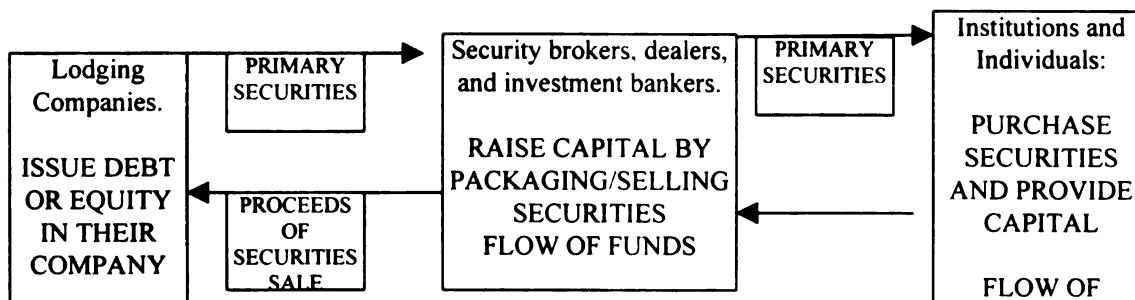
<sup>2</sup>The general environment includes social, demographic, economic, and technological issues.

markets are responsible for channeling funds from those units (households and businesses) that have a surplus, to those units that have a deficit (households, businesses, and government), thereby making funds available to businesses and individuals who are then able to finance their needs beyond the capacity of their current income. A company's purchases of raw material, acquisition of property and equipment, geographical expansion, product diversification, mergers and acquisitions, working capital needs, and various other financing needs are provided via the channeling of funds by the financial markets.

Various financial institutions are involved in the flow of funds in the financial markets. These markets can be placed into two categories: direct financial markets and indirect financial markets.

### Direct Financial Markets

In direct financial markets, the user of capital (such as a lodging company) and the provider of capital deal directly. However, due to the size and sophistication of these markets, brokers and dealer institutions usually conduct this matchmaking (see Figure 11).



Source: Adapted from Peter S. Rose, *Money and Capital Markets*, Fifth Edition, p. 40.

**Figure 11. ILLUSTRATION OF DIRECT FINANCE**

“Brokers” are middle persons that facilitate the finding of investors, such as individuals wanting to purchase real estate or stocks and other types of securities. A stockbroker is one type of broker. The purpose of the broker is mainly to match the buyer with the seller; the broker earns a commission from the resulting transaction. Brokers, because of their extensive knowledge of the financial market, serve as “matchmakers” in the market.

“Dealers” not only match buyers with sellers, but also purchase the security from the seller and resell it to a buyer. Thus, the dealer inherits some risk by “shelving” the security until an appropriate buyer is found. Dealers earn their income from the spread between the price at which they bought and the price at which they sell the security. Their contribution to facilitating the transfer of funds in the financial markets is their experience in finding buyers (individual and institutional investors) and sellers (issuers, such as lodging companies) of securities. Dealers have facilitated the recent growth in the commercial mortgage-backed securities market by packaging and offering these securities for sale.

Dealers and brokers operate in the financial markets either as security dealers or investment bankers. Companies such as Merrill Lynch, Goldman Sachs, Morgan Stanley, Dean Witter, and Bear Stearns are examples of companies that bring users and providers of capital together.

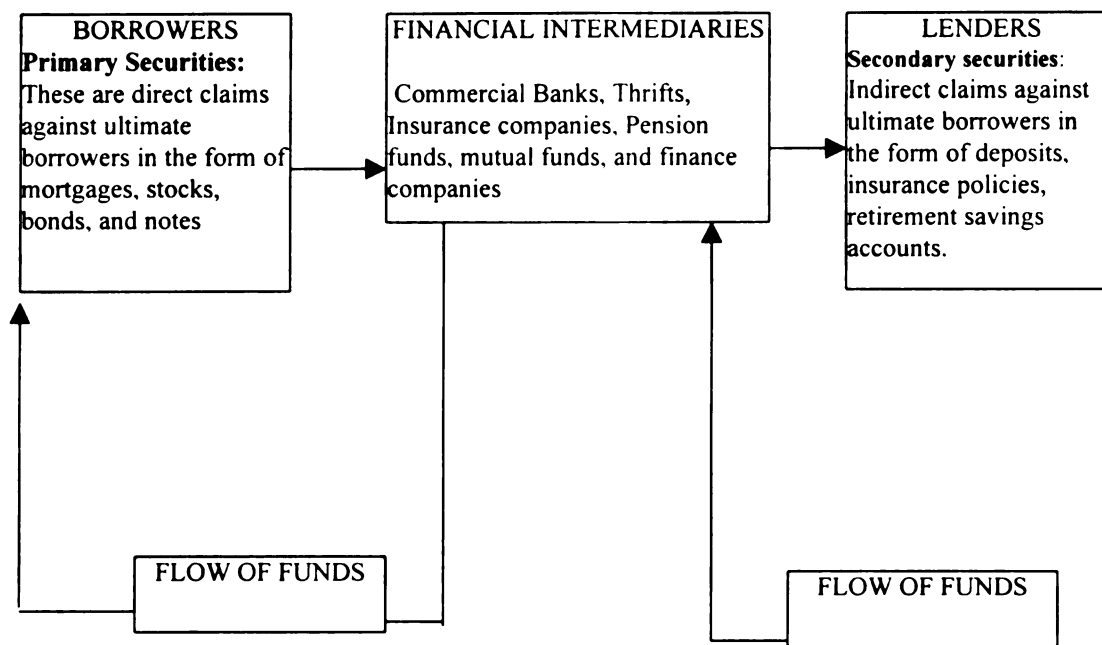


## **Indirect Financial Markets**

The indirect or “intermediation” financial markets are made up of commercial banks, thrifts, insurance companies, pension funds, mutual funds, and finance companies. While investment banks that are part of direct financial markets represent the borrower and issue primary securities (thereby acting as “dealers”), commercial banks (and others) that make up the indirect market function both as a lender and a borrower. They issue their own secondary securities (such as deposits) and accept primary securities from borrowers (such as mortgages) (see Figure 12).

While the intermediation role of these financial institutions (commercial banks, thrifts, insurance companies, and so on) is the same, the names of the primary securities they purchase and the secondary securities they issue are different (Kaufman, 1994).

While the secondary securities issued by banks are called “deposits,” those issued by life insurance companies are called “policies”; mutual funds issue “shares.” Primary securities accepted may be in the form of mortgages, commercial loans, bonds, notes, and stock.



Source: Adapted from Peter S. Rose, *Money and Capital Markets*, Fifth Edition, p. 41.

**Figure 12. ILLUSTRATION OF INDIRECT FINANCE**

## **The Current Environment of the Financial-Services Industry**

In general, the current environment of financial institutions is characterized by deregulation. Traditionally, commercial banks were the most regulated of all financial institutions. The regulations constraining banks included rules related to ownership and management, the maximum interest rate they could charge, restrictions on geographic

expansion, restrictions on the financial products and services they may sell, and restrictions related to the composition of their portfolio. Many of these restrictions have now been eliminated or are under pressure to be removed. For example, the current banking environment is focusing on the removal of price controls on interest rates, the reduction of restrictions on geographic expansion, and a limited opening of financial-product choices that banks may offer to their customers. The result of this overall deregulated environment has been to increase competitive pressures on banks and lower their rates of return.

### **Regulatory Issues**

The key regulatory issues which are having an impact on the environment of the financial-services industry are product expansion, geographic diversification, and capital reserves. These issues are discussed in the following sections.

#### **Product Expansion**

Historically, U.S. regulations have segmented the financial-services industry by the types of financial products they are able to sell. Regulations restricted depository institutions such as commercial banks and thrifts to loan-making activity, investment banks to selling securities, insurance companies to insurance products, and investment companies to selling mutual funds. This segmented market was stable, but it inhibited the growth of financial institutions, because they could not expand their line of financial products. The current environment of financial institutions finds many of these traditional, regulatory

“firewalls” being dismantled. In other cases, institutions are finding ways to bypass these restrictions.

The most famous “firewall” legislation is the Depression-era Glass-Steagall Act of 1933. The purpose of this act was to create a rigid separation between commercial banking and investment banking. Commercial banks were restricted to taking deposits and making loans; investment banks were restricted to underwriting, issuing, and distributing securities. The separation thus created was adhered to until 1963; after that, each type of bank has tried to penetrate into the other’s business. By 1989, affiliates<sup>3</sup> of large money-center (commercial) banks were involved in large-scale underwriting activity. While commercial banks getting into investment-banking activity have received more publicity, investment banks have also tried to chip away at commercial banks by trying to offer cash-management accounts to their brokerage customers.

Various actions are slowly eroding the power to keep commercial banking and investment banking separate. Twenty-three state-chartered banks have now been allowed to engage in securities activities, and 17 foreign banks are allowed to sell securities. Furthermore, many recent mergers, such as that between Bankers Trust and Alex Brown (forming BT Alex Brown) indicate a breach of the Glass-Steagall Act (Taylor, 1997).

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<sup>3</sup>Technically, an “affiliate” is the securities subsidiary of a bank holding company, through which a banking organization can engage in investment banking activities. For example, Citicorp is the holding company, Citicorp Securities is the investment bank, and Citibank is the bank (Saunders, 1994).

If Glass-Steagall is repealed, the wall separating the activities of commercial banks and investment banks could come down. This would provide commercial banks with new avenues for revenue growth and diversification, as well as with a chance to become more competitive with investment banking houses by offering a wider array of services. Even though Glass-Steagall is under heavy pressure to be repealed, the act has supporters as well as detractors. As such, its future is uncertain.

As with commercial banking and investment banking, barriers also exist between the banking and insurance industries. These restrictions are codified in legislation such as the Bank Holding Act of 1956, the Garn-St. Germain Depository Institutions Act of 1982, and the McCarran-Ferguson Act of 1945. However, starting in the 1980s, insurance companies attempted to bypass this restriction by establishing “non-bank” bank subsidiaries. Many large insurance companies such as Aetna, John Hancock, Prudential, and Travelers bought full-service banks, divested them of their demand deposits and commercial loans, and thus converted them to non-bank banks.

Even though the future growth of non-bank banks was capped with the passage of the Competitive Equality Banking Act of 1987, the non-bank banks had served to loosen the restrictions between banks and insurance companies. The recent \$83 billion merger between Citicorp (a bank) and Travelers (an insurance company) is testimony to the fact that the issue is still alive; this merger appears to be paving the way for other bank and insurance company mergers (Siconolfi, 1998).

Further evidence of a breakdown in the distinction between banks and other financial-services institutions is the operating subsidiary rule (November 1996) by the Comptroller of Currency. The regulation may eventually allow banks to conduct more

extensive insurance and securities underwriting activities in non-bank subsidiaries of the banks themselves, thereby eliminating the need for bank holding companies (*Harvard Law Review*, April, 1997).

In other areas, the most recent example of product expansion crossing traditional financial-market boundaries was the entry of TIAA-CREF, the largest private pension fund, into the mutual fund industry. The Taxpayer Relief Act of 1997 converted TIAA's tax-exempt status to taxable, and the institution decided to adapt by creating six mutual funds. Its previous tax-exempt status restricted the types of products and services it could offer (Strosnider, 1998).

Regulation also restricts financial institutions in their portfolio choices. For example, to improve the operation of private pension funds and reduce the risk to participants, in 1974 Congress enacted the Employee Retirement Income Security Act (ERISA). ERISA constrains a pension fund's investment policy by establishing the "prudent man" rule, which requires the manager of the fund to make investment decisions with the same care and judgment that a prudent individual would use in handling an investment (Gallo, 1992). As restrictions on the financial products institutions are allowed to sell are reduced, legislation related to portfolio choices will have to be reconsidered.

In the evolution of the financial-services industry, trends point to an era in which financial institutions will be able to offer more than their traditional line of financial

products. The financial-services reform bill<sup>4</sup> currently under consideration in Congress is pushing for the modernization of the entire financial-services industry by removing antiquated legislation restricting access of financial institutions to each others' markets (Greenspan, 1998).

### Geographic Diversification

The issue of product expansion by financial institutions is directly related to their ability to distribute (sell) their products nationally and internationally. As a result, regulation related to their geographic expansion becomes important. While insurance companies, investment banks, finance companies, and investment companies (selling mutual funds) are unhindered by rules related to geographic diversification, commercial banks and thrifts have not historically enjoyed this freedom. Unequal regulations with regard to geographic restriction have resulted in differences in the role of these various institutions as suppliers of capital. While investment banks, life insurance companies, and finance companies have unrestricted access nationwide, commercial banks are only now gaining (limited) access to nationwide banking.

Commercial banks have come a long way in their struggle to increase the geographic diversification of their products. Starting with unit banking (single office) at the beginning of the century, after many years they established the ability to offer in-state branch banking. The rules prohibiting interstate banking, initially established in 1927, are

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<sup>4</sup>The specific bill in question is H.R.10, the Financial Services Act of 1998. Allan Greenspan states, "The objective of the bill is simple and removes outdated restrictions that currently limit the ability of the U.S. financial-service providers, including banks, insurance companies, and securities firms, to affiliate with each other and enter each others' markets" (Greenspan, 1998).

only now being liberalized with the passage of the Riegle-Neal Interstate Banking and Branching Act of 1994 (Gentry, 1995).

### Capital Reserves

Regulations that are related to capital adequacy requires a financial institution to maintain a minimum level of capital as a percentage of its total asset base. The differences in these levels between financial institutions impacts their lending and investing decisions.

Commercial banks and thrifts are subject to risk-based capital ratio regulation.<sup>5</sup>

Risk-based capital ratio regulations require institutions to maintain minimum capital levels in relation to the riskiness of their assets. An institution holding a higher percentage of risky loans in its portfolio is required to maintain higher capital levels. This has direct implications for an institution's lending decisions, because higher capital reserve requirements reduce the overall funds available for making loans. For example, banks holding a higher percentage of hotel loans (considered risky) would be required to keep higher capital levels. This has an impact on how many hotel loans a bank wants in its overall loan portfolio.

Although not yet implemented by the life insurance industry, life insurance companies are in the process of implementing a risk-based capital structure similar to depository institutions.

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<sup>5</sup>The risk-based capital ratios were implemented in 1993, in what has come to be known as the Basel Agreement. Its main purpose was to institute an international standard for minimum capital requirements for commercial banks.



## **Competitive Issues**

As the financial-services industry continues to become more deregulated, formerly segregated financial institutions have started to compete for the same customers. This convergence of financial markets has had an impact on the competitive financial environment in many ways. Key issues are discussed in the following sections.

### Changes in Asset Size and Relative Market Share of Financial Institutions

The *Flow of Funds Account*, published by the Board of Governors of the Federal Reserve System (1992), tracks changes in the relative size of financial institutions (based on asset size) and their market share of assets (see Tables 49 and 50). Although commercial banks are the largest financial intermediary, the report indicates that commercial banks are losing their market share of total assets as compared to many other institutions. In 1950, commercial banks' share was 52 percent, was down to 36 percent by 1980 and further shrank to 28 percent by 1992. Life insurance companies have fallen from a market share of 22 percent in 1950 to 13 percent in 1992. The two big gainers in this competitive market for funds were pension funds, which increased their share from 2 percent in 1950 to 18 percent in 1992, and mutual funds, which increased their share from 1 percent in 1950 to 8 percent in 1992 (Kaufman, 1995).

Table 49

**ASSET RANK, DOLLAR SIZE, GROWTH RATE, AND MARKET SHARE OF  
MAJOR FINANCIAL INSTITUTIONS, 1950–1992**

<u>Intermediary 1992</u>	Asset Rank	Annual (\$Billions)	<u>Market Share (Percent of total assets, year end</u>					
			Percent Growth (1950–1992)	1950	1960	1970	1980	1992
Commercial Banks	1	3,629	7.7%	52%	38%	38%	36%	28%
Private pension funds	2	2,347	14.4%	2%	6%	9%	11%	18%
Life Insurance	3	1,625	7.8%	22%	20%	15%	12%	13%
Mutual Funds	4	1,057	14.4%	1%	3%	4%	2%	8%
State and local govt pension fund	5	988	13.1%	2%	3%	5%	5%	8%
Savings and loan asso	6	832	9.5%	6%	12%	14%	16%	6%
Finance Co's	7	808	10.9%	3%	5%	5%	5%	6%
Casualty insurance co's	8	629	9.7%	4%	5%	4%	5%	5%
Money market funds	9	548	0.0%	0%	0%	0%	2%	4%
Credit Unions	10	266	13.9%	0%	1%	1%	2%	2%
Savings banks	11	245	5.7%	8%	7%	6%	4%	2%
Total		12,974	9.3%	100%	100%	100%	100%	100%

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, Flows and Outstanding*, Fourth Quarter 1992, March 10, 1993; and Board of Governors of the Federal Reserve System, *Flow of Funds Accounts*, 1949–1978, December 1979.

**Table 50**

**CHANGES IN TOTAL ASSETS OF U.S. FINANCIAL INSTITUTIONS**  
**Billions \$U.S.**

<b>Financial Institutions</b>	<b>1960</b>	<b>1970</b>	<b>1980</b>	<b>1990</b>	<b>1992</b>
Commercial Banks	\$224	\$489	\$1,248	\$3,340	\$3,629
Savings and Loan Associations	70	173	622	1,097	832
Life Insurance Companies	116	201	464	1,367	1,625
Private Pension Funds	38	110	413	1,163	2,347
Public Pension Funds	20	60	198	752	988
Finance Companies	28	63	199	781	808
Property-casualty insurance companies	26	50	174	513	629
Money market funds	-	-	74	498	548
Savings Banks	41	79	172	264	245
Investment Companies	17	47	64	579	1,057
Credit Unions	6	18	72	217	266
Real Estate Investment Trusts	-	4	6	13	16
Security Brokers and Dealers	7	16	36	262	405

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Accounts: Financial Assets and Liabilities*, year-end, 1960–1992.

The implications of the changes in the relative and absolute market share of the financial institutions are clear. Financial institutions' current and future role as suppliers of capital will change as their asset base changes. If an institution is facing an environment in which its in-flow of funds is declining or the sources of its funds are changing, its lending and investing role will also change as a result. These changes, to a large extent, are determined by the regulations imposed upon specific financial institutions; the competitive environment; and changes in the social, economic, demographic, and technological trends in the general environment.

### Competition in Intermediation

The direct result of the deregulation-induced convergence of financial institutions is to create a highly competitive and fluid intermediation environment. While, in the past, commercial banks competed only with other commercial banks, investment banks with investment banks, and life insurance companies with life insurance companies, the current environment makes no such neat distinction among competitors. For example, commercial banks are establishing securities subsidiaries and are active in international underwriting; securities firms now provide checking and other banking services; and insurance firms are marketing an expanded array of products, including mutual funds.

The president and CEO of Norwest Corporation neatly summarized the breadth and complexity of the new competitive environment in the provision of financial services in the following statement (Kovacevich, 1994):

As a diversified financial-services company, we're competing aggressively for customers and revenues against thousands of banks, mortgage companies, consumer finance companies, insurance companies, brokerage houses, and investment managers on virtually every main street in the United States and Canada.

This growing array of "non-bank" competitors—5,300 securities firms, 13,000 credit unions, 8,300 insurance companies, 440 investment companies, 2,200 savings institutions—walk and talk like banks. . . . We compete for consumer loans, credit cards, for insurance, for mutual funds, and for mortgages with, among hundreds of others, Fidelity Investments, GE Capital, Edward D. Jones, American Express, Merrill Lynch, John Hancock, AT&T Capital, Ford Financial, Sears, and John Deere Credit Union.

It is interesting to note that these new "bank" companies include companies from a variety of different industries—communication, securities-brokerage, data-processing, travel-and-entertainment, insurance, and technology (McKinsey & Company, 1996).

In this new competitive environment, traditional financial institutions such as commercial banks are threatened by new and less regulated institutions that are providing cheaper and easily accessible capital, placing commercial banks at a competitive disadvantage. These non-bank institutions include finance companies, mutual fund companies, investment banks, insurance companies, and diversified financial-services companies.<sup>6</sup> Furthermore, corporations can go directly to the market by issuing their own commercial paper, thereby bypassing banks altogether.

In response to this competition, some commercial banks are adapting to this changing competitive environment by spinning off product lines and services to focus on a smaller number of functions. Bankers Trust, for example, shed its retail banking business, and Signet Bank its credit card business (Dwight, Crane, & Bodie, 1996). Furthermore, commercial banks are participating in the growing securitization market by selling loan portfolios and thereby freeing up capital to make more loans.

### Consolidation

The United States is still a nation of small banks. However, competitive pressures are forcing the formation of large financial-service organizations. Technological advances allow financial firms to compete for customers electronically without building banks at every street corner. Increased capital requirements restrict growth and make it difficult to compete as a small entity. Furthermore, declining profit margins and increased

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<sup>6</sup>An example of a diversified financial-services company is USAA, which makes the initial loan, such as an auto loan, and then can provide a host of other services to the customer, such as auto insurance, car rental services, travel services, and repair services.

competition from foreign and non-bank competitors make size a survival strategy for most U.S. financial institutions.

According to the Federal Deposit Insurance Corporation (FDIC), the number of FDIC-insured banks fell from 14,628 in 1975 to 9,941 in 1995. A similar reduction in numbers is true for other financial institutions, such as investment banks, life insurance companies, and finance companies. As of 1995, 75 FDIC-insured banks had assets of more than \$10 billion, with aggregate assets of \$2.3 trillion. This is equal to 53% of the total industry assets of \$4.3 trillion (Biggar, 1996).

The latest (and largest) example of recent consolidation activity was the April 1998 merger between Citicorp and Travelers. The new organization, called Citigroup, will have a total of \$700 billion in assets (Glassgall, Rossant, & Peterson, 1998). This combined organization has the ability to offer banking, insurance, and investment-banking services in one place. While the Citibank-Travelers deal was the largest recent merger, many others have taken place in recent years, including BankAmerica and NationsBank, ChaseManhattan and Chemical, Banc One and First Chicago NBD, Deanwitter and Morgan Stanley, and Bankers Trust and Alex Brown. It is important to note that consolidation is taking place at two levels: (1) within the commercial banking industry, where large commercial banks are growing larger, and (2) between commercial banks and other sectors of the financial services industry, such as insurance companies, mutual fund companies, and investment banks. The various combinations and permutations are just beginning.

### Simplification of the Regulatory Environment as a Result of Consolidation

If the trend toward consolidation of financial institutions continues, it may spur a similar trend among the regulatory agencies. Currently, the regulatory structure is set up to monitor banking, insurance, investment banking, and investment companies as separate entities. However, if these institutions merge, will separate and overlapping regulatory agencies be needed? In the early 1990s, the discussion of creating a “super-regulator” to take the place of the Comptroller of Currency, Federal Reserve, Office of Thrift Supervision, and the Federal Deposit Insurance Corp. was a hot topic (Standard & Poor’s, 1997).

### Declining Margins

Increasing competition has also increased the cost of funds for the various competing financial institutions. This has put pressure on them to broaden their portfolio and increase cross-selling efforts. This further provides an incentive for institutions to merge, in order to create economies of scale and gain a larger share of the market.

### **General Environmental Issues**

Three issues in the general environment of financial institutions are transforming the financial-services industry. They are:

1. Globalization
2. Technological changes

### 3. Demographic, social, and economic changes

These issues are discussed in the following sections.

#### Globalization

“Globalization is the gradual evolution of markets and institutions so that geographic boundaries do not restrict financial transactions” (Koch, 1992). With the globalization of capital markets, funds move more freely between lenders and investors, with minimal interference caused by national borders. Globalization is the net result of advances in information processing and telecommunications, the removal and restriction on cross-border flow of capital, the deregulation of domestic capital markets, and the development of unregulated off-shore markets. Globalization has been further fueled by competition among financial institutions that look beyond the United States in search of funds for their clients.

Another direct impact of globalization is the reduction of control by monetary authorities over the availability of credit. For example, if the Federal Reserve attempts to limit credit availability by raising interest rates, capital may still be tapped from international sources, which are attracted by the higher interest rates.

The deregulated climate changing the financial-services industry in the United States is also being exported to other nations. As Bench (1995) states: “To start with, the ongoing liberalization of finance within and across borders has involved both eliminating interest-rate controls and allowing various providers to offer more new products. The



liberalization process has also included the elimination of exchange controls, thereby facilitating a greater amount of cross-border capital flows.”

Also, globalization does not just mean that U.S. firms have access to international capital markets; the reverse is increasingly true as well. The recent growth of international banks such as Deutsche Morgan Grenfeld, the Union Bank of Switzerland, Swiss Bank Corporation, and Nomura are indicative of this trend. These firms have hired top employees from U.S. banks, which now compete in the same markets.

### Technological Changes

The speed of computing technology, the ability to store and manipulate vast amounts of data, the ability and speed with which information (financial and other) can be transferred, and the increasing user-friendliness of financial software are all transforming the financial-services industry. Examples of the impact technological changes have had on lending and investing include the following:

- ◆ Consumers can make more informed investment decisions because they have easy access to information.
- ◆ Sophisticated and large databases provide financial institutions with detailed information about customers. As a result, risk profiles can be more accurately determined by institutions. Furthermore, with past histories of customers, institutions are able to target sales and service efforts more efficiently.

- ◆ Financial institutions now have increasingly “intelligent” financial software, which will help them make better lending and investing decisions. Some of these decisions will be based on programmed criteria, further reducing the human judgment factor in lending decisions.
- ◆ The Internet and advances in telecommunication are converting the traditional relationship of borrowers and lenders to a more “virtual” relationship. Consumers can now access information via computer from multiple suppliers of financial products. They can then make decisions based upon lowest cost, highest return, and other objective measures. This dynamic is already taking place for products such as mutual funds and stocks.
- ◆ Technological advancements assist financial institutions in becoming “one-stop-shopping” firms by enabling them to offer various financial products via the Internet.
- ◆ Technological advancements may lead to the creation of new “virtual financial institutions,” further adding to the competitive landscape. These are already being formed: Security First is a virtual bank: Wit Capital is a cyberspace investment bank: and Insweb is a web-based insurance company (Staff, 1996).
- ◆ An even more challenging scenario for financial intermediaries may be the increase in direct finance, whereby large corporations wanting to raise capital may bypass investment banks and merely post bond issues on the relevant electronic bulletin board (Staff, 1994). Furthermore, improvements in trading technology is resulting in the creation of trading desks at large institutional investors, thus bypassing brokerage houses and negatively impacting their profits.

### Demographic, Social, and Economic Changes

Many of the changes taking place in the financial services industry are a response to broad demographic, social, and economic trends. Rose (1994) outlines some of these trends:

- ◆ The average age of the worldwide population is increasing. In the United States, the number of retirees is increasing. The present 3:1 ratio of working adults to retirees is expected to fall to 2:1 in the next century. This is partly a result of increases in the number of people taking early retirements (some retirees, however, begin second careers or start their own businesses). As the population ages, it will have profound effects on borrowing, saving, and consumption habits. Expected changes include a slowdown in the growth of consumer spending and borrowing, and a probable increase in savings rates.
- ◆ More women are entering the work force, with fewer of them choosing marriage and children. Women are also becoming more educated.
- ◆ The family unit is also changing. People are waiting longer to enter their first marriage, the divorce rate is increasing, and single-parent households are increasing.
- ◆ Manufacturing industries are being displaced by service industries in developed countries.
- ◆ Markets are becoming more international, facilitated by easier dissemination of information. The formation of the European Community, creating a common market of 12 European nations, is an example of this.

- ◆ The increasing internationalization of economies and societies is promoting interdependency. The current Asian crisis is a case in point; a crisis in one region of the world is now having an impact on the global economy.
- ◆ The growth of the middle class in emerging nations has increased the need for financial services.

## **Conclusions**

Financial institutions operating in both direct and indirect financial markets play a vital role in the supply of capital to businesses in general and the lodging industry in particular. The financial services industry, which is made up of commercial banks, life insurance companies, mutual fund companies, investment banks and other financial institutions, is undergoing many changes. It is essentially being transformed from a regulated and stable industry (1950s-1960s) into a deregulated industry that is very volatile. In this environment of deregulation, the traditional roles of these financial institutions are becoming blurred. This can be noted in expansion of financial products that institutions may offer and their ability of diversify geographically. As a result, competition has increased between these institutions, which now are beginning to offer similar financial products. All of these changes are taking place within the context of an increasing global economy, with many technological, demographic and social changes.

## Chapter 7

### THE DELPHI STUDY: ANALYSIS AND DISCUSSION OF RESULTS

The last three chapters were devoted to research questions about past and present changes in the lodging industry's structure, performance, and financing trends. They also covered the role of financial institutions as suppliers of capital and the regulatory, competitive, and general environmental factors that are transforming the financial-services industry. These areas constitute stages one and two of the research and provide the basis for the third stage of the research, the Delphi study. The purpose of the Delphi study was to predict future changes in the environment of financial institutions; predict the lodging industry's structure, operating performance, and capital needs in the future; and predict the future role of financial institutions as suppliers of capital to the industry.

This chapter presents, analyzes, and discusses the results of the Delphi study. The findings are based on the following five broad research questions posed in the Delphi study:

In the years 2000 and 2005, what will be:

1. *The economic, regulatory, and competitive environment of financial institutions?*
2. *The structure of the lodging industry?*
3. *The operating and investment performance of the lodging industry?*
4. *The lodging industry's need for capital?*
5. *The role of financial institutions as suppliers of capital to the lodging industry?*

For each of the five broad research questions, sets of specific sub-questions were asked to focus panelists attention on the key variables relevant to answering the broader research questions. The responses were summarized using two statistics: the median (MD) and the inter-quartile range (IQR). The median is the midpoint of the distribution of the panel's responses; the inter-quartile range is the middle 50 percent of their responses and is indicative of the degree of consensus among the Delphi panelists. The responses noted in the tables in this chapter are the responses of the final Delphi round, and may be interpreted as the expert panel's final decision for a particular question or issue.

In addition to the study's closed-ended questions, three questions were open-ended. The experts on the panel freely expressed their views when answering these questions, and their responses were organized, summarized, and—in some cases—directly transcribed, so as not to lose any meaning in the translation. The answers to the open-ended questions appear near the end of this chapter.

### **Research Question 1:**

#### ***In the Years 2000 and 2005, What Will Be the Economic, Regulatory, and Competitive Environment of Financial Institutions?***

##### **The General Economic Environment of Financial Institutions in the Years 2000 and 2005: Analysis of Results**

Based on the UCLA Anderson forecast (June, 1998), the economy is currently in its 87<sup>th</sup> consecutive month of expansion and the federal budget is in surplus for the first time in 30 years. In 1998, the first quarter real GDP growth was nearly five percent. With

steadily falling unemployment, low inflation, and rising stock markets, the U.S. economy is continuing to enjoy one of the best performances in its history (Kimbell & Dhawan, 1998).

#### Prediction of Economic Indicators for the Years 2000 and 2005

The predictions of the panelists concerning future economic indicators is presented in Table 51. The panelists expect that inflation, as measured by the Consumer Price Index (CPI), will remain essentially the same as today for both prediction periods.

Unemployment is expected to be higher in the year 2005 as compared to the current period. Both inflation and unemployment predictions are in the 3-4 IQR range (“about the same as today” to “unfavorable”).

The panel’s predictions on long-term interest rates were based by interest rates on 10- and 30-year treasury bonds. The panelists predicted that the interest rates for 10-year treasury bonds would remain about the same in 2000 and 2005 as today. However, there was wide disagreement on the interest rate for 30-year treasuries for the year 2005 (ranging from moderately higher to moderately lower than today’s rate).

As compared to the current period, personal income taxes are expected to be about the same in the year 2000, but are predicted to be lower than current levels in the year 2005.

Closely related to the personal income tax rate are the personal savings rate and disposable income. For the years 2000 and 2005, the panel predicts that these will be the same as in the current period. However, for 2005, there was almost no consensus with regard to disposable income, which had an IQR ranging from “favorable” to “unfavorable.”

As with personal income taxes, the panel's prediction regarding corporate income taxes was that they would remain essentially the same as today for both 2000 and 2005. The experts were quite optimistic about the federal deficit for the year 2000, which they said would be better (lower) than in the present period. Going further out, they were more pessimistic, with views ranging from "about the same as today" to "unfavorable."

**Table 51**  
**EXPERT PANEL'S PREDICTION OF KEY ECONOMIC INDICATORS**  
**(Years 2000 and 2005)**

ECONOMIC INDICATOR	1997	MD 2000	IQR 2000	MD 2005	IQR 2005
Unemployment rate (%)	4.9%	3.0	3.0-4.0	4.0	3.0-4.0
CPI (% change previous year)	2.5%	3.0	3.0-4.0	3.0	3.0-4.0
10 year T Bond (%)	6.8%	3.0	3.0-4.0	3.0	3.0-4.0
30 year T Bond (%)	7.7%	3.0	3.0-3.0	3.0	2.0-4.0
Personal income tax rate	12.4%	3.0	3.0-3.0	2.0	2.0-3.0
Personal savings rate	4.1%	3.0	2.0-3.0	3.0	3.0-3.0
Disposable income ((% change over previous year)	4.9%	3.0	2.0-3.0	3.0	2.5-4.0
Corporate income tax rate	32.0%	3.0	3.0-3.0	3.0	3.0-3.0
Federal deficit (% of GDP)	-0.5%	2.5	2.0-3.0	3.0	3.0-4.0

**Scale:**

**1 = Very favorable, 2 = Favorable, 3 = About the same as today, 4 = Unfavorable, 5 = Very unfavorable**

#### Prediction of the Stage of the Business Cycle in the Years 2000 and 2005

The predictions of the panelists concerning where we will be in the business cycle in the years 2000 and 2005 are presented in Table 52. The panel was almost evenly split between those that felt the economy is presently in an expansion phase and those that felt it had peaked (53 percent versus 47 percent). Most of the respondents (53 percent) predicted that in the year 2000 the economy will be at its peak; however, 40 percent predicted that it would be in a contraction phase, while 7 percent selected "trough." In the



year 2005, there was a wider divergence of views, with 20 percent predicting expansion, 53 percent selecting contraction, and 27 percent selecting trough.

**Table 52**

**EXPERT PANEL'S PREDICTION OF THE STAGE IN THE BUSINESS CYCLE  
OF THE U.S. ECONOMY  
(Years 2000 and 2005)**

<b>YEARS</b>	<b>EXPANSION % SELECTING</b>	<b>PEAK % SELECTING</b>	<b>CONTRACTION % SELECTING</b>	<b>TROUGH % SELECTING</b>
<b>1998</b>	53.0	47.0	0.0	0.0
<b>2000</b>	0	53.0	40.0	7.0
<b>2005</b>	20.0	0.0	53.0	27.0

Discussion of the General Economic Environment in the Years 2000 and 2005

Before asking the Delphi panelists to make specific predictions about the lodging and financial-services industries, it was important to ask their views on the general economy in the years 2000 and 2005. Both the lodging and the financial-services industry operates within the broader context of this general economic environment. It was expected that the panel's predictions about the lodging industry's operating and investment performance and their predictions about the future availability of capital would, to a large extent, be influenced by their view of the general economy's future.

The combined value of the unemployment rate and the inflation rate (CPI), often referred to as the "misery index," was unusually low from 1994 to 1997. There is an inverse relationship between the misery index and the economic well-being of the population, with a high index indicating low economic well-being, and vice versa (Frumkin, 1998). The median response of the participants indicated that this index would remain low in the year 2000. In 2005, unemployment is expected to be slightly higher

than today. However, there was weak agreement on the issue. Generally speaking, however, whenever the economy is in a state of expansion, the rate of unemployment tends to fall (as with the current period). However, when the economy is in a state of recession, the unemployment rate moves up rapidly (Clayton, 1992). This correlates with the panel's prediction of a slower future rate of growth and a higher rate of unemployment in the year 2005.

The CPI as a measure of inflation is important in part because it plays a role in the setting of monetary and fiscal policy. There is a direct relationship between the interest rate (discount rate) set by the Federal Reserve Board and the rate of inflation. If the chairman of the Federal Reserve Board (currently Alan Greenspan) thinks that the economy is getting overheated, raising inflation fears, he may make a recommendation (to the Board) to increase the discount rate; the converse is also true. This change in the rate of interest, in turn, has an impact on the supply of money, which in turn has an impact on the interest rates that individual financial institutions charge borrowers. The panel expects the CPI to remain stable for both of the prediction periods; therefore, we should not expect to see large changes in interest rates.

Long-term treasury bonds are debt instruments sold by the U.S. Treasury with maturities of 10 years or more. The interest rate on these investments is associated with the "risk-free rate," which represents U.S. government debt. Lending institutions fix their interest rate for commercial loans (including those to the lodging industry) as a percentage above the interest rate on treasuries. Therefore, the direction in which the long-term treasury-bond rate moves will have an impact on the rate of interest charged for hotel loans. In mid-1998, the 30-year treasury-bond rate was around 6.0 percent

(UCLA Anderson Forecast, June 1998). This dropped further to 5.60 percent in August 1998. By way of comparison, interest rates on 30-year treasuries were at 6.97 percent in August 1997 (Capital Sources, September 1998). The progressive lowering of these benchmark rates indicates that an economic slowdown is underway. Based on the panel's predictions for the year 2000, it appears that the treasury-bond rates are expected to be in the 6 percent range. The panel was indecisive in its long-term predictions of treasury-bond rates for the year 2005. However, if these rates increase in the future, it will indicate increasing economic growth and increasing investor confidence in the "international arena." Furthermore, "this will mean high demand for capital and higher rates for all debt" (Blew & Newman, 1998).

Disposable income is the income that is left after deducting personal income taxes and other taxes. Therefore, there is an inverse relationship between the two indicators (disposable income and personal income tax rate). Personal saving is what is left of the disposable income after all personal expenditures on goods and services are made (the personal savings rate is calculated by dividing personal savings by disposable income).

While all of these statistics are important, the personal savings rate is of particular importance because of its relationship to investment. The channeling of personal savings into investments is accomplished through intermediate transactions at banks and other financial institutions. In the United States, the overall rate of personal savings has declined from the 7 to 8 percent range of the 1960s and the 8 to 9 percent range of the 1970s and early 1980s to the current 4 to 5 percent range.

The expert panel does not expect to see any drastic changes in the three closely related economic indicators of personal income tax rate, personal savings rate, and

disposable income. For the past four years (1994–1997) these three indicators have held fairly steady. The effective tax rate on personal income<sup>1</sup> have changed from 11.0 percent to 12.4 percent, the personal savings rate has changed from 4.2 percent to 4.1 percent, and disposable income has changed from 4.6 percent to 4.9 percent (UCLA Anderson forecast, September 1997).

In keeping with the current federal-deficit-reduction trend, the panel predicts a period of budgetary surpluses in the years 2000 and 2005. This concurs with a recent article in the *Wall Street Journal* which reports that the current budgetary surplus is \$70 billion and is expected to increase to \$1.5 trillion by the year 2008 (Davis, 1998).

The Gross Domestic Product (GDP) is used as an instrument for measuring the output of the U.S. economy as a whole (its magnitude and growth or decline). As a result, the GDP's best known use is as an indicator of economic growth or decline (Darney, 1997). The real GDP increased at an annual rate of 4.8 percent in the first quarter of 1998, based on estimates of the U.S. Commerce Department's Bureau of Economic Analysis. This is the sixth quarter in a row that the U.S. economy has grown at above its estimated potential growth rate of about 2.2 percent (Kimball & Dhawan, 1998). According to the National Bureau of Economic Research (NBER), a recession occurs whenever total output, as measured by the GDP, declines for two consecutive quarters (Clayton, 1992).

After the expert panel made predictions about the future direction of key economic indicators, it made an overall prediction of the future stage in the business cycle it expects the U.S. economy to be in. The panel was optimistic about the current

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<sup>1</sup> Personal income is derived from wages, salaries, fringe benefits, profits from self employment, income from investments, social security, unemployment benefits, medicare and medicaid.

stage in the business cycle; however, it was evenly split between those that said the economy is still expanding and those that stated it had peaked. These predictions can be substantiated by factual data from two reliable sources. According to the National Bureau of Economic Research (NBER),<sup>2</sup> the current cyclical expansion started in 1991 and was still in progress as of the spring of 1997. More recent statistics from the Department of Commerce's Bureau of Economic Research indicated that the GDP grew by 4.8 percent in the first quarter of 1998. This would indicate that the economy is still expanding. This would make the prediction of the 53 percent who said that the economy would peak by the year 2000 more plausible. While the panel is split in its prediction for the year 2005, it is overwhelmingly pessimistic as to the stage of the business cycle that the U.S. economy will be in in 2005 (80 percent stated contraction or trough).

### **The Regulatory Environment of Financial Institutions in the Years 2000 And 2005: Analysis of Results**

In view of the transformation taking place in the financial-services industry (discussed in detail in Chapter 6), the Delphi participants were asked to predict specific changes in the regulatory environment of financial institutions.

#### **Prediction of the Regulatory Environment of Financial Institutions in the Years 2000 and 2005**

Table 53 reports the degree of agreement that the Delphi participants had with a series of statements about the future regulatory environment for financial institutions. Overall, the median response of the participants indicates that in 2000 and 2005, the regulatory

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<sup>2</sup>NBER is a private, non-profit organization that studies business cycles. It bases its decision of whether the economy is in an expansion or a recession by studying key economic indicators.

Table 53

**REGULATORY ENVIRONMENT OF FINANCIAL INSTITUTIONS  
(Years 2000 and 2005)**

<b>EVENT STATEMENT</b>				
	MD 2000	IQR 2000	MD 2005	IQR 2005
1. Overall, financial institutions will operate in a more deregulated environment, as compared to the current period.	2.0	2.0-2.0	2.0	2.0-3.0
2. The provision of the Glass-Steagall Act that separates commercial banking and investment banking activities will be repealed.	3.0	2.0-3.0	2.0	2.0-3.0
3. The regulations that separate the financial institutions based upon the financial products and services that they are allowed to sell will disappear.	3.0	2.0-3.0	2.0	2.0-3.0
4. The regulatory agencies that monitor financial institutions will merge.	3.0	3.0-4.0	3.0	3.0-4.0
5. Overall, regulatory differences between financial institutions (such as banks and finance companies) will be lower than the current period.	2.0	2.0-2.0	2.0	2.0-3.0
6. There will be no (or very minimal) restrictions on financial institutions to expand their operation to any part of the United States.	2.0	2.0-2.0	2.0	2.0-2.0
7. U.S. restrictions on foreign financial institutions wishing to operate in the United States will decrease.	2.0	2.0-2.0	2.0	2.0-2.0
8. In general, U.S. financial institutions will be able to operate globally, with lower restrictions than currently.	2.0	2.0-2.0	2.0	2.0-2.0
9. There will be an increase in government-backed financing programs, such as the SBA.	4.0	4.0-4.0	4.0	4.0-4.0
10. Overall, there will be tax-advantaged legislation for real estate investment that provides an impetus for financial institutions to increase real estate lending/investments.	4.0	3.0-4.0	4.0	3.0-4.0

**Scale:**

**1 = Strongly Agree, 2 = Agree, 3 = Undecided, 4 = Disagree, 5 = Strongly Disagree**

environment will be more deregulated than in the current period. However, there was a degree of uncertainty about whether the Glass-Steagall Act, which separates commercial banking and investment banking, would be repealed by the year 2000. By 2005, however, the level of agreement increased that this act would be repealed. The panelists also predicted that by 2005 regulations that segregate financial institutions in terms of their ability to sell products and services will be repealed.

As to the equality of regulations between the different financial institutions, the median response of the panel was that the inequities in regulations would be lower in the future than in the current period.

The median response of the panel also indicated that in 2000 and 2005, restrictions on the freedom of financial institutions to expand geographically to any part of the United States would be lower or non-existent. By the same token, however, the opinion of the panel was that foreign financial institutions wishing to expand their operations into the United States would also face lower restrictions. The panel also predicted that, in 2000 and 2005, most U.S. financial institutions will be able to operate globally with fewer restrictions than is currently the case.

The experts were pessimistic about the role of the federal government in assisting small businesses. They disagreed with the statement that government-backed programs, such as the Small Business Administration, will increase. This was true for both years 2000 and 2005.

Finally, the expert panel did not feel that in either 2000 or 2005, legislation will be enacted providing an impetus to financial institutions to increase real estate lending and investments.

### **The Competitive Environment of Financial Institutions in the Years 2000 and 2005: Analysis of Results**

#### **Prediction of the Competitive Environment of Financial Institutions in the Years 2000 and 2005**

Table 54 presents the predictions of the panel on the future competitive environment of financial institutions. The experts predicted that commercial banks' share of total financial assets will continue to decrease as a percentage, in relation to other financial institutions. Panelists were uncertain whether banks and thrifts would merge into one type of financial institution by the year 2000. However, the likelihood of that happening

by the year 2005 was thought to be higher. There was strong consensus on the question concerning whether many investment banks and money-center banks would merge into one type of financial institution. The panel agreed that they probably would.

The panelists also strongly agreed that there will be fewer financial institutions in the years 2000 and 2005 and that the size of the average financial institution will be larger. The latter had an IQR ranging from “Strongly Agree” to “Agree.” These larger institutions, the panel predicted, will be selling multiple financial products, such as mutual funds, insurance, and mortgages, in a “one-stop-shopping” model. This view was reinforced when the panel was asked if these institutions will compete for similar products in 2000 and 2005. There was strong consensus on this question, in which the panel agreed that institutions will compete by selling similar products in these years.

The respondents also agreed that there will be an increase in corporate customers going directly to the capital markets (versus relying on financial intermediaries) and there will be an increase in foreign financial institutions operating in the United States.



**Table 54****Competitive Environment of Financial Institutions**

<b>EVENT STATEMENT</b>	<b>MD 2000</b>	<b>IQR 2000</b>	<b>MD 2005</b>	<b>IQR 2005</b>
1. The share of total assets held by commercial banks will continue to decrease in relationship to other financial institutions	2.0	2.0-2.0	2.0	2.0-2.0
2. Banks and thrifts will merge into one type of financial institution.	3.0	2.0-3.0	2.0	2.0-3.0
3. Many of the investment banks and money-center banks will merge into one institution.	2.0	2.0-2.0	2.0	2.0-2.0
4. There will be fewer financial institutions as compared to the current period.	2.0	2.0-2.0	2.0	1.0-2.0
5. The size of the average financial institution will be larger than the current period.	2.0	1.0-2.0	2.0	1.0-2.0
6. There will be an increase in the number of financial institutions selling multiple financial products (for example: mutual funds, insurance, and mortgages, in a "one-stop-shopping" model).	2.0	1.0-2.0	2.0	1.0-2.0
7. Most financial institutions will compete for similar products.	2.0	2.0-2.0	2.0	2.0-2.0
8. Financial institutions will narrow their products and specialize in a few niche products.	4.0	4.0-4.0	4.0	4.0-4.0
9. There will be an increase in corporate customers raising capital directly, versus relying on financial intermediaries for capital.	2.0	2.0-2.0	2.0	2.0-3.0
10. There will be an increase in foreign financial institutions operating in the United States.	2.0	2.0-2.0	2.0	2.0-2.0

**Scale:**

**1 = Strongly Agree, 2 = Agree, 3 = Undecided, 4 = Disagree, 5 = Strongly Disagree**

Discussion of the Regulatory and Competitive Environment of Financial Institutions in the Years 2000 and 2005

The convergence of the financial-services industry that is currently underway is expected to continue into the future. By 2005, this convergence will be complete or close to completion. The newly structured financial-services industry is expected to be made up of larger and more consolidated financial institutions that sell multiple financial products over broader geographic areas. The overall competitive environment for financial institutions is expected to increase, due to these overall changes in the structural landscape as well as companies' direct access to financial markets (versus using financial intermediaries) and the increasing inroads of foreign financial institutions into the U.S. market. In general, the regulatory environment predicted by the panel will continue to

emphasize deregulation and be conducive to the industry's growth. Overall, because of the decreasing role of commercial banks as financial intermediaries, commercial banks will continue to be absorbed by other financial institutions and/or diversify into other financial products.

In this competitive and deregulated environment, it would be expected that financial innovation and cross-selling will be standard operating procedure. With institutions being able to sell multiple financial products (commercial loans, insurance policies, mutual funds, and securities), a typical hotel customer applying for a mortgage loan may be converted into a long-term customer for other financial products. Purchasing other financial products at the same institution might mean that the customer would be given a more favorable rate on the mortgage loan.

### **Research Question 2:**

#### ***In the Years 2000 and 2005, What Will Be the Structure of the Lodging Industry?***

In order to determine the structure of the lodging industry in the future, the Delphi panelists were asked to predict the future supply of hotel rooms based on tier (upscale, midscale, and so on), location, and region; predict the acquisition cost of hotels and their cost of replacement; and rank the top ten ownership entities of U.S. hotels (partnership, C-Corp, REIT, and so on). Collectively, these predictions provide a quantitative picture of the lodging industry in the years 2000 and 2005. This was supplemented with 11 open-ended questions that sought the experts' views on issues that are expected to help shape the structure of the lodging industry in 2000 and 2005.

## Structure of the Lodging Industry in Years 2000 and 2005: Analysis of Results

### Prediction of the Change in Lodging Room Supply in the Years 2000 and 2005 (by Tier)

Table 55 presents the results of the Delphi study related to changes in room supply by tier in the future. The upscale lodging tier was predicted to grow by 4.75 percent by the year 2000 (median response) and another 3 percent by the year 2005. This represents the fastest-growing segment during the prediction periods. On the other hand, “midscale with F&B” and independent hotels were expected to grow minimally. The number of independents, in fact, may even grow smaller by the year 2005. The other tiers were predicted to have slow growth, ranging from 2 to 3 percent. Overall, the Delphi panel predicted a period of slow growth in room supply for both of the prediction periods.

**Table 55**  
**PERCENTAGE CHANGE IN ROOM SUPPLY BY TIER**  
**U.S. LODGING INDUSTRY**  
**(1998–2000 and 2000–2005)**

TIERS	MD 2000 % Change 1998 to 2000	IQR 2000 % Change 1998 to 2000	MD 2005 % Change 2000 to 2005	IQR 2005 % Change 2000 to 2005
Upper Upscale	3.0	2.0-3.0	3.0	2.0-3.0
Upscale	4.75	3.0-5.0	3.0	2.0-3.0
Midscale with F&B	1.0	0-1.5	2.0	1.0-2.0
Midscale w/o F&B	3.0	2.0-3.0	3.0	2.0-3.0
Economy	2.0	2.0-4.0	3.0	3.0-4.0
Budget	2.0	2.0-3.0	3.0	2.0-3.0
Independent	0	-1.0-1.0	0	-1.0-1.0

### Prediction of the Change in Lodging Room Supply in the Years 2000 and 2005 (by Location)

Table 56 presents the results of the panel’s prediction on changes in the lodging room supply by location. The panel expects that the growth of the room supply in suburban

locations will be the highest (5 percent) for both of the prediction periods. All other locations are expected to grow equally at about a 3 percent growth rate for both 2000 and 2005.

**Table 56**  
**PERCENTAGE CHANGE IN ROOM SUPPLY BY LOCATION**  
**U.S. LODGING INDUSTRY**  
**(1998–2000 and 2000–2005)**

LOCATION	MD 2000 % Change 1998 to 2000	IQR 2000 % Change 1998 to 2000	MD 2005 % Change 2000 to 2005	IQR 2005 % Change 2000 to 2005
Urban	3.0	2.0-3.0	3.0	2.0-4.0
Suburban	5.0	4.0-5.0	5.0	3.0-6.0
Airport	3.0	3.0-4.0	3.0	2.0-5.0
Highway	3.0	2.0-3.0	3.0	2.0-5.0
Resort	3.0	3.0-4.0	3.5	3.0-5.0

Prediction of the Relative Share of Lodging Room Supply by Region in the Years 2000 and 2005

Table 57 presents the results of the panel's predictions related to changes in relative room supply by region. The three regions that will command the largest share of hotel room supply in the years 2000 and 2005 are the South Atlantic (24%), Pacific (16%), and Mountain (12%) regions. The East North Central and West South Central regions follow, and are closely ranked as fourth (11%) and fifth (10%), respectively. The Mid-Atlantic, West North Central, East South Central, and New England regions are expected to have the lowest amount of hotel room supply in the predicted years, ranging from 8.5 percent to 4.0 percent respectively. The experts did not predict any major shifts in room supply from year 2000 to year 2005 in these regions. The relative share of hotel room supply was nearly identical for both prediction periods.

**Table 57**

**RELATIVE SHARE OF U.S. LODGING ROOM SUPPLY BY REGION  
Years 2000 and 2005**

REGIONS	STATES	MD 2000(%)	IQR 2000 (%)	MD 2005 (%)	IQR 2005 (%)
South Atlantic	DE, MD, DC, VA, NC, SC, GA, FL	24.0	23.0-25.0	24.0	20.0-25.0
Pacific	WA, OR, CA, AK, HI	16.0	16.0-17.0	16.5	16.0-17.0
Mountain	MT, ID, WY, CO, NM, AZ, UT, NV	12.0	12.0-13.0	12.0	12.0-13.5
E. North Central	OH, IN, IL, MI, WI	11.0	10.0-12.0	11.0	10.0-12.0
W. South Central	AK, LA, OK, TX	10.0	10.0-10.5	10.0	10.0-10.5
Mid Atlantic	NY, NJ, PA	8.5	8.0-9.0	8.5	8.0-10.0
W. North Central	MN, IA, MO, ND, SD, NE, KS	6.5	5.0-6.75	6.0	5.0-6.95
E. South Central	KY, TN, AL, MS	6.5	6.0-6.6	6.2	6.0-6.7
New England	ME, NH, VT, MA, RI, CT	4.0	4.0-5.0	4.0	4.0-5.0

Prediction of the Average Selling Price per Room in the Years 2000 and 2005

Table 58 presents the results of the panel's predictions on the average selling price per room. The average selling price for an existing budget hotel was predicted at \$14,500 per room in 2000 and \$16,000 per room in 2005, an increase of a little over 10 percent.

"Economy: Limited Service" hotels were expected to sell for \$26,000 per room in 2000 and \$28,000 per room in 2005, an increase of almost 7 percent. "Economy: Full Service" selling prices were predicted at \$37,000 per room in 2000 and \$40,000 per room in 2005, an 8 percent increase.

"Mid-Market: Limited Service" hotels were expected to sell for \$45,000 per room in 2000 and \$49,000 per room in 2005, an almost 9 percent increase. "Mid-Market: Full Service" hotels were predicted to sell for \$50,000 per room in 2000 and \$55,000 per room in 2005, a 10 percent increase.

The experts predicted that "First Class: Upscale" hotels will sell for \$110,000 per room in 2000 and \$121,000 per room in 2005, an increase of 10 percent. Finally, luxury

hotels are expected to sell for \$275,000 per room in 2000 and \$300,000 per room in 2005, a 9 percent increase.

Budget, “Mid-Market: Full Service,” “First Class: Upscale,” and luxury hotel categories are predicted to have the highest average selling-price increases from 2000 to 2005, increasing 10 percent during that period. “Mid-Market: Limited Service” follows, with an increase of 9 percent. “Economy: Full Service” and “Economy: Limited Service” hotels are predicted to have the lowest increase in average selling price—8 percent and 7 percent, respectively.

**Table 58**  
**AVERAGE SELLING PRICE PER HOTEL ROOM**  
**Years 2000 and 2005**

TIERS	MD 2000	IQR 2000	MD 2005	IQR 2005
Budget	\$14,500	\$14,000-15,000	\$16,000	\$15,000-17,000
Economy: Limited Service	26,000	25,000-27,000	28,000	25,000-30,000
Economy: Full Service	37,000	35,000-38,000	40,000	36,000-40,000
Mid-Market: Limited Service	45,000	42,000-48,000	49,000	41,000-51,000
Mid Market: Full Service	50,000	49,000-51,000	55,000	50,000-58,000
First Class: Upscale	110,000	105,000-120,000	121,000	110,000-135,000
Luxury	275,000	275,000-290,000	300,000	280,000-325,000

Prediction of the Average Replacement Cost of Hotels in the Years 2000 and 2005

Table 59 presents the results of the panel’s prediction about the average replacement cost of hotels. The average replacement cost (cost to construct a new hotel) of a budget hotel was predicted at \$30,000 per room in 2000 and \$35,000 per room in 2005, an increase of almost 17 percent. “Economy: Limited Service” hotels were expected to be built for \$37,000 per room in 2000 and \$40,000 per room in 2005, an increase of 8 percent.

“Economy: Full Service” replacement costs were predicted at \$40,000 per room in 2000, increasing to \$45,500 per room in 2005, an almost 14 percent increase.

“Mid-Market: Limited Service” replacement costs per room were expected to be \$55,000 in 2000 and \$62,000 in 2005, an almost 13 percent increase. “Mid-Market: Full Service” hotels were predicted to cost \$72,000 per room to build in 2000 and \$88,000 per room to build in 2005, a 22 percent increase.

The experts predicted that “First Class: Upscale” hotels will be built for \$105,000 per room in 2000 and \$115,000 per room in 2005, an increase of 9 percent. Finally, luxury hotels were expected to be built for \$170,000 per room in 2000 and \$200,000 per room in 2005, an almost 18 percent increase.

**Table 59**

**AVERAGE REPLACEMENT COST PER HOTEL ROOM  
Years 2000 and 2005**

TIERS	MD 2000	IQR 2000	MD 2005	IQR 2005
Budget	\$30,000	\$30,000-32,000	\$35,000	\$33,000-37,000
Economy: Limited Service	37,000	35,000-38,000	40,000	37,000-44,000
Economy: Full Service	40,000	40,000-44,000	45,500	45,000-52,000
Mid-Market: Limited Service	55,000	55,000-56,000	62,000	60,000-65,000
Mid Market: Full Service	72,000	70,000-75,000	88,000	80,000-90,000
First Class: Upscale	105,000	100,000-110,000	115,000	110,000-130,000
Luxury	170,000	160,000-180,000	200,000	185,000-250,000

**Ratio of the Average Selling Price to the Replacement Cost in the Years 2000 and 2005**

The figures in Table 60 are derived by dividing the median responses in Table 58

(“Average Selling Price Per Hotel Room”) by the median responses in Table 59

(“Average Replacement Cost Per Hotel Room”). Table 10 provides the predicted ratio of average selling price to average replacement cost of hotel rooms, categorized by tiers, for

the years 2000 and 2005. It appears that the acquisition cost of budget hotels will be approximately half that of the cost to construct new budget hotels for both predicted years. In 2000, the average selling price (acquisition cost) of “Economy: Limited Service” hotels and “Mid-Market: Full Service” hotels will be 70 per cent of the cost to build new hotels in these tiers. In 2005, this ratio will remain the same for “Economy: Limited Service” hotels but will drop to 63 percent for “Mid-Market: Full Service” hotels. “Mid-Market: Limited Service” ratios are expected to be about 80 percent for both 2000 and 2005. The average selling price and average replacement cost of “Economy: Full Service” hotels will start to approach equilibrium (92% of replacement cost) in the year 2000 but will drop to 88 percent in 2005.

At the higher end of the spectrum, both “First Class: Upscale” hotels and luxury hotels will be costlier to buy than build. The ratio for “First Class: Upscale” hotels is expected to be 104 percent and 105 percent for the years 2000 and 2005, respectively. Luxury hotels will be even costlier to buy than build, with ratios of 162 percent in 2000 and 150 percent in 2005.

**Table 60**

**RATIO OF AVERAGE SELLING PRICE TO AVERAGE REPLACEMENT  
COST OF HOTELS\*  
(Price Per Room)**

TIERS	RATIO 2000 (%)	RATIO 2005 (%)
Budget	48.0%	46.0%
Economy: Limited Service	70.0	70.0
Economy: Full Service	92.5	88.0
Mid-Market: Limited Service	82.0	80.0
Mid Market: Full Service	70.0	63.0
First Class: Upscale	104.0	105.0
Luxury	162.0	150.0



\*This table was derived by dividing the figures in Table 58 by the figures in Table 59.

Predicted Ranking of the Top 10 Hotel Owners in the Years 2000 and 2005

Table 61 presents the results of the panel's predictions about the top ten hotel ownership entities. The experts predicted that in 2000 and 2005, partnerships and C-Corps will be the top two ownership entities, as measured by hotel rooms controlled. Individual U.S. investors were ranked third in the year 2000, but equity REITs are expected to replace them for the third spot in 2005. Equity REITs were ranked fourth for the year 2000 by the panel.

U.S. institutional investors were ranked fifth for both of the prediction years. Opportunity funds and S-Corps were tied for the sixth spot. Foreign institutions and individual international investors were expected to have the least holdings (ranked seventh and eighth, respectively).

**Table 61**

**RANKING OF TOP TEN OWNERSHIP ENTITIES OF U.S. HOTELS  
Years 2000 and 2005**

<b>HOTEL OWNER</b>	<b>MD 2000</b>	<b>IQR 2000</b>	<b>MD 2005</b>	<b>IQR 2005</b>
Partnership	1.0	1.0-2.0	1.0	1.0-2.0
C-Corp	2.0	2.0-3.0	2.0	1.0-3.0
Individual Investor (US)	3.0	3.0-4.0	4.0	3.0-5.0
Equity REIT (public)	4.0	3.0-4.0	3.0	2.0-4.0
Institutional Investor (US)	5.0	5.0-5.0	5.0	5.0-6.0
Opportunity Fund	6.0	6.0-7.0	6.0	6.0-6.0
S-Corp	6.0	5.0-8.0	6.0	6.0-8.0
Institutional Investor (Foreign)	7.0	7.0-8.0	7.0	7.0-8.0
Individual Investor (Foreign)	8.0	8.0-9.0	8.0	8.0-9.0

**Scale:**  
**1 = Most hotel rooms      9 = Least hotel rooms**

### Discussion of the Lodging Industry's Structure in the Years 2000 and 2005

The overall trends currently shaping the structure of the lodging industry were discussed in Chapter 4. As we will see in the following paragraphs, the Delphi panel has predicted a continuation of many of these trends in the years 2000 and 2005.

The period from 1993 to 1997 was one of recovery for the lodging industry, as is evidenced by an increase in the supply of rooms, especially in the "Midscale w/o F&B" and economy tiers. For each of these tiers, the room supply grew by 67 percent and 34 percent, respectively (see Table 62). On the other hand, the "Midscale with F&B" and independent tiers actually lost room supply. As a result of excessive building in the lower end of the market, the lodging industry is on the verge of overbuilding in this segment. This is reflected in the predictions by the panel: it predicted low growth in the lower tiers and modest overall growth in room supply.

While independent and "Midscale with F&B" hotels currently command a large percentage of the overall share of rooms (33 percent and 19 percent, respectively, in 1997), the future for these types of properties does not look very promising. The current negative growth trends and the negative growth predicted by the panel foretells a steadily eroding share of the market for these properties.

**Table 62****YEAR-END ROOM INVENTORY**

TIERS	1990	1991	1992	1993	1994	1995	1996	1997
Upper Upscale	401,625	402,301	406,923	403,459	403,280	413,988	425,170	438,988
Upscale	207,407	212,310	217,194	221,169	228,653	240,766	251,990	263,330
Midscale with F&B	683,613	683,521	682,823	683,529	683,357	674,549	674,422	679,143
Midscale w/o F&B	151,007	166,612	178,863	195,262	215,087	244,490	282,305	327,474
Economy	313,644	314,839	322,567	332,218	351,917	381,215	412,369	445,359
Budget	220,859	243,371	244,202	241,496	237,742	226,105	231,960	252,141
Independent	1,197,070	1,180,497	1,163,517	1,161,140	1,152,209	1,140,778	1,134,626	1,066,548

Source: Smith Travel Research.

Suburban and highway lodging properties currently have the largest share of hotel rooms (approximately 34 percent and 32 percent, respectively) in the market. Based on the panel's growth predictions, they will continue to maintain their market share in the future. The movement of business centers to the suburbs and the popularity of automobiles for travel is expected to continue into the future and support the growth of suburban and highway lodging properties.

The regional distribution of hotel rooms was expected to remain proportionately the same as in the current period; the panel predicted no major shifts. The South Atlantic, Pacific, and Mountain regions were expected to retain the major share of rooms—approximately 50 percent of the national supply.

While the average selling price of all hotels is predicted to show increases in 2000 and 2005, the largest increases were predicted for the upper end of the market. This is probably because the lower end of the market is becoming overbuilt. It is also interesting to note that the hotel segments in the middle were predicted to have the lowest increases in selling price, which may indicate that they are becoming unpopular with investors.

This could be the result of a lack of identity for these segments. This lack of identity may mean that these middle segments ultimately may be squeezed out or repositioned.

The panel predicted that it will still be cheaper to acquire than build in the lower end of the market but definitely be cheaper to build rather than buy in the upper segment of the market. This prediction was reinforced by the panel's view that the lower-end hotel tiers have an abundant supply of hotel rooms, while the upper tiers are currently performing strongly, which is driving up acquisition costs. Added to this may be the fact that luxury and upscale hotels are usually built in prime locations, and prime locations are hard to come by.

Finally, the Delphi participants were asked to make predictions on various issues affecting the structure of the lodging industry. These issues are listed in Table 63, and the participants' collective views are summarized in the sections that follow.

**Table 63**

<b>ISSUES RELATED TO STRUCTURE OF LODGING INDUSTRY</b>
1. Industry consolidation.
2. Strategic alliances.
3. Ownership profile of the lodging industry (private to public).
4. The type of hotels being developed.
5. The age of room inventory.
6. Segmentation of the industry (branding issues).
7. International expansion.
8. The creation and growth of new types of lodging products (time-share, assisted-living, extended-stay).
9. The status of independents (rate of conversion to franchise properties).
10. Industry competition.
11. Any other key issue related to the lodging industry's structure.

Summary of Predictions on Specific Issues Affecting the Lodging Industry's Structure in the Years 2000 and 2005

*Industry Consolidation.* Most experts predicted that the current trend toward consolidation in the lodging industry will continue, especially until the year 2000. This consolidation will take various forms, including the pairing of REITs with operating companies, the merger of U.S. and international hotel companies, and brand consolidation.

The view for the year 2005 is more split. About 70 percent of the respondents predicted that the trend toward consolidation will slow down by 2005; in fact, by that time the industry might even see some divestitures. However, the other 30 percent predicted that consolidation will continue in 2005. One of the participants also predicted that in 2005 new start-ups and a changing user profile will generate new lodging companies.

*Strategic Alliances.* The majority of the participants predicted that strategic alliances will continue up to the year 2000. However, there were differing views on the nature of these alliances. While some participants stated that the alliances would be between small companies, others stressed alliances between recognizable brands and tax-advantaged structures (such as REITs), and some stressed the international nature of the alliances. There was a minority view that strategic alliances will not work and will slowly fade away.

The view after 2000 ranged from those who felt the growth in strategic alliances would stabilize, to those who felt that they would start to break up. One of the

participants also predicted that, during 2005, more alliances are likely between hospitality management, real estate ownership and possible combination with distribution vehicles (franchisors).

*Ownership Profile (Private to Public).* The majority view among the panelists was that the trend toward public ownership would continue into the future; capital costs and access to capital markets were stated as the primary reasons. Both C-Corps and REITs were expected to increase their share of hotel ownership in the future. However, one of the participants stated that some companies that lose in the public arena might return to private capital markets in the future.

*Type of Hotels Being Developed.* The general consensus among the panelists was that budget and economy hotels would be a much lower percentage of the overall hotels developed in the year 2000. Full-service, first-class, luxury, and extended-stay products will be the primary choices for new development. Two participants stated that companies would start looking at small communities where “small pockets of demand” exist and develop “sleep-only” 50- to 70-room properties there. Overall, development is expected to slow down by 2005.

*Aging of Room Inventory.* The panel generally was in agreement that the room inventory is aging. However, it was split on whether the inventory would be replaced by newer properties in the future.

Those who said that in the future the average age of hotels would decline felt that inferior and older product would either be pushed out of the market or would require major renovation. One of the participants stated that budget and economy hotels will age quickly and have a short economic life, which will reduce the average age of the inventory. Another factor that might contribute to the reduction in the average age of hotels was the future addition of new types of products.

*Segmentation of the Lodging Industry (Branding Issues).* The overall consensus of the participants was that segmentation and branding would continue to grow and be a significant factor in the structure of the lodging industry until the year 2000. This growth will be fueled by the conversion of independent properties to branded properties and the development of new products, such as extended-stay properties. Furthermore, one of the participants stated that new distribution technology (such as the Internet) would aid in the increase of brands. However, participants stated that the rate of growth of new brands in the years ahead will be slower than the current rate. This will be the result of (1) some new brands not reaching critical mass,<sup>3</sup> which will lead to rebranding by established brands, and (2) the slowdown in the overall rate of new hotel development.

By 2005, most participants agreed that the segmentation of the lodging industry will stabilize and even, to an extent, start to decrease. This decrease will be a result of weaker brands and brands that do not focus on management exiting the market.

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<sup>3</sup>“Critical mass,” with regard to franchising, refers to the minimum number of franchisees required for the franchise company to at least cover its overhead costs.

*International Expansion.* There was universal consensus among the experts that the growth of the U.S. lodging industry into international markets will continue to increase in both prediction periods. There were four reasons stated for this increase. First, the U.S. lodging market has reached a mature phase, and therefore domestic growth has stabilized. Second, U.S. lodging companies will continue to follow American businesses as they expand overseas. Third, the economies of many emerging nations are growing at a fast clip, with means these nations have more “middle-class” people with disposable income and leisure time. Finally, good opportunities to purchase hotel real estate overseas as a result of depressed prices and the strong dollar will also spur the rate of international growth.

*The Creation and Growth of New Lodging Products.* The two relatively new lodging products most study participants mentioned were time-share properties and assisted-living facilities. The growth of the former is primarily due to three factors: First, the purchase of recreational properties in popular resort destinations is out of the reach of most Americans. Second, with the maturing of the baby boom generation, many Americans have reached a stage in their lives that affords them leisure time, disposable income, and a desire to visit destinations that suit their specific leisure tastes and preferences (skiing, diving, hiking, etc.). And finally, time-share companies have grown, becoming more organized and respectable. Many well-known hotel companies have started time-shares as well.



*Status of Independents.* The consensus of the panel was that independents would continue to decline in the future (for both prediction periods). This decline will be the result of increasing competition, lenders who will be reluctant to lend money for hotels unless they are part of a recognized brand, and the growing power and strength of hotel-chain reservation systems. This prediction does not apply to certain specialty hotels in resort and urban locations. However, a dissenting view on this prediction by one of the participants was that the rate of conversion from independents to brands will slow down in the future. This was primarily attributed to the growth of Internet-based reservations.

*Industry Competition.* Despite the increase in lodging industry consolidation, most of the experts predicted that the level of competition in the industry is expected to increase during the next few years, leading up to the year 2000. This was primarily attributed to the leveling of demand. Many of the participants predicted that the nature of the coming competitive environment is going to be severe. It was variously described as “deep turning,” “cannibalistic,” “parasitic,” “cut-throat,” and “fierce.” Where will this competition be focused? One of the participants stated that it will be focused mainly in the lower end of the market, which is expected to be overbuilt by the year 2000. In this environment, only the tough will survive. “Strong management,” “best-trained companies,” “technically astute,” and “strong brand recognition” were some of the survival factors considered to be important by the participants. This competitive environment is not expected to ease by the year 2005; in fact, some of the participants stated that it would get even tougher.

### **Research Question 3:**

#### ***In the Years 2000 and 2005, What Will Be the Operating and Investment Performance of the Lodging Industry?***

The Delphi panel was asked to predict the operating and investment performance of the lodging industry for the two prediction periods (2000 and 2005). The four most common operating performance indicators—occupancy percentage, average daily rate, revenue per available room (revpar), and pre-tax income—were used as the operating performance measures. The experts made their predictions for each of the five lodging industry tiers: budget, economy, mid-price, upscale, and luxury.

In addition to operating performance, the Delphi study was also interested in the investment return of the lodging industry. The lodging industry competes for capital in two areas: (1) with other commercial real estate investments, and (2) with different lodging companies. Therefore, the panel was asked to make predictions of relative rankings in both of these areas.

#### **Operating and Investment Performance of the Lodging Industry in Years 2000 and 2005: Analysis of Results**

##### **Prediction of the Operating Performance of Hotels (by Tier) in the Years 2000 and 2005**

Table 64 presents the results of the panel's predictions about the future operating performance of the U.S. hotel industry. The experts predicted that, in 2005, the occupancies for the upscale and luxury segments would be much higher (67 percent and 74 percent, respectively) than for the budget and economy segments, both of which were

predicted to have 60 percent occupancy in 2005. Occupancies for midscale hotels were predicted at 65 percent, which falls between the economy and upscale segments.

Interestingly, however, the growth predicted in the average daily rate from year 2000 to year 2005 was highest for both the budget segment and the luxury segment. The predicted rate increase was 17 percent for budget hotels and 15 percent for luxury hotels. Other hotel segment room-rate increases ranged from 7.5 to 11 percent.

Revenue per available room (Revpar), a statistic that takes into account both the average room rate and occupancy percentage, is predicted to increase by about 7 percent for the budget, economy, and midscale segments and between 13 and 14 percent for the upscale and luxury segments.

Pre-tax income predictions, the final indicator of lodging industry-operating performance, vary widely between the lodging segments. The common factor, however, was that for neither prediction periods were any of the segments expected to show negative pre-tax income. The budget and economy segments were expected to have the lowest profitability, predicted at between 5 and 6 percent for 2000 and 2005. The luxury segment is predicted to have the highest profitability, at 24 percent in 2000 and 23 percent in 2005. The profitability of midscale hotels was predicted to range from 14 percent in 2000 to 15 percent in 2005. Finally, upscale hotels were predicted to have a pre-tax income of 17 percent for both prediction periods.

**Table 64**

**OPERATING PERFORMANCE OF THE HOTEL INDUSTRY  
Years 2000 and 2005**

<b>BUDGET</b>	MD 2000	IQR 2000	MD 2005	IQR 2005
Occupancy (%)	60.0	60.0-60.0	60.0	60.0-60.0
Average Daily Rate (\$)	42.0	42.0-45.0	49.0	45.0-50.0
Revpar (\$)	26.0	25.0-26.0	28.0	17.0-29.0
Pre-Tax Income (%)	5.0	3.75-8.0	6.0	5.0-10.0

<b>ECONOMY</b>	MD 2000	IQR 2000	MD 2005	IQR 2005
Occupancy (%)	60.0	59.0-60.0	60.0	60.0-60.0
Average Daily Rate (\$)	53.0	40.0-54.0	57.0	54.0-58.0
Revpar (\$)	31.5	30.0-32.0	34.0	33.0-35.0
Pre-Tax Income (%)	6.0	5.0-8.0	5.0	5.0-10.0

<b>MIDSCALE</b>	MD 2000	IQR 2000	MD 2005	IQR 2005
Occupancy (%)	65.0	64.0-65.0	65.0	64.0-65.0
Average Daily Rate (\$)	67.0	66.0-68.0	72.0	70.0-75.0
Revpar (\$)	45.0	44.0-45.0	48.0	46.0-49.0
Pre-Tax Income (%)	14.0	13.0-15.0	15.0	15.0-15.6

<b>UPSCALE</b>	MD 2000	IQR 2000	MD 2005	IQR 2005
Occupancy (%)	68.0	67.0-68.0	67.0	67.0-68.0
Average Daily Rate (\$)	90.0	90.0-93.0	100.0	95.0-108.0
Revpar (\$)	61.0	60.0-62.0	69.0	68.0-69.0
Pre-Tax Income (%)	17.0	17.0-17.0	17.0	15.0-17.0

<b>LUXURY</b>	MD 2000	IQR 2000	MD 2005	IQR 2005
Occupancy (%)	74.0	73.0-75.0	74.0	72.0-75.0
Average Daily Rate (\$)	135.0	130.0-135.0	155.0	140.0-160.0
Revpar (\$)	100.0	98.0-101.0	114.0	110.0-120.0
Pre-Tax Income (%)	24.0	20.0-24.0	23.0	22.0-24.0

## Discussion of the Operating Performance of the Lodging Industry in the Years 2000 and 2005

The ability of an industry to attract capital is determined to a large extent by its operating performance, which impacts its overall profitability. Overall, demand for lodging industry products is definitely slowing down; occupancies have declined in the past two years (Bond, 1998). However, predicted future changes in operating results are not uniform across the various hotel segments. Based on the experts' predictions, it appears that the upper end of the market will experience higher demand, room rate, and overall profitability, and therefore should attract more capital than the budget and economy segments. Two contributing factors to this view may be seen among the experts' previous predictions on the structure of the lodging industry (research question 2), in which they said that the lower end of the lodging industry is becoming overbuilt and that the lower-end products have a shorter economic life, thus leading to faster physical obsolescence.

When comparing the growth in revenue per available room (Revpar), a statistic that includes both the occupancy and room rate component, we find that for the year 2000 it is virtually unchanged from the current revpar (1997). This would indicate that the industry has peaked in terms of demand for its product and that growth is limited in the United States. The net result of this could be more merger and consolidation activity, an increase in competition, more international growth, and the creation of new types of lodging products in order to increase sources of revenue. For 2005, the growth in revpar is mainly in the luxury and upscale segments of the industry. The lower end was predicted to have very minimal growth.

Historically, the lower end of the market, which includes limited-service hotels, have achieved a higher percentage of pre-tax income as compared to the upper end of the lodging market, which includes full-service hotels. For example, in 1996 the pre-tax income for limited-service hotels was 27 percent; for full-service hotels, it was 15.7 percent (Smith Travel Research, 1997). However, for the prediction periods covered in this study, it is interesting to note that the upper end of the market is expected to achieve higher profitability than the lower end.

Overall, it is also important to note that the panel predicted no growth in pre-tax income for any of the segments. This may be due to a combination of three factors: (1) the growth in revenue is merely keeping pace with increases in operating expenses such as labor and marketing, (2) hotels may be undertaking additional capital expenditures during this period for renovation and refurbishment to keep their properties competitive, and (3) panelists do not perceive opportunities to increase productivity and/or to cut operating costs.

#### Predicted Ranking of the Return on Hotel Investments as Compared to Other Commercial Real Estate Sectors in the Years 2000 and 2005

Table 65 presents the panel's prediction of the relative ranking of returns on hotel investments as compared to other commercial real estate investments. Hotel real estate was ranked third, in terms of total return, of the six commercial real estate investment categories. However, it should be noted that there was wide disagreement on this ranking among the panelists (IQR: 2–5). This ranking was the same for 2000 and 2005. Research

and development facilities and office building space were the top two categories, respectively.

**Table 65**  
**RANKING OF TOTAL RETURN ON COMMERCIAL REAL ESTATE INVESTMENTS**

TYPE OF INVESTMENT (Direct investment)	MD (RANK) 2000	IQR (RANK) 2000	MD (RANK) 2005	IQR (RANK) 2005
R&D	1.0	1.0-2.0	1.0	1.0-3.0
Office	2.0	2.0-3.0	2.0	2.0-3.0
Hotel Real Estate	3.0	2.0-5.0	3.0	2.0-5.0
Warehouse	4.0	4.0-6.0	4.0	4.0-6.0
Apartment	5.0	4.0-5.0	5.0	4.0-5.0
Retail	6.0	4.0-6.0	5.0	3.0-6.0

**Scale**

**1= Highest total return on investment**

**6= Lowest total return on investment**

Predicted Ranking of the Total Return on Investment in Lodging Stocks in the Years 2000 and 2005

Table 66 presents the experts' predictions on the total return on investments in lodging stocks. The experts predicted that both in 2000 and 2005, paired-share REIT stocks would have the highest total return<sup>4</sup>. They ranked regular REITs second (based on total returns of common stock). Total returns on investment in the common stock of extended-stay companies were ranked fifth.

However, it should be noted that consensus on predictions was weak on the total-return rankings for most hotel common stocks in the year 2005. This includes paired-

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<sup>4</sup> It should be noted however that the recent IRS restructuring Bill passed by the U.S. Congress in 1998 has taken away the tax advantages associated with the paired share structure. This is expected to impact total returns in the future.

share equity REITs (IQR 1.0–4.0), regular equity REITs (IQR 2.0–4.0), Hotel C-Corp extended-stay stocks (IQR 2.0–5.0), and Hotel C-Corp large-cap stocks (IQR 1.0–3.0).

**Table 66**

**RANKING OF TOTAL RETURN FOR INVESTMENTS IN LODGING  
COMMON STOCK**

TYPE OF INVESTMENT (Purchase of Common Stock)	MD 2000	IQR 2000	MD 2005	IQR 2005
Equity REIT (paired-share)	1.0	1.0-2.0	1.0	1.0-4.0
Equity REIT (regular)	2.0	2.0-4.0	2.0	2.0-4.0
Hotel C-Corp (large-cap)	3.0	3.0-3.0	3.0	1.0-3.0
Hotel C-Corp (small-cap)	4.0	3.0-4.0	4.0	3.0-4.0
Hotel C-Corp (extended-stay)	5.0	4.0-5.0	5.0	2.0-5.0

**Scale**

**1= Highest total return on investment**

**6= Lowest total return on investment**

Discussion of the Investment Performance of the Lodging Industry in the Years 2000 and 2005

While an analysis of the operating performance of the lodging industry is important to determine inter-sector strengths within the lodging industry, the investment performance of the lodging industry also should be compared with other investment sectors with which it competes for capital. Based on the analysis of total returns by property type conducted by the National Council of Real Estate Investment Fiduciaries (discussed in Chapter 4), the office and R&D (research and development) sectors of commercial real estate have shown the strongest return performance in the past two years, both years showing double-digit returns. The panel predicted that these sectors will be the top two performers in the future.



The lodging industry was ranked third (with a wide disagreement among the panelists) in terms of total returns. The segments at the lower end of the lodging industry are expected to show weaker investment returns; the segments at the higher end, stronger returns. At the same time, industry consolidation and international expansion are expected to improve investment returns. However, on the negative side, as the industry continues to restructure, with some C-Corps converting to REITs and some REITs contemplating a conversion to a C-Corp, individual company returns will be negatively affected. Also on the negative side, concerns about overbuilding in the industry may negatively impact the overall flow of financing, thus increasing the cost of financing and dampening total returns (Goetz, 1998). It is possible that these changing conditions made it difficult to reach a consensus on future investment returns and contributed to the divergence of the panelists' views.

Total return on investments in lodging stock includes return from capital appreciation and income return. While the median response of the Delphi panelists ranked paired-share REITs and equity REITs as the top two lodging stocks in terms of total returns, their long-term predictions were divergent. Some of the changes currently taking place in the REIT industry may explain this lack of a general consensus among the panelists.

Lodging REITs have been a very popular form of investment in lodging real estate. They have rewarded their investors with stellar double-digit total returns in the past few years. NAREIT reported total returns of 30 percent for lodging REITs in 1997 (NAREIT, 1998). However, this changed in 1998, with many REIT stocks losing half their value in the first eight months of 1998 (Crittenden Hotel/Motel Real Estate News,

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1998). A key piece of legislation that has negatively impacted the paired-share REIT structure is the IRS restructuring bill, passed in 1998. As a result of this legislation, all future acquisitions by paired-share REITs will not enjoy the former tax advantages of the paired-share status. Since this announcement, REIT stock prices have dropped. Starwood Hotels and Resorts (the largest REIT) has announced its conversion to a regular C-Corp, Patriot American is considering a similar conversion, and Capstar (a C-Corp) and American General Hospitality (a REIT) have formed a new organizational structure known as a paper-clip REIT.<sup>5</sup> The new company is called Meristar (Cruz, 1998).

#### **Research Question 4:**

***In the Years 2000 and 2005, What Will Be the Lodging Industry's Need for Capital?***

Research question 4 asked the panel of experts to predict the nature of demand for capital by the lodging industry. The sub-questions in this category covered the level of demand for capital, based on the type of financing activity, segment or tier of the lodging industry, location of the hotel, and type of owner.

#### **Lodging Industry's Need for Capital in Years 2000 and 2005: Analysis of Results**

##### **Prediction of the Financing Activity Requiring Capital in the Years 2000 and 2005**

Table 67 presents the results of the panel's predictions of the type of financing activity within the lodging industry that would be undertaken to meet demand for capital in the

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<sup>5</sup>Paper-clip REITS were discussed in Chapter 5.

future. The lodging industry is expected to demand less or about the same amount of capital for U.S. construction, conversions, and mergers and acquisitions in 2000 as compared to the current period. However, demand for capital to finance acquisition, construction, and renovation activity overseas will be higher than in the current period. This trend is expected to continue in 2005 as well.

**Table 67**

**DEMAND FOR LODGING CAPITAL BASED UPON TYPE OF FINANCING ACTIVITY**

FINANCING ACTIVITY	MD 2000	IQR 2000	MD 2005	IQR 2005
Construction	4.0	3.0-4.0	4.0	3.0-4.0
Conversion	3.0	3.-3.0	3.5	3.0-4.0
Mergers and acquisitions (corporate)	3.0	3.0-3.0	3.0	3.0-4.0
Acquisition of individual hotels	3.0	3.0-4.0	4.0	3.0-4.0
Acquisition of portfolio of hotels	3.0	3.0-4.0	4.0	3.0-4.0
Expansion overseas: acquisition	2.0	2.0-3.0	2.0	2.0-2.0
Expansion overseas: construction	2.0	2.0-3.0	2.0	2.0-3.0
Renovation/upgrading	2.0	2.0-3.0	2.0	2.0-2.0

**Scale:**

**1 = Much Higher, 2 = Higher, 3 = About the Same, 4 = Lower, 5 = Much Lower**

Prediction of Lodging Tiers Demand for Capital in the Years 2000 and 2005

Table 68 presents the results of the panel's prediction on each lodging tier's demand for capital. For the year 2000, the "upper upscale" and Upscale tiers will demand higher capital than they do today; capital demand will be about the same as today for the midscale products and will be lower for the economy, budget, and independent products. In 2005, demand for capital will continue to remain lower than today for the tiers ranging from independent to midscale; the level of capital demanded by "upper upscale" and upscale tiers is expected to be about the same as today.

**Table 68****DEMAND FOR LODGING CAPITAL BASED UPON LODGING TIER**

TIERS	MD 2000	IQR 2000	MD 2005	IQR 2005
Upper Upscale	2.0	2.0-2.0	3.0	3.0-4.0
Upscale	2.0	2.0-2.0	3.0	3.0-4.0
Midscale with F&B	3.0	3.0-4.0	4.0	4.0-4.0
Midscale w/o F&B	3.0	3.0-3.0	4.0	4.0-4.0
Economy	4.0	4.0-4.0	4.0	4.0-5.0
Budget	4.0	4.0-4.0	4.0	4.0-5.0
Independent	4.0	3.0-4.0	4.0	3.0-4.0

**Scale:****1 = Much Higher, 2 = Higher, 3 = About the Same, 4 = Lower, 5 = Much Lower**

Prediction of the Demand for Capital for Lodging Products Based on Location in the  
Years 2000 and 2005

Table 69 presents the panel's predictions concerning the demand for lodging capital based on the location of lodging products. Hotel products demanding the most capital in 2000, according to the experts, will be urban, suburban, and resort locations. According to the panelists, capital-demand levels in 2000 will be higher than today for these properties. In 2000, capital demand for airport properties will remain about the same as today; highway hotels will demand less than current levels. For 2005, urban, suburban, and resort products demand for capital will taper off to about today's levels; however, airport and highway hotels will demand less capital than today.

**Table 69**

**DEMAND FOR LODGING CAPITAL BASED UPON LOCATION OF HOTEL**

LOCATION	MD 2000	IQR 2000	MD 2005	IQR 2005
Urban	2.0	2.0-3.0	3.0	2.0-4.0
Suburban	2.0	2.0-3.0	3.0	3.0-4.0
Airport	3.0	3.0-4.0	4.0	3.0-4.0
Highway	4.0	4.0-4.0	4.0	4.0-5.0
Resort	2.0	2.0-2.0	3.0	2.0-3.0

**Scale:**

**1 = Much Higher, 2 = Higher, 3 = About the Same, 4 = Lower, 5 = Much Lower**

Prediction of Lodging Capital by Type of Owner in the Years 2000 and 2005

Table 70 presents the results of the panel's predictions on the demand for lodging capital by type of owner. Equity REITs and C-Corps are expected to demand more capital in the year 2000 than they do today; however, all other owners, individuals, and institutions are expected to demand about the same amount of capital as they do today. Overall, demand for capital in the year 2005 is expected to be about the same as today by all of the owners, with the sole exception of S-Corps (capital demand for them will be lower in 2005 than it is today).

**Table 70**

**PREDICTION OF DEMAND FOR LODGING CAPITAL BY TYPE OF OWNER**

OWNERS	MD 2000	IQR 2000	MD 2005	IQR 2005
Equity REIT (Public)	2.0	2.0-3.0	3.0	2.0-4.0
C-Corp	2.0	2.0-3.0	3.0	2.0-4.0
S-Corp	3.0	3.0-3.0	4.0	3.0-4.0
Partnership	3.0	2.0-3.0	3.0	2.0-4.0
Individual Investor (U.S.)	3.0	3.0-3.0	3.0	3.0-4.0
Institutional Investor (U.S.)	3.0	2.0-3.0	3.0	2.0-3.0
Individual Investor (Foreign)	3.0	2.5-3.0	3.0	3.0-4.0
Institutional Investor (Foreign)	3.0	3.0-3.0	3.0	3.0-3.0
Opportunity Fund	3.0	3.0-3.0	3.0	2.0-4.0

**Scale:**

**1 = Much Higher, 2 = Higher, 3 = About the Same, 4 = Lower, 5 = Much Lower**

Discussion of Lodging Industry's Need for Capital in the Years 2000 and 2005

The panel predicted a lower need for construction capital in both 2000 and 2005, indicating that it doesn't view the lodging industry's growth as coming from major increases in room supply. Its prediction of higher future capital needs for international acquisition and construction is indicative of a maturing of the U.S. lodging industry (which means fewer growth opportunities). This also suggests elements of opportunistic investing, as real estate values are lower in some overseas countries as compared to the United States. The panel's prediction about increasing uses of capital for renovation and upgrades in both 2000 and 2005 is in keeping with its view that the lodging product is aging and many facilities need to be upgraded in order to remain competitive. The panel predicts that financing needs for the acquisition of individual hotels and hotel portfolios in the year 2000 will remain about the same as today; the need will be lower in 2005. The panel's prediction that financing needs for corporate mergers-and-acquisitions activity will be about the same as today in both 2000 and 2005 (1998 mergers-and-acquisitions

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activity has slowed down as compared to the previous two years) is indicative of an industry that has approached the peak of its consolidation, with fewer lucrative deals left.

The Delphi panel's prediction that the future need for capital will be found more in the upscale segment is consistent with its previous prediction that the upscale segment is the least overdeveloped segment. Furthermore, the operating performance from this segment was predicted to be high in the future; the converse was true of the middle and lower tiers. The lower tiers will demand the least amount of capital, as the panel predicts that this tier will become overbuilt during the prediction period, further depressing operating performance.

With the growth of gaming and time-share vacation concepts, it is not surprising that the Delphi panel predicted a higher need for capital in the resort segment. However, it was interesting to note that the panel identified a higher need for capital in both urban and suburban locations. This prediction appears to be contradictory, as, generally speaking, growth in suburban locations is at the expense of urban locations. This contradiction may be partially explained by the growth of urban time-share concepts (discussed in Chapter 5), the conversion of urban buildings to hotels, and urban renewal projects being undertaken by cities across the nation.

As discussed in chapters 4 and 5, the ownership structure of the lodging industry has changed and continues to change. While earlier in the century, individual owners dominated the industry, the current trend is toward multiple ownership entities such as REITs, partnerships, and opportunity funds. The panel's prediction that equity REITs and C-Corps will demand more capital in the year 2000 than in the present period may indicate a resurgence of growth plans for C-Corps and REITs (as of October 1998, REITs

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in particular had considerably slowed down their acquisition activity due to declining prices of their stock). However, this raises the question: will market capitalization for these two public entities be restored in order to access public sources of capital or will they be dependent upon private debt and equity sources? Overall, the panel's prediction of capital needs by the ownership entities during 2000 and 2005 presumes an overall slowdown of financing activity, because the median response concerning the capital needs of most owners was 3.0, indicating that capital needs will be about the same as today.

#### **Research Question 5:**

##### ***In the Years 2000 and 2005, What Will Be the Role of Financial Institutions as Suppliers of Capital to the Lodging Industry?***

The final research question asked the panel of experts to predict the role of financial institutions as suppliers of capital to the lodging industry. A series of sub-questions covered issues such as the relative role of financial institutions in providing equity and debt to the lodging industry, lending criteria, cost of loans, loan size, segments and types of lodging products expected to be financed, types of financing provided, and the stage of financing in which the various financial institutions will be involved. Finally, the experts were asked (via open-ended questions) to provide their views on the financing role of a specific financial institution they were familiar with and the overall availability of capital for the lodging industry in the years 2000 and 2005.

**Role of Financial Institutions as Suppliers of Capital to the Lodging Industry in  
Years 2000 and 2005: Analysis of Results**

Prediction of the Relative Share of Equity Capital Investment in Lodging Industry Real  
Estate by Financial Institutions in the Years 2000 and 2005

Table 71 presents the panel's predictions of the relative share of equity capital directly invested by financial institutions in lodging industry real estate. The experts predicted that in 2000 and 2005, pension funds and life insurance companies will be the two top equity investors in lodging real estate. The median percentages reported were 40 percent and 20 percent, respectively, for both prediction periods. Investment companies (mutual funds), investment banks, and conduits rounded out the top five equity investors.

**Table 71**  
**RELATIVE SHARE OF EQUITY CAPITAL IN LODGING INDUSTRY REAL  
ESTATE BY FINANCIAL INSTITUTIONS**

INSTITUTION	MD 2000	IQR 2000	MD 2005	IQR 2005
Pension Fund	40.0%	37.0-40.0%	40.0%	35.0-40.0%
Life Insurance Company	20.0	20.0-20.0	20.0	15.0-20.0
Investment Company (mutual fund)	10.0	8.0-15.0	15.0	12.0-15.0
Investment Bank	10.0	10.0-11.0	10.0	10.0-15.0
Conduit	8.0	5.0-10.0	10.0	4.0-15.0
Finance Company	4.0	3.5-5.0	3.0	3.0-6.5
Commercial Bank	2.0	2.0-6.0	2.0	2.0-5.0
Thrift Institution	1.0	1.0-1.0	1.0	1.0-1.0

Prediction of the Relative Share of Equity Capital Investment in Lodging Stocks by  
Financial Institutions in the Years 2000 and 2005

Table 72 presents the panel's predictions for equity capital investment in lodging stocks by financial institutions. Investment companies and pension funds were predicted to be the top two investors in lodging stocks. In the year 2000, investment companies and

pension funds were expected to each have 30 percent of these stocks. In 2005, pension funds are expected to reduce their investment percentage to 25 percent; however, the degree of consensus among panelists was weak (IQR 20–40 percent). Life insurance companies and investment banks follow, with 20 percent and 10 percent, respectively, in 2000. In 2005, they are both expected to increase their investments in lodging stocks, to 24 percent and 15 percent, respectively. Depository institutions and finance companies were not considered to be providers of equity capital to the lodging industry.

**Table 72**

**RELATIVE SHARE OF EQUITY CAPITAL INVESTMENT IN LODGING STOCKS BY FINANCIAL INSTITUTIONS**

INSTITUTION	MD 2000	IQR 2000	MD 2005	IQR 2005
Investment Company (mutual fund)	30.0%	25.0-30.0%	30.0%	30.0-35.0%
Pension Fund	30.0	28.0-35.0	25.0	20.0-40.0
Life Insurance Company	20.0	18.0-20.0	24.0	20.0-30.0
Investment Bank	10.0	10.0-15.0	15.0	10.0-15.0
Commercial Bank	5.0	4.0-5.0	4.0	2.0-4.0
Conduit	2.0	1.0-2.7	2.0	1.5-2.5
Finance Company	2.0	2.0-2.0	2.0	2.0-2.0
Thrift Institution	1.0	1.0-1.0	1.0	1.0-1.0

Prediction of the Relative Share of Direct Loans Provided by Financial Institutions for Lodging Construction or Acquisition in the Years 2000 and 2005

Table 73 presents the panel's predictions on direct loans provided by financial institutions for construction and acquisition. Financial institutions provide debt capital directly to the lodging industry by providing mortgage loans for construction or acquisition.

Commercial banks and life insurance companies will be the primary financial institutions providing such loans in the years 2000 and 2005. Commercial banks were predicted to

have 40 percent of the total market in 2000 and 2005; life insurance companies, 20 percent in 2000 and 16 percent in 2005. Conduits and investment banks were predicted to have a 10-percent share in 2000 and 2005. Thrifts, finance companies, and pension funds are expected to have 5 percent of the market in both years.

**Table 73**

**RELATIVE SHARE OF DIRECT MORTGAGE LOANS PROVIDED BY  
FINANCIAL INSTITUTIONS FOR LODGING CONSTRUCTION OR  
ACQUISITION**

INSTITUTION	MD 2000	IQR 2000	MD 2005	IQR 2005
Commercial Bank	40.0%	35.0-40.0%	40.0%	30.0-40.0%
Life Insurance Company	20.0	15.0-20.0	16.0	15.0-20.0
Conduit	10.0	10.0-15.0	10.0	10.0-15.0
Investment Bank	10.0	10.0-13.0	10.0	8.0-15.0
Thrift Institution	5.0	5.0-5.0	5.0	4.0-5.0
Finance Company	5.0	5.0-6.0	5.0	5.0-6.0
Pension Fund	5.0	5.0-5.0	5.0	5.0-5.0
Investment Company (mutual fund)	1.5	1.0-2.0	2.0	2.0-2.0

Prediction of the Relative Share of Debt Securities Purchased by Financial Institutions in  
the Years 2000 and 2005

Table 74 presents the predictions of the panel on the relative share of debt securities purchased by financial institutions. Financial institutions provide capital to the lodging industry indirectly by purchasing debt securities such as commercial mortgage-backed securities. The primary purchasers of debt securities in 2000 and 2005 will be life insurance companies and investment companies, each at 20 percent for both years. Pension funds and commercial banks follow in third and fourth place, at 16 and 15 percent of the total share in 2000, 14 and 15 percent in 2005. The panel thought that investment banks and conduits will each command about 10 percent of the market for

both prediction periods. Finance companies and thrifts are not considered to be major providers of capital via debt securities.

**Table 74**  
**RELATIVE SHARE OF DEBT SECURITIES PURCHASED BY FINANCIAL INSTITUTIONS**

INSTITUTION	MD 2000	IQR 2000	MD 2005	IQR 2005
Life Insurance Company	20.0%	20.0-25.0%	20.0%	20.0-24.0%
Investment Company (mutual fund)	20.0	20.0-23.0	20.0	18.0-23.0
Pension Fund	16.0	15.0-16.0	14.0	13.0-16.0
Commercial Bank	15.0	15.0-15.0	15.0	15.0-15.0
Investment Bank	10.0	10.0-10.0	10.0	10.0-10.0
Conduit	9.5	8.75-10.0	11.0	9.5-14.25
Finance Company	2.5	2.0-3.25	2.5	1.75-3.25
Thrift Institution	2.0	1.75-2.0	2.0	1.0-2.0

Discussion of the Relative Role of Financial Institutions in Providing Debt and Equity Capital to the Lodging Industry in the Years 2000 and 2005

The capital provided to the lodging industry can be categorized as “equity” or “debt.”

Tables 71–74 illustrate the relative role of financial institutions in the provision of capital to the lodging industry in the future. It is clear from these tables that pension funds and life insurance companies are expected to be the major sources of direct-equity capital for lodging real estate in the future. On the other hand, mutual funds, pension funds, and life insurance companies are predicted to be the largest purchasers of lodging company stock. A surprising prediction was the increased role of mutual funds in direct-equity lodging real estate investment. While mutual funds have been purchasers of lodging industry stock in the past, their involvement in direct-equity investment has been limited. The

future merging of financial institutions predicted by the participants may provide a partial explanation for this change.

The panel was quite consistent in their prediction of relative role of equity investment by financial institutions from year 2000 to 2005.

On the debt side, commercial banks were expected to remain the dominant source of mortgage capital for both prediction periods, followed by life insurance companies. Life insurance companies were expected to reduce their share of mortgage debt in 2005 (apparently, this loss was offset by an increase in their role as equity providers in 2005). The role of conduits and investment banks is predicted to remain constant at 10 percent in both 2000 and 2005. It is important to note that, despite the overall reduction in the market share of commercial banks (as a percent of total financial institutions' assets), the panel does not predict a decline in their role as providers of mortgage capital to the lodging industry.

The panel was very positive about the role of life insurance companies, mutual fund companies, commercial banks, and pension funds as purchasers of debt securities in the future. These four institutions are expected to control approximately 70 percent of the debt securities in both of the prediction periods. While, in the past, commercial banks participated in the debt market mainly through the provision of mortgage capital, they are expected to play an increasing role as purchasers of debt securities.

#### Future Lending Criteria and Lending Terms by Financial Institutions for Hotel

##### Mortgages: Analysis of Results

*Prediction of the Debt Service Coverage Ratios for Direct, Single-Hotel Mortgages in the Years 2000 and 2005.* Table 75 presents the predictions of the panel on the debt-service-



coverage ratios for direct, single-hotel loans by financial institutions. The Delphi experts were asked to predict debt-service-coverage ratios for direct, single-hotel mortgages. Their median responses do not exhibit much variation across the financial institutions. In the year 2000, the highest coverage ratios were for life insurance companies, money-center banks, and community banks (at 1.40); the lowest coverage ratios were for thrift institutions, finance companies, and investment banks (at 1.30). Median responses for regional banks and pension funds in the year 2000 were at 1.35. For 2005, the median responses for all financial institutions were 1.40.

**Table 75**  
**DEBT-SERVICE-COVERAGE RATIOS FOR DIRECT, SINGLE-HOTEL MORTGAGES**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Life Insurance Company	1.40	1.35-1.40	1.40	1.40-1.40
Conduit	1.40	1.40-1.40	1.40	1.40-1.45
Money-Center Bank	1.40	1.30-1.40	1.40	1.40-1.40
Community Bank	1.40	1.35-1.40	1.40	1.40-1.40
Regional Bank	1.35	1.35-1.40	1.40	1.40-1.40
Pension Fund	1.35	1.30-1.40	1.40	1.40-1.40
Thrift Institution	1.30	1.30-1.40	1.40	1.35-1.40
Finance Company	1.30	1.30-1.40	1.40	1.35-1.40
Investment Bank	1.30	1.30-1.32	1.40	1.30-1.40

*Prediction of Loan-to-Value Ratios for Direct, Single-Hotel Mortgages in the Years 2000 and 2005.* Table 76 presents the panel's predictions on loan-to-value ratios (LTV) for direct, single-hotel mortgages. The experts' predictions on LTV ratios for direct, single-hotel mortgages were very consistent across all financial institutions. In 2000, all lenders were predicted to have LTV ratios of 75 percent; in 2005, with the exception of thrift

institutions, pension funds, and investment banks (whose LTV ratios remained at 75), the LTV ratios of all lenders were predicted to fall to 70 percent.

**Table 76**

**LOAN-TO-VALUE RATIOS FOR DIRECT, SINGLE-HOTEL MORTGAGES**

LENDER	MD 2000 (PERCENTAGE)	IQR 2000 (PERCENTAGE)	MD 2005 (PERCENTAGE)	IQR 2005 (PERCENTAGE)
Community Bank	75.0	75.0-75.0	70.0	70.0-75.0
Regional Bank	75.0	75.0-75.0	70.0	70.0-75.0
Money-Center Bank	75.0	75.0-75.0	70.0	70.0-75.0
Thrift Institution	75.0	75.0-75.0	75.0	70.0-75.0
Finance Company	75.0	75.0-75.0	70.0	70.0-75.0
Conduit	75.0	75.0-75.0	70.0	70.0-75.0
Pension Fund	75.0	75.0-75.0	75.0	70.0-75.0
Life Insurance Company	75.0	75.0-75.0	70.0	70.0-75.0
Investment Bank	75.0	75.0-75.0	75.0	70.0-75.0

*Prediction of Loan Terms for Direct, Single-Hotel Mortgages for the Years 2000 and 2005.* Table 77 presents the panel's predictions on loan terms for direct, single-hotel mortgages. The median response of the experts was that pension funds and life insurance companies will have loan terms of 20 years and 15 years, respectively, in the year 2000. In 2005, terms will reduce to 15 years for both institutions. Regional banks are ranked third, with 12-year loan terms in both years. Community banks, money-center banks, thrifts, conduits, and investment banks all will have loan terms of 10 years in both years, according to the experts. Finally, finance companies loan terms are predicted to be 7 years in both 2000 and 2005.

**Table 77****LOAN TERMS BY FINANCIAL INSTITUTIONS FOR DIRECT, SINGLE-HOTEL MORTGAGES**

LENDER	MD 2000 (YEARS)	IQR 2000 (YEARS)	MD 2005 (YEARS)	IQR 2005 (YEARS)
Pension Fund	20.0	18.0-20.0	15.0	15.0-15.0
Life Insurance Company	15.0	15.0-15.0	15.0	15.0-15.0
Regional Bank	12.0	10.0-15.0	12.0	10.0-15.0
Community Bank	10.0	10.0-10.0	10.0	10.0-10.0
Money-Center Bank	10.0	10.0-10.0	10.0	10.0-10.0
Thrift Institution	10.0	10.0-10.0	10.0	10.0-11.0
Conduit	10.0	10.0-10.0	10.0	10.0-10.0
Investment Bank	10.0	10.0-10.0	10.0	10.0-10.0
Finance Company	7.0	7.0-10.0	7.0	7.0-10.0

*Prediction of the Amortization Period for Direct, Single-Hotel Mortgages in the Years 2000 and 2005.* Table 78 presents the panel's predictions of amortization periods for direct, single-hotel mortgages. According to the experts, the amortization period will vary narrowly (between 20 and 25 years) among all the financial institutions for both prediction periods.

**Table 78****AMORTIZATION PERIOD FOR DIRECT, SINGLE-HOTEL MORTGAGES**

LENDER	MD 2000 (YEARS)	IQR 2000 (YEARS)	MD 2005 (YEARS)	IQR 2005 (YEARS)
Finance Company	25.0	25.0-25.0	25.0	20.0-25.0
Conduit	25.0	25.0-25.0	25.0	25.0-25.0
Pension Fund	25.0	25.0-25.0	23.0	22.0-25.0
Life Insurance Company	25.0	25.0-25.0	25.0	22.0-25.0
Investment Bank	25.0	25.0-25.0	25.0	25.0-25.0
Money-Center Bank	25.0	20.0-25.0	20.0	20.0-20.0
Thrift Institution	22.0	20.0-25.0	22.0	20.0-25.0
Community Bank	20.0	20.0-20.0	20.0	20.0-20.0
Regional Bank	20.0	20.0-25.0	20.0	20.0-20.0

*Prediction of Interest Rates for Direct, Single-Hotel Mortgages in the Years 2000 and 2005.* Table 79 presents the panel's predictions on interest rates charged for direct, single-hotel mortgages. The interest-rate prediction by the panel does not foresee much difference in interest rates among financial institutions. In the years 2000 and 2005, rates vary narrowly between 8.50 percent and 9.25 percent.

**Table 79**

**INTEREST RATES FOR DIRECT, SINGLE-HOTEL MORTGAGES**

LENDER	MD 2000 (PERCENTAGE)	IQR 2000 (PERCENTAGE)	MD 2005 (PERCENTAGE)	IQR 2005 (PERCENTAGE)
Community Bank	8.50	8.20-9.0	9.0	9.0-9.0
Money-Center Bank	8.60	8.50-9.0	8.50	8.25-9.0
Pension Fund	8.60	8.20-8.80	8.50	8.30-9.0
Life Insurance Company	8.60	8.20-8.80	8.50	
Regional Bank	8.75	8.50-9.0	8.80	8.75-9.25
Conduit	8.85	8.80-9.0	9.0	8.9-9.0
Thrift Institution	9.0	9.0-9.0	9.0	9.0-9.20
Investment Bank	9.0	9.0-9.0	9.0	9.0-9.35
Finance Company	9.25	9.0-9.5	9.0	9.0-9.5

*Prediction of Loan Size for Direct, Single-Hotel Mortgages in the Years 2000 and 2005.*

Table 80 presents the panel's predictions on the minimum and maximum size of loans that will be made by financial institutions in 2000 and 2005. Life insurance companies and investment banks are predicted to make the largest direct, single-hotel mortgages in the years 2000 and 2005; their maximum loan-size IQR ranges from \$75 million to \$100 million. Pension funds follow, with a loan-size IQR of \$45 million to \$100 million. Money-center banks are predicted to have loan-size IQRs of \$50 million to \$60 million.

These four large lenders are predicted to make minimum loans of between \$5 million and \$10 million for both prediction periods.

Regional banks and conduits could be considered intermediate lenders according to the size of their loans, which ranged from \$15 million to \$17.5 million in 2000; loans by conduits are predicted to increase slightly to \$18 million in 2005. Finance companies could also be considered intermediate lenders; they are predicted to make maximum loans of \$20 million in 2000 and \$22.5 million in 2005. The minimum loan size for the intermediate lenders is expected to be between \$2 million and \$4 million.

Finally, thrifts and community banks (small lenders) are predicted to have maximum loans of \$10 million and minimum loans of \$1.5 million and \$2 million, respectively.

**Table 80**

**LOAN SIZE FOR DIRECT, SINGLE-HOTEL MORTGAGES**

LENDER	MD 2000 MIN-MAX (MILLIONS)	IQR 2000 MIN-MAX (MILLIONS)	MD 2005 MIN-MAX (MILLIONS)	IQR 2005 MIN-MAX (MILLIONS)
Community Bank	Min: 2.0 Max: 10.0	Min: 2.0-2.0 Max: 10.0-10.0	Min: 2.0 Max: 10.0	Min: 2.0-2.0 Max: 10.0-15.0
Regional Bank	Min: 4.0 Max: 15.0	Min: 2.0-5.0 Max: 15.0-20.0	Min: 5.0 Max: 15.0	Min: 2.0-5.0 Max: 15.0-20.0
Money-Center Bank	Min: 5.0 Max: 50.0	Min: 5.0-5.0 Max: 50.0-60.0	Min: 5.0 Max: 50.0	Min: 5.0-5.0 Max: 50.0-60.0
Thrift Institution	Min: 1.5 Max: 10.0	Min: 1.0-2.0 Max: 10.0-12.0	Min: 1.5 Max: 10.0	Min: 1.0-2.0 Max: 10.0-15.0
Finance Company	Min: 2.0 Max: 20.0	Min: 1.0-2.0 Max: 15.0-20.0	Min: 2.0 Max: 22.5	Min: 1.0-2.0 Max: 20.0-22.50
Conduit	Min: 2.0 Max: 17.50	Min: 2.0-2.0 Max: 17.5-20.0	Min: 2.0 Max: 18.0	Min: 2.0-2.0 Max: 17.5-20.0
Pension Fund	Min: 10.0 Max: 45.0	Min: 5.0-10.0 Max: 45.0-100.0	Min: 10.0 Max: 45.0	Min: 5.0-10.0 Max: 45.0-100.0
Life Insurance Company	Min: 10.0 Max: 75.0	Min: 5.0-10.0 Max: 75.0-100.0	Min: 10.0 Max: 75.0	Min: 5.0-10.0 Max: 75.0-100.0
Investment Bank	Min: 10.0 Max: 75.0	Min: 5.0-10.0 Max: 75.0-100.0	Min: 10.0 Max: 75.0	Min: 5.0-10.0 Max: 75.0-100.0

*Discussion of Lending Criteria and Terms by Financial Institutions for Hotel Mortgages.*

The structure of a loan made by a lender is a function of six interrelated elements (criteria and terms). These include the debt-coverage ratio, loan-to-value ratio, loan term, amortization period, interest rate, and size of loan. These lending criteria and terms are generally affected by the overall economic environment, the Federal Reserve's monetary policy, the regulatory environment of financial institutions, and the performance of the industry or company to which the loan is being made. These lending terms and criteria determine the ability of hotel borrowers to access capital. When conditions are favorable, more borrowers will be able to access loans; when conditions are stringent, the reverse is true. In the early 1980s, lending terms and criteria were relaxed and favored borrowers, which resulted in an oversupply of "undisciplined" capital to the lodging industry, which led to overbuilding. Because of the overbuilding in the lodging industry and other commercial real estate sectors, lending terms and criteria were tightened from 1990–1993, which resulted in a scarcity of capital for the lodging industry. From 1994 to today, lending terms have improved, and once again the lodging industry has ready access to capital.

Based on the predictions of the Delphi panel, the overall lending terms and criteria for the two prediction periods will remain favorable. Debt-coverage ratios, which provide the lender with a cushion against a reduction in the property's income stream, were predicted at about 1.40<sup>6</sup>; this is approximately the same as the current period's debt-coverage ratio. In the early 1990s, when lending criteria were stringent, the debt-coverage

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<sup>6</sup>A debt-coverage ratio of 1.40 means that the lender requires \$1.40 in net income for each \$1.00 in debt.

ratio was as high as 1.70. Similarly, loan-to-value ratios<sup>7</sup> were predicted at 75 percent in 2000; most financial institutions were expected to reduce this to 70 percent in 2005. To put this in perspective, loan-to-value ratios in 1997–1998 have been in the 75 to 80 percent range. Therefore, the panel's prediction for 2000 is a continuation of this liberal trend. However, the panelists were more conservative for 2005, when they predict that lenders will demand more equity in proportion to debt. It is important to note that there is a direct relationship between the debt-coverage ratio and loan-to-value ratios and the amount of debt capital flowing to the lodging industry. The Delphi panel's predicted loan-to-value ratio and debt-coverage ratios are indicative of an optimistic scenario in terms of debt availability in the predicted years.

It is interesting to note that there is not much variation among the financial institutions with regard to interest rates in the predicted periods. This may be indicative of two factors: (1) the continued increase in competition among financial institutions, and (2) the merging of different types of financial institutions into single, larger entities, resulting in multiple sources for their capital base.<sup>8</sup> In keeping with its predictions for other lending terms, the panel's interest-rate predictions of 8.0 to 9.25 percent are optimistic. Interest rates, based upon a financing survey by HMBA and *Lodging Hospitality*, were in the 8.0 to 9.0 percent range as of April 1998 (Lemon, 1998).

In the short term, the panel's predictions on terms are still favorable at 15 to 20 years for permanent lenders such as life insurance companies and pension funds, and 10 years for construction lenders such as commercial banks. In comparison, at the height of

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<sup>7</sup>The loan-to-value ratio expresses the relationship between the amount of a loan and the value of the property when the loan is made. At a 75 percent LTV, a property valued at \$1 million could get a loan of up to \$750,000.

the building boom in the early and mid-1980s, many loans were made with 5- to 10-year terms, because lenders were afraid of looming inflation (Arnold, 1994). Judging by their predictions about interest rates, it appears that the panelists are quite optimistic about long-term inflation prospects and do not foresee a major reduction of loan terms in the future.

Changes in the minimum loan sizes that financial institutions are willing to make in the future are clear indications of the competitive landscape that is expected to prevail in the future for financial institutions. The overall differences between the minimum-loan size of large lenders (pension funds, investment banks, life insurance companies, money-center banks), intermediate lenders (regional banks, finance companies), and small lenders (community banks, thrifts) have been progressively narrowing. Based on the panel's predictions, thrifts (small lenders) will make minimum loans of about \$1 million, but finance companies (intermediate lenders) will also compete in this market by making minimum loans of \$1 million as well. Large lenders are also expected to drop their threshold; the panel's predicted IQR for minimum loans for large lenders ranged from \$5 million to \$10 million.

#### Lodging Segments and Products Financed by Financial Institutions in the Future:

##### Analysis of Results

*Prediction of Sources of Financing for the Luxury Hotel Segment in the Years 2000 and 2005.* Table 81 presents the panel's predictions of the sources of financing for the luxury

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<sup>a</sup>For example, if a financial institution is a combination of a commercial bank and an investment bank, its cost of capital may be lower, thus giving it the ability to provide loans at a lower rate of interest.



hotel segment. Investment banks, pension funds, and life insurance companies will be the primary providers of funds for luxury hotels in 2000, with the experts indicating a “high probability” for these institutions to finance luxury hotels. In 2005, pension funds and life insurance companies are expected to scale back a little; the experts predicted a “moderate probability” for them in 2005. Money-center banks, regional banks, and conduits have a “moderate probability” of providing funds for this segment in both prediction periods.

**Table 81**

**SOURCES OF FINANCING FOR THE LUXURY SEGMENT OF THE LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Investment Bank	1.0	1.0-1.0	1.0	1.0-2.0
Pension Fund	1.0	1.0-1.0	2.0	1.0-2.0
Life Insurance Company	1.0	1.0-1.0	2.0	1.0-2.0
Money-Center Bank	2.0	1.0-2.0	2.0	1.0-2.0
Regional Bank	2.0	2.0-2.75	2.5	2.0-3.0
Conduit	2.0	2.0-3.0	2.0	2.0-3.0
Finance Company	3.0	3.0-3.0	3.0	3.0-4.0
Community Bank	3.0	3.0-3.0	3.0	3.0-4.0
Thrift Institution	4.0	4.0-4.0	4.0	4.0-4.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for the Upscale Hotel Segment in the Years 2000 and 2005.* Table 82 presents the panel’s predictions on the sources of financing for the upscale hotel segment. As with the luxury segment, investment banks, pension funds, and life insurance companies are expected to be the primary providers of funds for upscale hotels in 2000 and 2005. In addition, money-center banks are also expected to participate in lending to this segment.

**Table 82**

**SOURCES OF FINANCING FOR THE UPSCALE SEGMENT OF THE  
LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Investment Bank	1.0	1.0-1.0	1.0	1.0-2.0
Pension Fund	1.0	1.0-1.0	2.0	1.0-2.0
Life Insurance Company	1.0	1.0-1.0	1.0	1.0-2.0
Money-Center Bank	1.0	1.0-2.0	2.0	2.0-2.0
Conduit	2.0	1.50-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-3.0	2.0	2.0-3.0
Thrift Institution	3.0	3.0-3.0	3.0	3.0-3.0
Finance Company	3.0	3.0-3.0	3.0	2.0-3.0
Community Bank	3.0	3.0-3.0	3.0	3.0-4.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for the Midscale Hotel Segment in the Years 2000 and 2005.* Table 83 presents the panel's predictions on the sources of financing for the midscale hotel segment. All financial institutions are expected to have a "moderate probability" of providing funds to this segment for both prediction periods. However, the larger institutions, such as pension funds, life insurance companies, and investment banks, are expected to have a lower probability, indicated by a wider dispersion in the IQR (2.0–3.0). Conversely, conduits may be the primary providers to this segment in 2000 and 2005, as indicated by an IQR of 1.0–2.0.

**Table 83****SOURCES OF FINANCING FOR THE MIDSCALE SEGMENT OF THE  
LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Community Bank	2.0	2.0-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-2.0	2.0	2.0-2.0
Money-Center Bank	2.0	2.0-2.0	2.0	2.0-3.0
Thrift Institution	2.0	2.0-2.0	2.5	2.0-3.0
Finance Company	2.0	2.0-2.0	2.0	2.0-2.5
Conduit	2.0	1.0-2.0	2.0	1.0-2.0
Pension Fund	2.0	2.0-3.0	2.0	2.0-3.0
Life Insurance Company	2.0	2.0-3.0	2.0	2.0-3.0
Investment Bank	2.0	2.0-3.0	2.0	2.0-3.0

**Scale:****1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for the Economy Hotel Segment in the Years 2000 and 2005.* Table 84 presents the panel's predictions of the sources of financing for the economy hotel segment. The only financial institutions expected to have a "high probability" of providing financing for the economy segment in 2000 and 2005 are community banks. All other institutions range from "moderate probability" to "low probability" with respect to the likelihood of providing financing to the economy segment.

**Table 84**

**SOURCES OF FINANCING FOR THE ECONOMY SEGMENT OF THE  
LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Community Bank	1.0	1.0-1.0	1.0	1.0-2.0
Finance Company	2.0	2.0-3.0	2.0	2.0-3.0
Conduit	2.0	2.0-3.0	3.0	2.0-3.0
Regional Bank	2.0	2.0-2.0	3.0	2.0-3.0
Thrift Institution	2.0	2.0-3.0	3.0	2.0-3.0
Money-Center Bank	3.0	3.0-3.0	3.0	3.0-3.0
Pension Fund	3.0	3.0-4.0	3.0	3.0-4.0
Life Insurance Company	3.0	3.0-4.0	3.0	3.0-4.0
Investment Bank	3.0	2.0-4.0	3.0	3.0-4.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for the Budget Hotel Segment in the Years 2000 and 2005.* Table 85 presents the panel's predictions of the sources of financing for the budget hotel segment. No financial institution received a "high probability" ranking as a provider of funds to the budget segment. However, community banks, thrifts, and finance companies are predicted at "moderate probability." Regional banks, money-center banks, and conduits have a "low probability" in financing this sector, and life insurance companies and pension funds will not participate in funding budget hotels.

**Table 85****SOURCES OF FINANCING FOR THE BUDGET SEGMENT OF THE LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Community Bank	2.0	1.0-2.0	2.0	1.0-2.0
Thrift Institution	2.0	2.0-3.0	2.0	2.0-3.0
Finance Company	2.0	2.0-3.0	2.0	2.0-3.0
Regional Bank	3.0	2.0-3.0	3.0	2.0-3.0
Money-Center Bank	3.0	3.0-4.0	3.0	3.0-4.0
Conduit	3.0	2.0-3.0	3.0	2.0-3.0
Pension Fund	4.0	3.0-4.0	3.0	3.0-4.0
Life Insurance Company	4.0	3.0-4.0	4.0	3.0-4.0
Investment Bank	3.0	3.0-4.0	3.0	3.0-4.0

**Scale:****1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for the Extended-Stay Hotel Segment in the Years 2000 and 2005.* Table 86 presents the panel's predictions on the sources of financing for the extended-stay hotel segment. There is a moderate probability that the extended-stay segment will receive funding in 2000 and 2005 from all nine lenders considered. The panel was uniform in its prediction across all financial institutions. Furthermore, it reached a high degree of consensus in its prediction about financing for this segment.

**Table 86**

**SOURCES OF FINANCING FOR THE EXTENDED-STAY SEGMENT OF THE  
LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Community Bank	2.0	2.0-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-2.0	2.0	2.0-2.0
Money-Center Bank	2.0	2.0-2.0	2.0	2.0-3.0
Thrift Institution	2.0	2.0-2.0	2.0	2.0-2.0
Finance Company	2.0	2.0-2.0	2.0	2.0-2.0
Conduit	2.0	2.0-2.0	2.0	2.0-3.0
Pension Fund	2.0	2.0-3.0	3.0	2.0-3.0
Life Insurance Company	2.0	2.0-3.0	3.0	2.0-3.0
Investment Bank	2.0	2.0-3.0	2.0	2.0-3.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for Convention Hotels in the Years 2000 and 2005.*

Table 87 presents the panel's predictions of the sources of financing for convention hotels. Pension funds and life insurance companies are expected to be the primary providers of financing for convention hotels in the year 2000. Pension funds will continue to provide funds in 2005, but life insurance company funding will taper off. Financing of this product type by investment banks, money-center banks, and conduits was rated as "moderately probable."

**Table 87****SOURCES OF FINANCING FOR CONVENTION HOTELS**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Pension Fund	1.0	1.0-1.0	1.0	1.0-3.0
Life Insurance Company	1.0	1.0-1.0	2.0	1.0-3.0
Investment Bank	2.0	1.0-2.0	2.0	2.0-2.0
Money-Center Bank	2.0	2.0-2.0	2.0	2.0-3.0
Conduit	2.0	2.0-3.0	2.0	2.0-3.0
Finance Company	3.0	3.0-4.0	3.0	3.0-4.0
Regional Bank	3.0	2.0-3.0	3.0	3.0-4.0
Thrift Institution	4.0	4.0-4.0	4.0	4.0-4.0
Community Bank	4.0	4.0-4.0	4.0	4.0-4.0

**Scale:****1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for Casino Hotels in the Years 2000 and 2005.* Table 88 presents the panel's predictions of the sources of financing for casino hotels. The only two financial institutions expected to finance casino hotels with "moderate probability" are investment banks and money-center banks. All other institutions are not likely to be involved in financing casinos in the future.

**Table 88****SOURCES OF FINANCING FOR CASINO HOTELS**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Investment Bank	2.0	2.0-2.0	2.0	2.0-3.0
Money-Center Bank	2.0	2.0-2.0	3.0	2.0-3.0
Pension Fund	3.0	3.0-4.0	3.0	3.0-4.0
Life Insurance Company	3.0	3.0-4.0	3.0	3.0-4.0
Finance Company	3.0	3.0-4.0	3.0	3.0-4.0
Conduit	3.0	3.0-4.0	3.0	3.0-4.0
Regional Bank	3.0	3.0-4.0	4.0	3.0-4.0
Community Bank	4.0	4.0-4.0	4.0	4.0-4.0
Thrift Institution	4.0	4.0-4.0	4.0	4.0-4.0

**Scale:****1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for Resorts in the Years 2000 and 2005.* Table 89 presents the panel's predictions of the sources of financing for resorts. The panel predicted that there is a "high probability" that resorts will be financed by life insurance companies, investment banks, and pension funds in 2000 and 2005. There is a "moderate probability" that resorts will receive funds from money-center banks, conduits, and regional banks in those years.

**Table 89**  
**SOURCES OF FINANCING FOR RESORTS**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Life Insurance Company	1.0	1.0-1.0	1.0	1.0-2.0
Investment Bank	1.0	1.0-2.0	1.0	1.0-2.0
Pension Fund	1.0	1.0-1.0	2.0	1.0-3.0
Money-Center Bank	2.0	1.0-2.0	2.0	2.0-3.0
Conduit	2.0	2.0-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-3.0	3.0	3.0-4.0
Finance Company	3.0	3.0-3.0	3.0	3.0-4.0
Thrift Institution	4.0	4.0-4.0	4.0	4.0-4.0
Community Bank	4.0	4.0-4.0	4.0	4.0-4.0

**Scale:**  
**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Financing for Motels in the Years 2000 and 2005.* Table 90 presents the panel's predictions of the sources of financing for motels. There is a "moderate probability" that motels will receive financing from community banks, regional banks, finance companies, thrifts, and conduits in the year 2000. Thrifts and conduits are expected to reduce their participation in 2005.



**Table 90****SOURCES OF FINANCING FOR MOTELS**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Community Bank	2.0	2.0-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-2.0	2.0	2.0-3.0
Finance Company	2.0	2.0-2.0	2.0	2.0-3.0
Thrift Institution	2.0	2.0-2.0	3.0	2.0-3.0
Conduit	2.0	2.0-2.0	3.0	2.0-3.0
Money-Center Bank	3.0	2.0-3.0	3.0	2.0-3.0
Pension Fund	3.0	3.0-4.0	3.0	3.0-4.0
Life Insurance Company	3.0	3.0-4.0	3.0	3.0-4.0
Investment Bank	3.0	3.0-3.0	3.0	3.0-3.0

**Scale:****1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Discussion of the Lodging Segments and Products Financed by Financial Institutions in the Years 2000 and 2005.* The Delphi panel expects that pension funds, life insurance companies, investment banks, and money-center banks will primarily finance luxury and upscale hotels in the two prediction periods. This is consistent with its earlier prediction that these segments will have high operating performance ratios in the future.

Furthermore, changes in the relative additions to the supply of hotel rooms from 1990 to 1997 also indicate that, while the room supply of midscale and economy segments grew by 84 percent, the top two tiers only increased by 31 percent (Smith Travel Research, 1997).<sup>9</sup> This inequity in room supply (more supply of rooms than demand) has had a negative impact on the operating performance of the lower tiers.

Despite a high percentage of net additions in the room supply of economy hotels in the past five years, the panel predicted that there is a high probability that community banks will continue to finance these products. Their specialized knowledge of economy

hotels and the markets where these loans are made is probably the reason for this optimistic projection by the panel.

The traditional sources of capital for midscale, economy, and budget hotels have been finance companies and regional banks. These institutions are predicted to be moderate to low probability sources of financing for these sectors in the prediction periods. The fast rate with which the room supply in these segments has grown in the past five years is likely one reason for the panel's low confidence in their willingness to provide future financing for low tier properties.

The extended-stay segment has shown very high growth in the past three years. In 1995, the segment had 366 properties and 43,000 rooms; this has grown to 893 properties and 100,361 rooms (Smith Travel Research, 1998; Chapter 4, current study). This is an overall room growth of 133 percent. As a result, overbuilding fears may be developing in the lending community. Therefore, the panel's overall prediction of "moderate probability" on the future financing potential for this product is not surprising.

Furthermore, an Arthur Anderson study reported by Shroders Research (Shroders, February 25, 1998) indicates that the extended-stay segment may be suffering from an erosion of brand loyalty. Even established extended-stay products such as Residence Inn have a low customer loyalty, according to that study.

The panel predicted that life insurance companies and pension funds have a high to moderate probability of financing convention hotels in 2000 and 2005. Convention hotels in general have shown high operating performance ratios. In 1996, their operating statistics were 72.5 percent occupancy, \$130.17 average daily rate, and operating profits

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<sup>9</sup>Please note that there was also a decrease in supply of certain segments by 22 percent, and other segment changes are not shown; as a result, 84 percent and 31 percent do not add to 100 percent.

of \$16,014 per available room (PKF *Trends*, 1997). However, convention hotels are expensive to construct and require tax and other development incentives from cities in order to make their construction financially feasible.

Casino hotels, by combining lodging and entertainment, have created a product that has become very popular with travelers. The tremendous growth of hotel rooms in Las Vegas in recent years is an example of this popularity. However, the Delphi panel was tentative in its prediction of financing availability for this product. The consensus was toward a moderate to low probability that financing would be available for casinos in 2000 and 2005. Three factors may have contributed to this tentative prediction: (1) there is a general feeling in the lending community that some of the large casino destinations are approaching an overbuilt status, (2) casino hotels are expensive to build, and (3) while casino gambling is currently legal in 22 states, its growth will depend on more states legalizing gambling.

Resorts have a high probability of being financed by the large lenders in the prediction periods. Lender interest in the future performance potential of resorts is fueled by four factors: (1) the trend in fitness, leisure, and recreation is expected to continue into the future, (2) the market mix of the resort product, while heavily dependent on tourists, is well diversified, as 40 percent of the mix is from conventions, conferences, and business travelers, (3) this product is expensive to construct, so barriers to entry are high, and (4) the increasing growth and interest in the time-share resort market is expected to further fuel interest in resorts.

## Types of Hotel Mortgage Loans Provided by Financial Institutions in the Future:

### Analysis of Results

*Prediction on Sources of Construction Loans for the Lodging Industry in the Years 2000 and 2005.* Table 91 presents the panel's predictions of sources of construction loans for the lodging industry. The panel predicts that depository institutions such as community banks, regional banks, money-center banks, and thrifts will be the construction lenders in years 2000 and 2005. However, only community banks in the year 2000 have a "high probability" of being involved with construction financing during the prediction periods. Furthermore, the level of consensus was weak—an IQR of 1.0–3.0 for community and regional banks, 2.0–3.0 for money-center banks, and 3.0–4.0 for thrifts. All other institutions are not expected to be involved in construction lending during 2000 and 2005.

**Table 91**

### **SOURCES OF CONSTRUCTION LOANS BY FINANCIAL INSTITUTIONS FOR THE LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Community Bank	1.0	1.0-2.0	2.0	1.0-3.0
Regional Bank	2.0	1.0-2.0	2.0	1.0-3.0
Money-Center Bank	2.0	2.0-2.0	2.0	2.0-3.0
Thrift Institution	2.0	2.0-3.0	3.0	3.0-4.0
Finance Company	3.0	2.0-3.0	3.0	3.0-4.0
Conduit	3.0	2.0-4.0	3.0	2.0-4.0
Life Insurance Company	3.0	3.0-4.0	3.0	3.0-4.0
Investment Bank	3.0	3.0-3.0	3.0	3.0-4.0
Pension Fund	4.0	3.0-4.0	4.0	4.0-4.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Mini-Perm Loans for the Lodging Industry in the Years 2000 and 2005.* Table 92 presents the panel's predictions on sources of mini-perm<sup>10</sup> loans for the lodging industry. Money-center banks have a "high probability" of being involved in mini-perm loans in the year 2000; in 2005, this tapers off to a "moderate probability." All other institutions have a moderate to low probability of being involved in this form of financing.

**Table 92**

**SOURCES OF MINI-PERM LOANS BY FINANCIAL INSTITUTIONS FOR THE LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Money-Center Bank	1.0	1.0-2.0	2.0	1.0-2.0
Community Bank	2.0	2.0-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-2.0	2.0	2.0-2.0
Life Insurance Company	2.0	2.0-3.0	2.0	2.0-3.0
Thrift Institution	2.0	2.0-3.0	3.0	2.0-3.0
Finance Company	2.0	2.0-2.0	2.0	2.0-2.0
Conduit	3.0	2.0-3.0	3.0	2.0-3.0
Pension Fund	3.0	3.0-3.0	3.0	3.0-3.0
Investment Bank	3.0	3.0-3.0	3.0	3.0-3.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Term/Bullet Loans for the Lodging Industry in the Years 2000 and 2005.* Table 93 presents the panel's predictions of sources of term/bullet loans<sup>11</sup> for the lodging industry. The experts predict that money-center banks will be the primary providers of term/bullet loans in the year 2000. This tapers off to "moderate probability" in 2005. All other institutions have a moderate to low probability of being involved in this form of financing.

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<sup>10</sup> This is a combination of a construction and permanent loan.

**Table 93****SOURCES OF TERM/BULLET LOANS BY FINANCIAL INSTITUTIONS FOR THE LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Money-Center Bank	1.0	1.0-1.0	2.0	1.0-2.0
Community Bank	2.0	2.0-2.0	2.0	2.0-2.0
Regional Bank	2.0	2.0-2.0	2.0	2.0-3.0
Thrift Institution	2.0	2.0-3.0	3.0	2.0-3.0
Finance Company	2.0	2.0-2.0	2.0	2.0-3.0
Conduit	2.0	2.0-3.0	3.0	2.0-3.0
Pension Fund	2.0	2.0-3.0	3.0	2.0-3.0
Life Insurance Company	2.0	2.0-2.0	2.0	2.0-2.0
Investment Bank	3.0	2.0-3.0	3.0	2.0-3.0

**Scale:****1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Prediction of Sources of Permanent Loans for the Lodging Industry in the Years 2000 and 2005.* Table 94 presents the panel's predictions of sources of permanent loans for the lodging industry. Pension funds and life insurance companies are expected to be the primary providers of permanent financing in 2000 and 2005. Money-center banks and conduits are expected to have a "moderate probability" of involvement in this form of financing for both prediction periods. Other financial institutions are not expected to be involved in permanent financing.

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<sup>11</sup> These are fixed rate loans with no (or minimal) amortization prior to maturity.

**Table 94**

**SOURCES OF PERMANENT LOANS BY FINANCIAL INSTITUTIONS FOR THE  
LODGING INDUSTRY**

LENDER	MD 2000	IQR 2000	MD 2005	IQR 2005
Pension Fund	1.0	1.0-2.0	1.0	1.0-2.0
Life Insurance Company	1.0	1.0-1.0	1.0	1.0-2.0
Money-Center Bank	2.0	2.0-2.0	2.0	2.0-3.0
Conduit	2.0	2.0-2.0	2.0	2.0-3.0
Community Bank	3.0	2.0-3.0	3.0	3.0-3.0
Regional Bank	3.0	2.0-3.0	3.0	3.0-3.0
Thrift Institution	3.0	2.0-3.0	3.0	3.0-3.0
Finance Company	3.0	2.0-3.0	3.0	3.0-3.0
Investment Bank	3.0	3.0-3.0	3.0	3.0-3.0

**Scale:**

**1 = High Probability, 2 = Moderate Probability, 3 = Low Probability, 4 = Not Probable**

*Discussion of the Type of Hotel Mortgage Loans Provided by Financial Institutions in the Years 2000 and 2005.* Commercial banks have been considered the traditional construction lenders. However, they cut back their construction lending as a result of the real estate crash during the 1987–1992 period. They started to return to this form of lending as the lodging industry recovered in the mid -1990s. Although, relative to other financial institutions, commercial banks will continue to be the primary source construction loans, the panel’s prediction appears to be that they will play a limited role in construction lending in 2000 and 2005. Only community banks are predicted to have a high probability of involvement in construction loans. There may be three reasons of this prediction: (1) the panel sees a general slowdown in lodging construction activity during the prediction periods, (2) alternative sources of financing—such as foreign banks, foreign investors, and REITs—may be expected to replace U.S. commercial banks as

sources of construction funds, and (3) commercial banks may become more involved in purchasing debt securities rather than making direct construction loans in the future.

The two traditional sources of permanent financing—pension funds and life insurance companies—are predicted to have a high probability of continued involvement with this type of lending.

Mini-perm loans, which are a combination of a construction loan and a permanent loan, were extensively used in the 1980s. It is interesting to note that even though all financial institutions indicate a moderate probability offering these loans, they are all competing for making these types of loans.

The overall predictions of the panel, in terms of the role of financial institutions in providing the various types of direct mortgage financing, show that there will be a general slowdown in practically all stages of mortgage financing during 2000 and 2005.

### **Open-ended Responses of the Delphi Participants**

In addition to responding to the specific closed ended questions in the questionnaire, the Delphi participants were invited to give open-ended responses to questions concerning (1) the role of financial institutions (they were asked to choose one that they were familiar with) in providing capital to the lodging industry in the years 2000 and 2005, and (2) the availability of capital for the lodging industry in 2000 and 2005. What follows are their responses.



## **The Role of Financial Institutions as Sources of Capital for the Lodging Industry in 2000 and 2005**

### Prediction 1 Financing in general (REIT President)

“The industry has always experienced overbuilding when lending institutions elect to aggressively compete with each other. To the extent that the commercial banks become larger and larger through mergers, we may see heated competition with the conduits, life insurance companies, and investment banks. I am not certain that mutual funds will ever become large direct investors, but I suspect they will more likely stay in the game through the public markets, always keeping their eye on the exit if they get uncomfortable.

“To the extent that Wall Street continues to figure out ways to package debt and equity and sell it, we suspect that there will continue to be a healthy availability of capital. As the limited-service segment experiences selected overbuilding, it will be educational to watch how lenders behave with that condition. We anticipate the strong getting stronger and the big getting bigger.”

### Prediction 2 Commercial Banks (Finance Professor)

“2000: strains on availability of funds due to a downturn in the economy.

“2005: increased availability of funds but decreased willingness to lend because of loan losses in prior years.”

### Prediction 3 Commercial Banks (REIT/ Hotel Operator)

“Continued consolidation through 2000, diminishing through 2005. Expansion of product/services being offered. Expected to remain a fairly stable source of capital through 2000 and increasing through 2005.”

### Prediction 4 Commercial Banks (Lodging Market Research President)

“Most types of financial institutions will merge during the next few years. Commercial banks will offer virtually all types of financial services.”

### Prediction 5 Commercial Banks ( Investment Banker)

“Commercial banks will continue be a source of significant debt and equity capital in the years 2000 and 2005.”

Prediction 6 Commercial Banks (Mortgage Bank President)

“I have worked for three banks in my career. For the year 2000, I feel banks will be big suppliers of hotel capital, due to the availability of capital. Because of the good market and all the mergers going on in anticipation of the repealing of Glass-Steagall, banks will become bigger players in equity for hotels.”

Prediction 7 Money-Center Banks (Chief Financial Officer, Hotel Operating Company)

“I believe institutions like Chase Securities will continue to be excellent sources of capital over the next 7 to 10 years. These institutions are multi-level players providing the services of a commercial bank and an investment bank. They have an enormous appetite to do competitive deals in both of these areas. Due to their size and influence, banks like Chase will continue to be major conduits to large syndication in the hospitality industry’s financing. I have found these institutions willing to work on deals with favorable terms and conditions to allow you to grow your business.”

Prediction 8 Investment Banks (Franchise Company President)

“Investment banks: large in 2000 and larger in 2005. A key source for industry and getting bigger.”

Prediction 10 Investment Banks (Acquisition Fund President)

“Investment banks: far greater impact on capital markets by this group, through directly or indirectly providing capital to the global corporate world.”

Prediction 11 Investment Banks (Life Insurance Company Managing Director)

“Significant increase in public sources of funds for growth: equity raised, bonds, perpetual preferred stock.

“Population growth and continued focus on Social Security substitution will create demand for liquid (publicly traded) securities.

“Inflationary trends will focus on maximization of returns and protection against fixed-income depletion.

“The current low inflation, low unemployment should continue into 2000. However, by 2005, international dislocation and governmental regulation will impact economic growth.”

#### Prediction 12 Investment Banks (REIT President)

“Investment banks will expand their products and services and continue to acquire related financial institutions, consolidate nationally, and expand at an accelerating rate internationally. They will, however, be more regulated and their fees will be lower as competition increases and companies seek capital with in-house staff.”

#### Prediction 13 Conduits (Finance Professor)

“Conduits will continue to increase origination volume relative to commercial banks. Their biggest competition will come from the I. Banks [investment banks] they work for, as many I. Banks will attempt to get into the direct-lending business for small loans.

“The regulatory environment will remain essentially the same.”

#### Prediction 14 Commercial Banks and Life Insurance Companies (Hotel/Motel Broker)

“Large commercial banks were once the commercial lenders of large hotels, but they don’t seem to have returned to the marketplace. I assume they will be back to finance resorts and urban hotels at the back of the boom (early next decade).

“Life insurance companies were once the long-term lenders for large hotels, but they don’t seem to have returned to the marketplace. My guess is that their real estate investing is now in mortgage-backed securities and REIT shares.

“When the stock market cools off, they’ll switch back to real estate again when the yields become attractive again.”

#### Prediction 15 Life Insurance Companies (Investment Banker)

“I believe that life insurance companies will make fewer and fewer direct investments in mortgage loans on hotels and other types of commercial properties in the future—less with each passing year. They will invest in mortgage securities, but the life insurance companies themselves will originate fewer and fewer of the mortgage loans that collateralize these securities.”

#### Prediction 16 Pension Funds (Investment Advisor)

“For 2000 and 2005, I believe pension funds will return to investing a greater percentage of their real estate allocations into direct investments vs. equity REITs.

“Also, by 2005 I see a greater absolute percentage of invested funds going into real estate vs. Today, as follows:\*

Percentage of All Tax-Exempt Investments

	<b>1997</b>	<b>2000</b>	<b>2005</b>
Real Estate	5%	6%	7-8%
Non-Real Estate	95%	94%	92-93%”

\*Based on a typical \$10 billion fund

Prediction 17 Pension Funds (Finance Professor)

“Pension funds have been traditionally late to the real estate market. They have tended to buy when real estate prices have been high and sell during depressed markets. Many pension funds have done a poor job of managing their money. There will be increased pressure to regulate pension funds by limiting what they may invest in. This will result in pension funds being less active in real estate investments in the future. I predict that the latest investments made by pension funds will result in further losses, which will cause the government to crack down on pension plans.”

Prediction 18 Mutual Funds (Investment Advisor)

“The inflow of dollars into equity mutual funds these past couple of years is unprecedented. They have exceeded over \$200 billion in both 1996 and 1997!! In 1996 alone, this represents the equivalent (I understand) of almost the entire amount of money flowing into mutual funds for the past five years combined.

“The tremendous growth in the inflow of funds is attributable to the growth of 401k-defined contribution plans, along with an increase in the number of individuals investing in the stock market (which currently is approximately 43 percent).

“The shift in pension plans from defined-benefit to 401k-defined contribution plans has in effect shifted decision-making from pension fund advisors to individuals.

“Given the return performance of the stock market, along with the perceived liquidity and diversification offered by mutual funds (as opposed to investing directly), many 401k and individual investors have opted to invest in the stock market via mutual funds versus their own.

“My understanding is that mutual funds currently represent a significant source of capital for both REITs and public hotel companies.

“I expect that the following issues will substantially impact whether we can anticipate mutual funds continuing to invest in the hotel industry:

- a) the inflow of investment in equity mutual funds—this is a very important barometer for monitoring the potential availability of funds in general for investments.

- b) Return performance of the hotel industry in particular versus alternative investments. Up until recently hotels as an industry group (based upon the return information available, which currently is still limited) have outperformed essentially all other investment classes.

“With the potential for significant overbuilding, for margin erosion, and for declining investment returns, the industry is at a critical juncture. If industry returns cannot remain competitive (adjusted for perceived risk) relative to alternative investments, we can anticipate that it will become increasingly challenging to attract investment capital.”

### **The Availability of Capital for the Lodging Industry in 2000 and 2005**

As mentioned earlier, the Delphi participants were asked to make predictions regarding the availability of capital for the lodging industry in the years 2000 and 2005. What follows are their responses on this subject.

#### Prediction 1 (Finance Professor)

“The capital market for hotels will be tight for the next couple of years. I predict a recession for the year 2000 or slightly after, and the industry slowly recovering by year 2005. There is beginning to be an over-supply of rooms in many regions, which will culminate in an overbuilt situation in the next five years. This will cause capital markets to shrink from loaning money to the lodging industry. The growth of lodging will go overseas as developing countries increase their business climate, which will require first-class hotels. The market in the United States will remain competitive and grow slowly, which will limit the profit potential of new developments.”

#### Prediction 2 (Hotel/Motel Broker)

“Capital is always available at some cost. Inflation and rates are going up, so a supply of money will be available in 2000 but there will be fewer loan requests. Lenders will be more cautious in the mid-market and lower hotel segments, which will be overbuilt—seriously so by 2000.

“By 2005, demand for loans in these segments will be far less. Demand for first-class and luxury coming out of the development pipeline and at higher rates.”

### Prediction 3 (Investment Banker)

“The lodging industry as a whole will have peaked as an investment alternative by 2000. Losses in the intervening years will make it a less attractive choice than today in the year 2005.

“Capital availability in 2000 will be roughly equal to today, although directed toward the high-end market segments. Capital availability will be less in 2005.”

### Prediction 4 (Finance Professor)

“Anticipate a downturn in the economy sometime around 2000 (+/-).

“By 2005, anticipate a continued slow period of economic growth. This will make it tough for all aspects of hotel industry financing.”

### Prediction 5 (REIT President)

“One constant, regardless of whether it is the year 2000 or 2005, will be performance. To the extent that borrowers exhibit an ability to meet the threshold requirements, i.e., LTV, coverage ratios, etc., then lenders will continue to lend. It is my personal opinion that the flow of capital emerging from the global economic cycle will not abate. Lodging will continue to have access to that capital as long as we avoid a major train wreck via overbuilding. Overbuilding will remain the single largest threat to capital availability. Should the lending community loosen its standards, this will disrupt the equilibrium that currently exists.”

### Prediction 6 ( President REIT Operating Company)

“Capital availability will become more restrictive for the lodging industry in 2000, as new supply comes on line and capital sources begin to view lodging as a less desirable investment. Considering the cyclical nature of the industry, it is likely that this trend will reverse within a five-year cycle and, depending upon other economic conditions at the time, may improve again in 2005.”

### Prediction 7 (Investment Banker)

“Both debt and equity capital will be available for the hotel market in the years 2000 and 2005, but it will be sourced more from banks, investment banks, and conduits than in prior years or cycles.”

#### Prediction 8 (Chief Financial Officer, Hotel Operating Company)

“As my answers indicate, I believe that the next 2 to 3 years will continue to be strong for the hospitality industry. Capital should continue to be plentiful, especially for full-service hotels under established brands. I believe that by 2005, things will change: the current surge in limited-service building and expansion will take its toll on the industry, because of the experience in the late 1980s. I believe the financial community will be quick to tighten up the availability of capital at the first signs of weakness. The phases I predict for the industry look something like the following:

Expansion: 1996–2001

Saturation: 2001–2003

Disposition: 2002–2004

Conversion: 2003–2005

Foreclosure: 2004–2005

(I have asked my peers, who believe that within 5 years (2003) the industry cycle will turn.)”

#### Prediction 9 (Acquisition Fund President)

“Abundance in 2000, far less in 2005.”

#### Prediction 10 (Finance Professor)

“Capital will be available as long as two things happen: (a) the industry is favorably viewed, and (b) the money supply is expanding.

“There are some hints that the lending community is becoming cautious at the lower-price tiers of the industry. Lenders still bullish on urban and resort properties.

“We are at the peak of an economic cycle. If things get worse, all industries—not just real estate—will find it hard to raise capital.”

#### Prediction 11 (Mortgage Banker)

“It all relates to the hotel demand, profits, and occupancies in any given period of time.”

#### Prediction 12 (Life Insurance Company Managing Director)

“Capital will become more expensive as the risks of inflation and product oversupply continue to increase.

“The public market access will continue to fuel growth, and the related liquidity of the public market will provide a risk-escape comfort. I believe that the efficiency of

the public markets will tighten capital supply, thus reducing new construction in the period 1999–2001. This will prevent the excess development last seen in 1989–1991. The consolidation period and reduction in excesses will lead to renewed growth in 2002–2005. However, a return to inflation and changes in governmental regulation, social issues, and continued foreign opportunities will all create a demand for funds.”

#### Prediction 13 (Investment Advisor)

“A. J., I wish I could give you more of an answer, but I do not want to guess, because it would be just that. Let me say this about capital:

1. There is no historical basis upon which to claim that public financing of the industry will continue ad-indefinitum.
2. The public markets will reward winners and punish losers—who will perish like the Edsel.
3. Remember that the hotel REIT may well be behaving like the stock market, and not in concert with lodging statistics. So if the market turns amidst strong lodging fundamentals, then what?
4. Culture and service: I do not believe “merged” companies will find it easy to provide superior customer service. Quite the contrary. I predict senior management dislocation, service erosion, and an ultimate threat to brand franchisers amongst most of the consolidators, led by Starwood.”

### **Synthesis of the Delphi Study’s Results**

The results of the Delphi study presented, analyzed, and discussed in this chapter are predictions that the Delphi panelists made about two interdependent industries, the lodging industry and the financial-services industry. The premise of the study was that changes in the environment of the financial-services industry in the future, and changes in the structure and the operating and investment performance of the lodging industry in the future, will impact the future role of financial institutions as suppliers of capital to the lodging industry.



As a starting point, the purpose of the first research question was to establish a consensus on the future environment of financial institutions. The panel predicted that the growth rate of the overall economy will be progressively slower and enter into a period of general slowdown by the year 2005. By 2000, the economy is expected to have peaked and will possibly enter into a period of contraction. In 2005, the economy is expected to be in or near the bottom of the business cycle. However, the panel was broadly optimistic about the stability of the key economic indicators for the prediction periods. Therefore, inflation, personal and corporate tax rates, the personal savings rate, and disposable income are not expected to be much different than in the current period.

Within this economic context, financial institutions are predicted to be operating in a less deregulated and increasingly competitive environment. The convergence of institutions within the financial-services industry will create opportunities for them to provide various combinations of financial products to the lodging industry.

The future growth of companies in the lodging industry is not predicted to be in the form of major increases in room supply, but through consolidation, strategic alliances, international expansion, and the introduction of some new products. As a result, the panelists see the future of the lodging industry as dominated by large hotel companies, diversified both in terms of geographic expansion and product offering. In this type of operating environment, in which the industry has only limited growth potential by increasing room supply, hotel companies that have renovated and have fresh products under strong management will be increasingly important. As a result, while fierce competition is expected to continue up to the year 2005, the panel believes that by that year there will be a shake-out of older properties with weak management and not-so-

clearly-identified brands. In this competitive, low-growth environment, the overall growth in pre-tax income projected by the panel was flat, showing almost no growth between 2000 and 2005.

It appears that this shake-out will take place mostly in the budget, economy, and “midscale with food and beverage” segments. The panel viewed these segments as overbuilt or approaching an overbuilt status. This is reflected in the panel’s prediction of slow or no growth in the room supply within these segments. Conversely, the luxury and upscale segments (due to limited barriers to entry) are predicted to be the most popular hotel segments in which to acquire or develop hotels.

The locational and regional distribution of the lodging industry is not expected to be much different in the prediction periods than in the current. Hotels in suburban locations and resorts are expected to grow at a faster rate than properties in other locations. The South Atlantic, Pacific, and Mountain regions are expected to command the lion’s share of hotel room supply (over 52 percent).

In 2000 and 2005, the lodging industry is expected to be dominated by partnerships, C-Corps, individual investors, and equity REITs, which indicates that the industry will still consist of a mixture of private and public ownership entities.

In the near future, the lodging industry will need capital less for construction and more for renovation and international expansion. It is expected that upper-tier hotels and hotels in suburban and resort locations will need more capital than other types of properties. While REITs and C-Corps were predicted to have a higher need for capital in the year 2000 than they do today, there was a lack of consensus among the panelists about the total returns on REIT stocks in the future.

The top providers of equity capital to the lodging industry in the future are expected to be pension funds, life insurance companies, investment companies (mutual funds), and investment banks. Debt capital sources will be primarily commercial banks, life insurance companies, investment companies, pension funds, investment banks, and conduits.

With debt-coverage ratios predicted in the 1.30 to 1.40 range, loan-to-value ratios at 70 to 75 percent, interest rates from 8.5 to 9.0 percent, and loan terms at about the same lengths as during the current period, the panelists were generally positive about the attitude of the lending community toward the lodging industry in the future.

However, not all hotel products are expected to be viewed with favor by lenders and investors in the future. Luxury/upscale hotels, convention hotels, and resorts are expected to be favored by the large lending institutions. The popularity of lending and investing in extended-stay products is expected to wane.

### **Suggestions for Future Research**

The current research has uncovered many areas of future research, related to theory, methods and content. Specific suggestions in each of these areas are provided below.

#### **Theory**

The foundation literature reviewed in the study identified various levels of organizational analysis such as organization set, organization population and organizational communities. While most of the existing research focuses on the organization set and

organization population level of analysis, research at the communities' level is non-existent. At this level the research may focus on a population of hotels (such as luxury hotels) and various suppliers of capital, such as a population of banks, a population of finance companies or a population of pension funds for example. From a purely theoretical perspective, future research could identify various communities of these interdependent populations.

For those who are interested in studying specific variables in the environment of the lodging industry, this research provides a basic categorization of the dimensions. These include, dimensions such as stability vs change, homogeneity vs heterogeneity, munificence vs scarcity, and others discussed in chapter two. Each of these dimensions can become an area of future research. For example, researchers interested in studying availability of financing for small, medium or large hotels, may identify variables to study along the munificent-scarcity dimension.

## **Methods**

From a methodological point of view the first logical future study may test the accuracy of Delphi predictions in year 2000 and again in year 2005. As this was the first study that used the Delphi technique to make predictions about lodging industry structure and financial issues, the continued use of this method will depend on the efficacy of this method.

If this method is effective, many variations the Delphi panel design may result. One such design may consist of two panels-one panel made up of the users of capital,

such as the lodging industry, and another made up of suppliers of capital, such as financial institutions. A comparison of the two panels may reveal interesting (and possibly) divergent predictions.

The prediction categories and variables identified in this research may be used by those who want to use quantitative research methods to conduct survey research on various issues related to lodging industry finance. While the current instrument was specifically designed for the Delphi study, and may be too long for survey research, it may be reduced and modified to suit that purpose.

### **Content**

The historic review of the lodging industry structure, performance, and financing was descriptive in nature. However, researchers interested in this area of research will find a wealth of information to help them identify issues, concerns, events that have shaped the industry in this century. Individual research topics that may be of interest to future researchers include:

- Product segmentation
- Globalization of the lodging industry
- Consolidation of the lodging industry
- Impact of brand saturation (as a result of increasing brands)
- The future of independent hotels
- Specific research into alternative lodging products such as “Time Share”, “Interval Ownership”, “Assisted living facilities”
- Shift in the ownership base of the lodging industry (from individuals to institutions)
- The future of ownership structures such as REITs (related research into REIT may include topics such as REIT structure, REITs as financing vehicles) There is an overall dearth of information about REITs.
- The role of investment banks as a source of financing is also under researched and not very well understood.

- Not much has been researched about “Financial Engineering” and is an area ripe for future research
- The amount of capital flowing to the lodging industry from the various financial institutions is an area in which we have very limited information.

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## **APPENDIX A**

### **A Compendium of Useful Information for Delphi Participants**

## **CATEGORY 1**

### **Economic, Regulatory, and competitive environment Of Financial Institutions**

#### **KEY ECONOMIC INDICATORS**

KEY INDICATORS	1994	1995	1996	1997
Real GDP (% change previous yr)	3.5	2.0	2.8	3.6
CPI (% change previous yr)	2.6	2.8	2.9	2.5
Disposable Income (% change previous year)	4.6	6.0	4.7	4.9
Personal savings Rate (%)	4.2	4.8	4.3	4.1
Unemployment rate (%)	6.1	5.6	5.4	4.9
Personal income tax rate (%)	11.0	11.2	12.0	12.4
Corporate tax rate (%)	31.3	31.1	30.9	32.0
Deficit (% of GDP)	-2.7	-2.4	-1.4	-0.5
10 year T Bond (%)	7.1	6.6	6.4	6.8
30 year T Bond (%)	8.0	7.6	7.4	7.7

Source: UCLA Anderson Forecast, September 1997

#### **A LIST OF FINANCIAL INSTITUTIONS**

1. Commercial Bank
2. Thrift Institution
3. Finance Company
4. Pension Fund
5. Life Insurance Company
6. Investment Company (mutual fund)
7. Conduit
8. Investment Bank

## **CATEGORY 2**

### **The structure of the lodging Industry**

#### **CATEGORIZATION OF INDUSTRY SEGMENTS**

For the purpose of this study, two segment categorizations have been used in the questionnaire. Certain questions have the Smith Travel Research categories, while other questions have the National Hotel Realty, (Lodging Econometrics) categories. Each of these is briefly explained below.

#### **SMITH TRAVEL RESEARCH LODGING SEGMENTS**

##### **Upper Upscale Chains-**

Full service with chain wide ADR's of over \$100

**Example:** Four Seasons, Hilton Hotels, Hyatt, Intercontinental, Meridien.

##### **Upscale Chains-**

Full service with chain wide ADR's of between \$75 and \$100

**Example:** Adams Mark, Club Med, Radisson, Doubletree Hotels.

##### **Midscale Chains with F&B-**

Full service with chain ADR's less than \$75

**Example:** Holiday Inn, Howard Johnson

##### **Midscale Chains Without F&B-**

Limited-service with chain wide ADR's over \$55

**Example:** Comfort Inn, Hampton Inn, La Quinta

##### **Economy Chains-**

Limited-service with chain wide ADR's between \$45 and \$55

**Example:** Days Inn, Super 8

##### **Budget Chains-**

Limited-service with chain wide ADR's less than \$45

**Example:** Motel 6, Econo Lodge, Scottish Inn

##### **Independents**

#### **NATIONAL HOTEL REALTY LODGING SEGMENTS**

**BUDGET:** Microtel

**LIMITED SERVICE (Economy):** Econolodge, Super 8, Sleep Inn

**LIMITED SERVICE (Mid Market):** Comfort Inn & Suites, La Quinta

**FULL SERVICE (Economy):** Days Inn, Howard Johnson

**FULL SERVICE (Mid Market):** Holiday Inn, Quality Inn, Ramada Inn

**FIRST CLASS (Upscale):** Radisson, Doubletree, Hyatt, Marriott

**LUXURY:** Ritz Carlton, Four Seasons



**NET ROOM CHANGE**  
**By Chain Segment**  
**1990-1997 (March Ytd)**

Segment	Net Room Change (B-C)	Net Rooms Constructed (B)	Net Room Conversions (C)
Upper Scale	43,838	42,924	914
Upscale	63,909	37,891	26,018
Midscale with F&B	-6,705	21,605	-28,310
Midscale w/oF&B	156,794	118,667	38,127
Economy	132,121	97,514	34,607
Budget	19,335	17,410	1,925
Independent	-66,393	6,089	-72,482

Source: Smith Travel Research. Host Study. (1997)

**PERCENTAGE CHANGE IN ROOMS AVAILABLE**  
**1996-1997**

SEGMENT	PERCENT CHANGE
Upper Scale	3.2
Upscale	4.5
Midscale with F&B	.7
Midscale w/oF&B	16.0
Economy	8.0
Budget	8.7
Independent	-.6

Source: Smith Travel Research

**TOTAL ROOMS AVAILABLE**

LOCATION	ROOMS January 1998	ROOMS January 1997
Urban	518,634	505,795
Suburban	1,243,815	1,169,726
Airport	244,865	238,110
Highway	1,158,669	1,131,316
Resort	427,527	417,842

Source: Smith Travel Research

**PERCENTAGE CHANGE IN ROOMS AVAILABLE  
1996-1997**

LOCATION	PERCENT CHANGE
Urban	1.9%
Suburban	5.1
Airport	1.7
Highway	3.2
Resort	1.8

Source: Smith Travel Research

**PERCENTAGE CHANGE IN ROOMS AVAILABLE  
1994-1997**

LOCATION	CAGR* Percent
Suburban	3.3%
Highway	2.7
Resort	1.1
Airport	0.9
Urban	0.8

Source: Smith Travel Research.

\* CAGR= Compound Annual Growth Rate

**TOTAL ROOM AVAILABLE**

REGION	ROOMS January 1998	ROOMS January 1997
New England	142,989	140,151
Middle Atlantic	307,701	301,147
South Atlantic	860,843	827,646
East North Central	425,966	407,044
East South Central	228,921	216,356
West North Central	247,298	236,148
West South Central	367,149	350,364
Mountain	436,006	417,889
Pacific	576,637	566,044

**PERCENTAGE CHANGE IN ROOMS AVAILABLE  
1996-1997**

<b>REGION</b>	<b>PERCENT CHANGE</b>
New England	.6
Middle Atlantic	1.7
South Atlantic	3.4
East North Central	4.1
East South Central	5.7
West North Central	4.5
West South Central	4.9
Mountain	4.5
Pacific	1.2

Source: Smith Travel Research

**CONSTRUCTION PIPELINE OF HOTELS BY REGION  
1996**

<b>REGION</b>	<b>SHARE OF PROJECTS</b>	<b>SHARE OF ROOM SUPPLY</b>	<b>STATES</b>
South Atlantic	22.6%	23.9%	DE,MD,DC,VA,WV,NC,SC,GA,FL
Pacific	16.5	16.5	WA,OR,CA,AK,HI
West South Central	15.0	10.2	AK,LA,OK,TX
Mountain	13.0	11.7	MT,ID,WY,CO,NM,AZ,UT,NV
East North Central	10.8	11.7	OH,IN,IL,MI,WI
Mid-Atlantic	8.3	8.8	NY,NJ,PA
West North Central	5.5	6.8	MN,IA,MO,ND,SD,NE,KS
East South Central	5.4	6.3	KY,TN,AL,MS
New England	2.4	4.1	ME,NH,VT,MA,RI,CT

Source: F.W. Dodge; U.S. Department of the Census, Bear Stearns & Co

**NEW HOTEL CONSTRUCTION  
1987-1997  
NUMBER OF PROPERTIES**

<b>YEAR</b>	<b>PROPERTIES</b>
1987	891
1988	888
1989	859
1990	818
1991	475
1992	393
1993	411
1994	539
1995	790
1996	1045
1997	1300

Source: Smith Travel Research. (1997 is an estimate)

**NEW HOTEL CONSTRUCTION**  
**1987-1997**  
**Number of Rooms**

YEAR	ROOMS
1987	118,877
1988	108,523
1989	103,277
1990	99,486
1991	51,197
1992	36,397
1993	39,810
1994	44,778
1995	63,552
1996	91,150
1997	115,000

Source: Smith Travel Research. (1997 is an estimate)

**LODGING INDUSTRY MARKET VALUES**  
**(Per room)**

Segment	1990 (\$)	1991 (\$)	1992 (\$)	1993 (\$)	1994 (\$)	1995 (\$)	1996 (\$)	1997 (\$)
Luxury	74.161	61.907	69.652	71.092	90.136	113.051	126.947	137.905
Upscale	42.949	39.392	47.488	49.562	65.026	77.320	83.576	94.106
Midscale	34.953	36.294	42.119	45.946	52.038	62.952	64.775	70.194
Economy	29.572	26.245	27.784	28.085	29.498	35.367	36.121	36.411
Budget	25.400	21.818	22.679	22.998	27.498	33.003	34.797	37.168

Source: Hospitality Valuation Services. Note: The segments are not the same as those on the questionnaire, because the information in the table above is from HVS.

See Appendix for additional information.

## AVERAGE SELLING PRICE PER HOTEL ROOM 1991-1997

BRAND	1991	1992	1993	1994	1995	1996	YTD 1997
	\$	\$	\$	\$	\$	\$	\$
<b>BUDGET</b>							
<b>Total</b>	11,562	9,592	13,559	11,495	11,804	13,152	
<b>LIMITED SERVICE (Economy)</b>							
Econolodge	12,382	11,616	11,994	13,707	20,128	18,016	17,500
Knights Inn	12,207	12,263	10,222	17,828	-	-	-
Super 8	25,726	15,362	22,204	24,314	19,649	31,162	28,001
Travelodge	21,796	20,638	15,953	17,515	17,873	35,802	19,029
Sleep Inn	-	-	-	-	-	42,309	-
Suburban Lodges	-	-	-	-	-	-	43,561
Other Hotels							
<b>Total</b>	17,230	15,125	15,113	26,609	20,538	23,616	24,270
<b>LIMITED SERVICE (Mid-Market)</b>							
Comfort Inn	17,045	21,703	24,270	38,168	36,306	26,443	29,577
Fairfield Inn	-	-	-	34,799	-	43,508	55,926
Hampton Inn	28,170	26,939	25,149	49,051	46,819	56,033	48,402
Holiday Inn Express	44,000	17,151	26,339	40,565	33,800	36,299	42,258
Shoney's	23,000	-	23,636	25,709	28,283	-	-
Wellesley Inns	-	-	-	-	-	37,708	17,857
Other Hotels	34,276	32,995	39,302	33,981	45,220		
<b>Total</b>	30,819	28,676	32,482	40,022	42,244		
<b>FULL SERVICE (Economy)</b>							
Days Inn	15,725	18,637	16,647	19,807	22,546		
Howard Johnson	17,392	19,310	12,127	20,550	12,571		
Rodeway Inn	13,363	10,900	13,889	8,013	-		
Other	13,633	14,880	11,502	13,070	19,129		
<b>Total</b>	14,402	16,359	13,543	16,421	19,239		
<b>FULL SERVICE (Mid-Market)</b>							
Best Western	27,893	18,688	26,087	25,951	29,003	34,197	34,009
Courtyard by Marriott						78,382	66,475
Four Points by Sheraton						-	88,843
Holiday Inn	23,003	25,440	24,976	33,741	44,108	41,868	40,942
Quality Inn	22,050	22,191	16,342	15,691	27,365	28,634	20,942
Ramada Inn	24,243	16,243	16,621	19,299	20,503	35,080	34,534
Wyndham Garden						73,067	-
Other	32,875	35,519	34,217	33,664	43,714	45,415	52,776
<b>Total</b>	25,970	26,478	25,552	27,647	42,117	47,173	46,453
<b>FIRST CLASS (Upscale)</b>							
Crown Sterling Suites	-	-	-	-	-	108,304	-
Doubletree	62,630	43,110	37,086	48,675	53,316	82,108	93,379
Embassy Suites	44,542	57,860	43,868	52,412	66,922	87,594	120,515
Hilton	31,738	31,336	41,556	40,920	58,505	56,011	92,609
Homewood Suites						83,131	75,198
Hyatt	39,766	63,319	55,153	60,818	103,961	92,816	66,179
Marriott	87,620	66,178	49,499	65,894	75,451	84,235	130,790
Omni	79,116	75,585	36,145	40,306	42,824	39,663	-
Radisson	26,672	32,404	30,031	49,304	52,270	66,202	70,728
Residence Inn	-	51,976	59,930	73,859	74,948	86,179	88,862
Sheraton	47,732	34,341	23,514	47,384	46,416	73,672	96,805
Other	61,596	60,038	58,990	74,094	68,422	82,927	98,955
<b>Total</b>	49,991	49,126	44,306	57,943	65,174	80,686	97,121
<b>LUXURY</b>							
Ritz Carlton	-	-	-	-	-	119,503	-
Other	152,951	161,847	160,893	144,754	176,910	194,697	248,317
<b>Total</b>	152,951	161,847	160,893	144,754	176,910	175,822	248,317
<b>GRAND TOTAL</b>	33,568	32,414	32,689	45,533	54,255	66,422	80,256

Source: Lodging Econometrics by National Hotel Realty. Various Issues. Based upon average selling price for each brand. Please note that the year to year average selling price per room of individual brands are affected by the number of hotels sold in that year.

### **“WHO OWNS AMERICA’S HOTELS?”**

*A survey conducted by PKF consulting in 1993*

OWNER	PERCENTAGE
Partnership	40%
Individual	19
Hotel Company	17
Joint Venture	8
Other	6
Insurance	3
Bank	2
Pension Fund	1
REIT	1
S&L	1
Construction Co	1
Government	1

Source: Trends, by PKF Consulting. 1993

### **“OWNERS OF U.S. COMMERCIAL REAL ESTATE”**

OWNER	AMOUNT (\$)	PERCENTAGE
Corporations	\$1.7 Trillion	43.1%
Partnerships	1 Trillion	25.6
Not for profit	411 Billion	10.5
Government	234 Billion	6.0
REIT's	142 Billion	3.6
Institutional Investor	128 Billion	3.3
Financial Institution	114 Billion	2.9
Other	104 Billion	2.6
Individuals	96 Billion	2.4

Source: Forbes, December 29, 1997.  
Original source, AEW Capital Management.

### CATEGORY 3

#### The operating and investment performance of the Lodging industry

#### ANALYSIS OF LODGING INDUSTRY PERFORMANCE

Yr	Supply % Chg	Demand % Chg	Occ	% Chg	ADR	% Chg	RevPAR	% Chg	GOP	Profits \$Billions
1990	3.2%	1.9%	63.5%	(1.1%)	\$57.96	2.9%	\$36.82	2.9%	25.5 %	-5.7
1991	1.4	(1.3)	61.8	(2.6)	58.08	0.2	35.91	(2.5)	27.4	-2.8
1992	0.7	1.9	62.6	1.3	58.91	1.4	36.87	2.7	29.5	0.0
1993	0.3	1.7	63.5	1.4	60.53	2.8	38.42	4.2	30.5	2.4
1994	1.0	3.0	64.7	1.9	62.86	3.8	40.70	5.9	36.2	5.5
1995	1.2	1.7	65.1	0.6	65.81	4.7	42.83	5.2	37.0	8.5
1996	2.1	2.3	65.2	0.2	69.66	5.9	45.47	6.2	38.2	12.5

Source: Smith Travel Research. 1997

#### ANALYSIS OF LODGING INDUSTRY PROFITABILITY Pre-Tax Income (Loss)

Year	Full Service	Limited Service
1990	(10.2%)	(1.5%)
1991	(6.0)	1.9
1992	(1.4)	10.5
1993	2.6	13.8
1994	6.8	14.6
1995	9.6	23.0
1996	15.7	27.0

Source: Smith Travel Research. 1997

#### LUXURY HOTEL SEGMENT Annual Trends 1990-1997\*

Year	Occupancy Percent	Percent Change	ADR \$	Percent Change	RevPAR \$	Percent Change	Rm Demand (% chg)	Rm Supply
1990	69.3%	-1.3%	100.51	6.7%	\$69.61	4.6%	4.1%	6.1%
1991	67.2	-2.1	99.36	-1.1	66.76	-4.1	1.0	4.1
1992	68.9	1.7	11.92	1.6	69.50	4.1	4.6	2.1
1993	70.5	1.6	103.66	2.7	73.03	5.1	4.1	1.7
1994	72.6	2.1	108.22	4.4	78.52	7.5	4.9	1.9
1995	72.8	0.2	114.20	5.5	83.14	5.9	1.4	1.0
1996	74.2	1.4	121.86	6.7	90.40	8.7	4.2	2.2
1997*	74.4	0.2	129.41	6.2	96.28	6.5	3.3	3.0

Source: BT Alex Brown Incorporated Research and Smith Travel Research.  
1997 are BT Alex Brown Inc estimates.

## UPSCALE HOTEL SEGMENT

### Annual Trends

1990-1997\*

Year	Occupancy Percent	Percent Change	ADR \$	Percent Change	RevPAR \$	Percent Change	Rm Demand (% chg)	Rm Supply (% chg)
1990	65.3%	-0.3%	\$70.56	3.1%	\$46.06	2.6%	3.5%	4.0%
1991	64.5	-0.8	70.48	-0.1	45.46	-1.3	1.1	2.3
1992	65.9	1.4	71.37	1.3	47.02	3.4	3.2	1.1
1993	67.2	1.3	73.57	3.1	49.46	5.2	2.7	0.6
1994	68.1	0.9	76.45	3.9	52.07	5.3	2.7	1.3
1995	67.8	-0.3	80.23	4.9	54.41	4.5	1.9	2.3
1996	67.6	-0.2	84.28	5.0	56.96	4.7	3.4	3.7
1997*	67.4	-0.2	88.49	5.0	59.66	4.7	3.7	3.9

Source: BT Alex Brown Incorporated Research and Smith Travel Research.

- \* 1997 are BT Alex Brown Inc estimates

## MIDPRICE HOTEL SEGMENT

### Annual Trends

1990-1997\*

Year	Occupancy Percent	Percent Change	ADR \$	Percent Change	RevPAR \$	Percent Change	Rm Demand (% chg)	Rm Supply (% chg)
1990	62.8%	-1.1%	\$55.29	2.6%	\$34.73	0.9%	1.5%	3.3%
1991	61.4	-1.4	54.75	-1.0	33.61	-3.2	-0.7	1.6
1992	62.5	1.1	54.97	0.4	34.34	2.2	3.0	1.2
1993	63.3	0.9	55.71	1.4	35.29	2.7	2.2	0.8
1994	65.0	1.6	57.54	3.3	37.38	5.9	4.1	1.5
1995	65.7	0.7	60.41	5.0	39.69	6.2	3.2	2.0
1996	65.5	-0.2	64.20	6.3	42.03	5.9	2.5	2.9
1997*	64.8	-0.7	68.05	6.0	44.08	4.9	3.2	4.3

Source: BT Alex Brown Incorporated Research and Smith Travel Research.

- \* 1997 are BT Alex Brown Inc estimates

## ECONOMY HOTEL SEGMENT

### Annual Trends

1990-1997\*

Year	Occupancy Percent	Percent Change	ADR \$	Percent Change	RevPAR \$	Percent Change	Rm Demand (% chg)	Rm Supply (% chg)
1990	61.6%	-0.9%	\$43.16	1.6%	\$26.58	0.1%	1.2%	2.7%
1991	59.6	-2.0	42.84	-0.7	25.51	-4.0	-2.4	0.9
1992	60.0	0.5	42.81	-0.1	25.70	0.7	1.0	0.2
1993	60.6	0.6	43.47	1.5	26.35	2.5	0.9	0.0
1994	61.4	0.8	44.94	3.4	27.59	4.7	1.7	0.4
1995	61.8	0.4	46.98	4.6	29.04	5.3	1.5	0.8
1996	61.3	-0.5	49.46	5.3	30.33	4.4	0.9	1.8
1997*	60.5	-0.8	52.08	5.3	31.50	3.9	1.8	3.2

Source: BT Alex Brown Incorporated Research and Smith Travel Research.

- \* 1997 are BT Alex Brown Inc estimates



**BUDGET HOTEL SEGMENT**  
**Annual Trends**  
**1990-1997\***

Year	Occupancy Percent	Percent Change	ADR \$	Percent Change	RevPAR	Percent Change	Rm Demand (% chg)	Rm Supply (% chg)
1990	61.9%	-0.9%	\$35.45	0.9%	\$21.93	-0.5%	-0.2%	1.2%
1991	59.4	-2.5	35.28	-0.5	20.95	-4.5	-4.8	-0.8
1992	59.1	-0.3	35.18	-0.3	20.78	-0.8	-1.3	-0.8
1993	59.6	0.6	35.54	1.0	21.20	2.0	-0.3	-1.2
1994	61.1	1.5	36.22	1.9	22.14	4.5	2.5	0.0
1995	61.5	0.4	37.56	3.7	23.10	4.3	0.3	-0.3
1996	61.1	-0.4	39.87	6.2	24.36	5.4	-0.8	-0.2
1997	59.9	-1.2	42.47	6.5	25.44	4.4	-1.5	0.5

\*

Source: BT Alex Brown Incorporated Research and Smith Travel Research.

- \* 1997 are BT Alex Brown Inc estimates

**TOTAL RETURN BY PROPERTY TYPE AND TOTAL INDEX**  
**1990-1997**

Year	Office	Retail	R&D	Warehouse	Apartment	NCREIF (Classic)
1990	(1.05)	5.96%	1.04%	2.44%	5.80%	2.30%
1991	(11.44)	(1.84)	(5.62)	(2.94)	(1.82)	(5.58)
1992	(8.00)	(2.23)	(8.78)	(2.43)	1.72	(4.26)
1993	(3.93)	4.84	.83	(1.52)	8.72	.27
1994	3.88	6.00	5.75	8.5	12.07	6.38
1995	7.16	3.99	11.25	12.70	11.66	15.95
1996	13.34	4.85	18.18	12.79	11.53	10.29
1997	17.35	8.39	26.00	13.76	12.76	13.74

Source: National Council of Real Estate Investment Fiduciaries

**TOTAL REIT RETURNS**  
**1990-1997**

Year	All	Equity
1990	(17.35)%	(15.35)%
1991	35.68	35.70
1992	12.18	14.59
1993	18.55	19.65
1994	0.81	3.17
1995	18.31	15.27
1996	35.75	35.27
1997	18.86	20.26

Source: NAREIT. (NAREIT reported a total return of 30.09%  
for lodging REITs in 1997)

**VARIOUS MARKET INDEXES  
TOTAL RETURNS  
(As of 1/31/98)**

<b>Index</b>	<b>Value</b>	<b>12 Months Total Return</b>	<b>3 Years Annualized Return</b>	<b>5 Years Annualized Return</b>	<b>10 Years Annualized Return</b>
S&P 500	980.28	26.9%	30.5%	20.3%	17.7%
Dow Jones Industrial	7906.50	18.2	29.9	21.9	18.4
Amex Composite	668.42	13.4	15.4	10.2	9.5
NYSE Composite	1619.36	18.1	29.6	19.3	17.9
Wilshire 5000	9340.80	28.2	29.8	19.7	17.4
NASDAQ Composite	1619.36	18.1	29.6	19.3	17.9
Lehman Bros Govt/Corp	890.54	11.2	10.3	7.5	8.9
Salomon Bros Mortgages	1021.77	9.4	9.9	7.2	9.1

Source: CDA/Wiesenerberger Mutual Funds Update. (1998)

**COMPOUND ANNUAL RATES OF RETURN BY DECADE**

	1920's	1930's	1940's	1950's	1960's	1970's	1980's	1990's	1987-96
Large Cap Stocks	19.2%	-0.1%	9.2%	19.4%	7.8%	5.9%	17.5%	14.4%	15.3%
Small Cap Stocks	-4.5	1.4	20.7	16.9	15.5	11.5	15.8	15.6	13.0
Long term Corp Bond	5.2	6.9	2.7	1.0	1.7	6.2	13.0	9.8	9.5
Long Term Govt Bond	5.0	4.9	3.2	-0.1	1.4	5.5	12.6	10.0	9.4
Treasury Bills	3.7	0.6	0.4	1.9	3.9	6.3	8.9	4.9	5.5
Inflation	-1.1	-2.0	5.4	2.2	2.5	7.4	5.1	3.3	3.7

Source: SBBI 1997-year book. Ibbotson Associates

**AMERICAN HOTEL & MOTEL ASSOCIATION  
LODGING PROPERTY INDEX  
(Total Returns)**

<b>Year and Quarter</b>	<b>Total Return</b>
1995 Q4	5.9%
1996 Q1	6.36
1996 Q2	9.33
1996 Q3	8.05
1996 Q4	9.37
1997 Q1	9.25
1997 Q2	8.94
1997 Q3	14.08

Source: AH&MA and The Cornell University  
School of Hotel Administration

**BT ALEX BROWN LODGING INDEXES  
(Total Returns)**

<b>Index</b>	<b>Year End 1997</b>	<b>Total Return 52 Weeks As of (10/31/97)</b>
Lodging Index (Large Cap)	33.9%	38.8%
Small-Cap Lodging Index	12.6	10.4
Lodging C-Corp Index	33.4	42.8
Extended Stay Index	-47.5	-6.8
Lodging REIT Index	28.3	57.5

Source: BT Alex Brown Incorporated Research  
And FactSet Research Systems, Inc.

## CATEGORY 5

### The role of financial institutions as suppliers of capital To the lodging industry

#### INSTITUTIONAL CAPITAL SOURCES COMMERCIAL REAL ESTATE

	1993		1994		1995	
Institution	Equity	Debt	Equity	Debt	Equity	Debt
Commercial	11.4%	43.3%	6.4%	39.8%	2.4%	39.7%
Banks						
Life	19.6	26.0	20.6	25.0	21.1	20.3
Insurance						
Pension	46.4	6.5	49.1	3.3	42.7	3.5
Funds						
REITs	4.3	0.50	9.8	0.8	18.5	1.5
Thrifts	4.8	11.1	3.2	14.0	1.2	13.4
Foreign	13.6	12.6	10.9	10.9	12.3	12.5
Investors						
CMBS						5.8
issuers						
Other						3.4
Total	\$258.8	\$915.3	\$262.66	\$918.56	\$235.55	\$992.55
(Billions)						

Source: Emerging Trends in Real Estate. REAL ESTATE RESEARCH CORPORATION  
AND EQUITABLE REAL ESTATE INVESTMENT MANAGEMENT INC. Various  
issues

#### “WHO PROVIDES (HOTEL) FINANCING”

SOURCE	PERCENTAGE
Bank	58%
Other Source**	36.0
Seller	24.0
Insurance Company	24.0
Pension Fund	18.9
Savings & Loan	3.4

Source: PKF Consulting. Hospitality Investment Survey. 1996

\*\* Other sources included investment banks, SBA Loans, Mortgage funds,  
Conduits and private equity.

**PUBLICLY RAISED CAPITAL**  
**(For the Lodging Industry)**  
**\$ Millions**

<b>Source</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Non REIT IPO	0.0	140.7	0.0	159.5	738.2	1,310.4
REIT IPO	0.0	0.0	39.8	295.6	901.8	348.4
Secondary offering	289.0	0.0	663.3	597.5	1,125.8	4,503.2
Debt Offering	800.0	0.0	419.5	1,082.5	2,076.0	4,338.6
Total Flow of Public funds	1,089.0	140.7	1,122.6	2,135.1	4,481.8	10,500.6

Source: National Hotel Realty, Smith Travel Research and the Conference Board

**HOTEL LENDING/INVESTMENT CRITERIA**  
**1986-1996**

	<b>1986</b>	<b>1988</b>	<b>1990</b>	<b>1992</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>
Overall Cap rate	10.90%	11.10%	10.20%	11.90%	11.20%	11.04%	11.10%
Discount rate (IRR)	13.80%	14.60%	15.0%	16.0%	14.70%	14.57%	14.10%
Holding period (yrs)	9.3	8.8	9.6	8.4	7.10	6.27	6.7
Debt Coverage Ratio	1.30	1.30	1.30	1.60	1.40	1.38	1.40
Income Growth rate	4.00%	4.40%	4.80%	3.80%	3.90%	3.89%	4.00%
Expense Growth rate	4.30%	4.30%	4.70%	3.60%	3.70%	3.44%	3.30%
Interest Rate	10.1%	11.6%	11.5%	8.9%	9.9%	9.59%	9.10%
Loan to Value	72.5%	73.6%	69.0%	67.4%	68.0%	69.12%	69.70%

Source: PKF Consulting

**SURVEY OF HOTEL LENDING TERMS  
CONDUCTED BY HMBA  
(1997)**

Lender	Loan Size Million \$	Interest Rate	Loan To Value (%)	Debt Coverag e Ratio	Amortization Period (Years)	Loan Term Years
Community & Regional Banks	Up to 7	Prime + 1-2 pts	65-80	1.3-1.5	15-25	5-20
Money Center Banks	5 minimum	LIBOR + 1-3 pts	Up to 75	1.35-1.6	15-20	3-7
<b>SBA Loan Providers</b>						
7 (a) Owner	Up to 1.5	Prime + 1.75- 2.75pts	Up to 80	1.2-1.4	15-25	5-25
Occupied 504	Up to 3	Prim + 2-2.75 pts	Up to 85	1.2-1.4	15-25	10-20
Mortgage Conduit Programs	2 minimum	2-3.25 pts over treasuries	70-75	1.35-1.5	20-25	10-20
Credit Companies	5 minimum	2.5-3.5 over treasuries	Up to 75	1.3	20	5-7
Life Insurance Cos.	10 minimum	1.8-2.5 pts over treasuries	70-75	1.35-1.4	25	5-20
Mezzanine Placement	5 minimum	Prime + 1.5-5 pts tied to LTV ratio	Up to 85	1.2-1.4	25	5

Source: Lodging Hospitality. May 1997.

**MORTGAGE TERMS FOR HOTEL PROPERTIES  
1995 VS 1996**

TERMS	HIGH		LOW		AVERAGE	
	1995	1996	1995	1996	1995	1996
<b>Loan to Value</b>						
Full Service	100.0%	80%	50.0%	55%	68.0%	68.23%
Limited Service	100.0%	80%	50.0%	55%	70.0%	69.65%
Resort	80.0%	80%	45.0%	65%	66.0%	70.32%
All Properties	93.0%	80%	48.3%		68.0%	69.12%
<b>Interest Rate</b>						
Full Service	12.0%	11.50%	8.0%	8.0%	9.7%	9.65%
Limited Service	12.0%	11.0%	8.0%	8.5%	9.55	9.65%
Resort	13.0%	10.45%	8.9%	8.0%	10.6%	9.34%
All Properties	12.3%		8.3%		9.9%	9.59%
<b>Amortization</b>						
Full Service	30.0	30.0	15.0	15.0	21.6	21.53
Limited Service	30.0	27.5	15.0	15.0	20.4	19.60
Resort	30.0	27.5	15.0	17.5	21.4	21.29
All Properties	30.0		15.0		21.1	20.83
<b>Loan Term</b>						
Full Service	21.5	20.0	5.0	3.0	8.2	7.73
Limited Service	21.5	20.0	5.0	5.0	8.7	8.57
Resort	21.5	20.0	5.0	5.0	9.1	8.43
All Properties	21.5		5.0		8.7	
<b>Debt Coverage</b>						
Full Service	1.7	1.67	1.2	1.2	1.4	1.38
Limited Service	1.7	1.70	1.2	1.2	1.4	1.37
Resort	1.8	1.50	1.1	1.2	1.5	1.39
All Properties	1.7		1.2		1.4	1.38

## **MORTGAGE FINANCING TERMINOLOGY**

**Construction Loan:** A short term loan made while the project is being constructed. The loan is paid off when the project is completed and the hotel opens. Historically, commercial banks have been considered the construction lender because these loans (which are short term) match the liability structure of the banks.

**Mini-Perm Loan:** In some cases rather than negotiating a construction loan and a permanent loan, a single loan may be obtained from an interim lender and used to finance construction and short term (2 to 5 years) permanent financing. This variation, used in place of obtaining a construction loan and permanent loan is the so called “mini-perm” loan. It was extensively used during the 1980 development boom throughout the United States as lenders aggressively competed against one another for a larger share of the construction loan market.

**Permanent Loan:** A permanent loan takes effect after the term of a construction loan or mini-perm loan and is used to pay off the previous lender. This loan is generally amortized over a twenty or thirty year term.

**Term or Bullet Loan:** These are intermediate term (3-15 years) fixed rate loans with no (or minimal) amortization prior to maturity. If a construction lender does not want to provide a mini-permanent loan after the construction has been completed, the borrower can get a term or bullet loan as a take out. By using a term/bullet loan the property can establish a track record, after which it can seek more favorable terms on a long-term permanent loan.

Sources: Chapter 16. Capital Sources and Financing. John Tarras, Daniel S. Abrams and John N. Whitman, In Hotel Investments Handbook. (1997). Real Estate Finance and Investments. William B. Bruggeman and Jeffrey D. Fisher. (1994). Real Estate Investor's Deskbook. Alvin Arnold. (1994)

**APPENDIX B**  
**IREFAC Membership Listing**



CONTACT : FOR IREFAC LISTING

MR. MICHAEL GEHRISCH  
VICE PRESIDENT  
AND CHIEF FINANCIAL OFFICER  
AMERICAN HOTEL AND MOTEL ASSOCIATION

1201 NEW YORK AVENUE  
SUITE 600  
WASHINGTON DC 20005-3931

TEL: (202) 289-3173

**APPENDIX C**  
**Interview Format**

## LODGING FINANCE Discussion Outline

### Purpose of Meeting

The purpose of the meeting is to achieve **4 objectives**. Estimated discussion time: 45 minute to 1 hour.

Discuss the impact of the various factors on the financial institution's decision to lend and invest in the lodging industry.

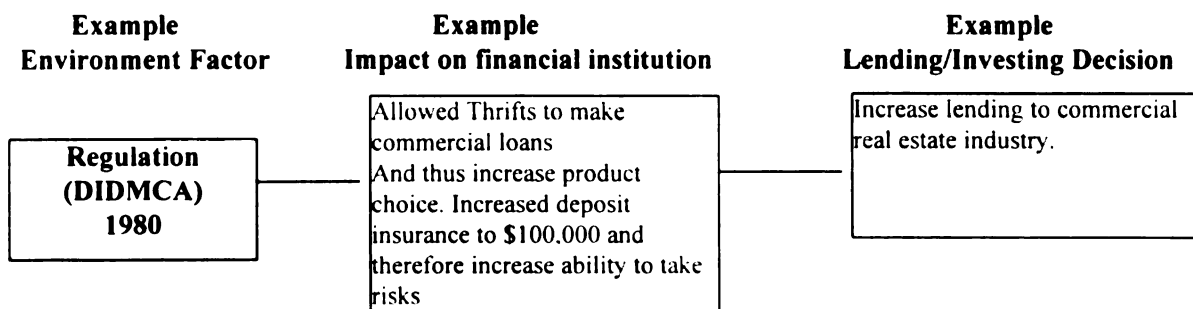
- I. To familiarize myself with you, by understanding the role you play in your organization and the role of your organization with regard to lodging finance.
- II. Discuss the impact of the various factors on the financial institution's decision to lend and invest in the lodging industry.
- III. Discuss the current environment with regard to financial institution capital availability for the lodging industry.
- IV. What are some of the questions you would like to know about the future of lodging finance?

### **Objective I ( Discussion Questions)**

- a. Describe your organization (size, scope, structure of org, type of institution etc)
- b. Describe your department (role, function etc)
- c. Describe your experience, role with regard to lodging finance.

### **Objective II (Discussion Questions)**

- a. What Financial Institutions are the major participants in financing the lodging industry?
- b. Would you agree that the decision of a financial institution to lend or invest is influenced by environmental factors as shown in the attached graphic, titled "**The Environment of Financial Institutions?**"
- c. I would like to generate **a list of impacts** that each factor has on the institution's decision to lend or invest. Obviously, we will discuss the environment of the financial institutions with which you are familiar. Here is an example of what I mean:



**Objective III (Discussion Question)**

How would you **characterize the current environment** of financial institutions? **For Example:** What impact is the non-bank competition having on the banking industry?, what is the impact of interstate deregulation on the banks ability to lend?, What about capital adequacy requirements? To what extent is a merging of the functions of financial institutions taking place?

**Objective IV (Discussion Question)**

If you could ask 5 questions about the future of lodging finance, what would they be?

**I WOULD APPRECIATE ANY PRINTED MATERIAL THAT YOU COULD PROVIDE ME WITH REGARD TO LODGING INDUSTRY FINANCE, RESEARCH REPORTS, INDUSTRY PROFILE AND INFORMATION ABOUT YOUR FINANCIAL INSTITUTION.**

**APPENDIX D**

**Initial Mailing Packet to Expert Panel**

November 24, 1997

Dear Mr

I am working with the American Hotel and Motel Association to formulate a research team to **predict changes in the role of financial institutions in the lodging capital market and its impact on the growth and development of the lodging industry**. The research method for the study is called the DELPHI TECHNIQUE (see attached explanation). I would like to invite you to participate in this study due to your broad expertise in the area of hotel financing.

As a member of the Delphi team you will make a special contribution towards shaping our view of the **future lodging capital market**, due to your experience and unique role in the industry. You will take part in this **anonymous forecasting exercise** with others, who like you offer a unique perspective. Some are institutions that supply capital, others are agents such as brokers or security dealers that work with institutions at one end and users (lodging industry) at the other end, and yet other team members are money managers who invest institutional capital. Senior hotel chain executives bring a users perspective to this study and as such are valuable team members. Finally, consultants and academic team members add value to the study, as they are good observers of both the lodging industry and the financial institutions that supply capital. **As a group, this Delphi Research Team will make predictions about significant events, their impact on the role of financial institutions as suppliers of capital to the lodging industry and the consequent influence on the growth and development of the lodging .**

The study is being conducted as part of my doctoral dissertation at Michigan State University, however, all study participants will get a printed copy of the study results. I sincerely hope that you are able to participate in this important forecasting study. I have attached **two forms**, please return both forms back in the return envelope enclosed, by **December 10<sup>th</sup>, 1997**.

Sincerely,

A.J.Singh

**Contact me at:**

Campus: (517) 353-9211  
Home: (517) 347-7057  
Email: singharj@pilot.msu.edu

## THE DELPHI STUDY

### What is a Delphi Study?

It is a technique used to combine expert knowledge and opinion to arrive at an informed group consensus about events in the future. The Delphi technique is based upon the assumption that although future events are uncertain, their probabilities can be approximated by individuals who are able to make informed judgements about future contingencies.

### The Delphi Process in Brief

A list is initially made of a small number of people, who are knowledgeable in a particular area (such as hotel finance). This Delphi research team is then asked to respond to questions about a specific issue/problem. The Delphi respondents submit their answers to the Delphi coordinator (generally via mail, fax or email), who then tabulates the responses and returns them back to the respondents. The respondents have the benefit of viewing each others answers to the questions without ever disclosing their identity. Furthermore, they are not pressured to answer in a particular way.

These questionnaire rounds are designed to achieve consensus by giving the Delphi panelists an opportunity to modify their responses after viewing the aggregate responses of the panel. The questionnaire rounds continue until variation between the rounds is minimum. This then is the consensus view of the Delphi panel which finally emerges. Generally, Delphi studies go upto 4 rounds, before consensus is reached.

### Time Commitment

The Delphi panel does not have to physically meet or travel to a particular location. The coordinator, via mail, fax or email sends the questionnaires. These are mailed back to the coordinator, who tabulates the responses from the panel and mails it back, asking them to reconsider their responses, this is **round two**. These rounds continue until consensus is reached. The whole process could take up to two months. The panels main work is fill out the questionnaire and review the responses mailed back to them after I tabulate each round.

## **Delphi Study Participation**

**Please include me as a Delphi Study Participant.** \_\_\_\_\_

**I will not be able to participate however, I have recommended some individuals on the attached form.** \_\_\_\_\_

**Please call me at the following number. I have some questions before deciding.** \_\_\_\_\_

**Phone:** \_\_\_\_\_

**Name:** \_\_\_\_\_

**Company:** \_\_\_\_\_

**Position:** \_\_\_\_\_

**Phone:** \_\_\_\_\_



**APPENDIX E**  
**Copy of Questionnaire**

DELPHI STUDY

**LODGING CAPITAL MARKETS INTO THE NEXT MILLENNIUM  
Year 2000 and 2005**

**A.J.Singh \* Michigan State University  
(517) 347-7057 \* email: singharj@pilot.msu.edu**

March 10, 1998

Dear

We are finally, ready to begin the Delphi Study on the future of lodging capital markets. You are participating in this study, as part of a research team along with 39 other industry experts representing various aspects of lodging industry finance.

This mailing represents **ROUND 1** of the research study. I have enclosed the **Delphi Questionnaire** and a **Compendium** with information about the study, some background material and historical information that may help you when you make your predictions about years 2000 and 2005.

I would like to remind you that this study is more than merely a survey. In fact it is like a virtual conference, in which you are asked to make long term predictions. In effect, you are going "back to school" for two or three forecasting sessions. The only difference is that you are making these forecasts from the privacy of your home or office, and therefore not pressured by any outside influence. At the same time, as you will see in Round 2, you gain the perspective of the other participants in the study.

I am grateful to all of you, for agreeing to participate in the study. I am especially, grateful to all the participants who have worked with me so far in designing the study, identifying the key issues, and pilot testing the questionnaire.

Please mail your responses to me by, March 20<sup>th</sup>. I will compile and mail back the responses/results to you by March 25<sup>th</sup>.

Wishing you prognostication with a clear mind,

Sincerely,

A.J.Singh

## **GENERAL INSTRUCTIONS (Round 1)**

Before you begin, please take a moment and read the general instructions.

1. This is ROUND ONE of the study. After I have received responses from all the other participants, I will send you the summarized results of their responses, in ROUND TWO. At that point you will have an opportunity to reformulate your predictions on the same issues.
2. The Delphi exercise is intended to be an interactive session (a “virtual” roundtable if you will). As such, there may be some issues and questions on which you feel more comfortable in responding, while on others you may feel tentative. I urge you to respond to all questions, as you will have an opportunity to change your views in subsequent rounds. Please respond to the open ended questions, as I will summarize the collective views of the group and report it in ROUND 2.
3. For questions in which you are asked to make numerical predictions, base year numbers are provided. These numbers are provided only for your reference. You may chose to ignore this information, and base your prediction on other information. After all you are the expert.
4. Although the questionnaire has been divided into separate categories, some of the questions may be related. For example, in a subsequent round, if your views change about the future macro economic environment (Category 1) they will probably impact your views on the role of financial institutions in providing financing (Category 4).
5. To assist you with your “crystal ball” gazing, I have enclosed a compendium of useful historical statistics. You may want to refer to this for trend information.

This questionnaire is divided into five categories. Within each category is a list of specific questions related to that particular category. Your task is to make predictions based upon your expert opinion about each of the questions. Here are the five categories:

### **IN THE YEARS 2000 AND 2005 WHAT WILL BE?**

- 1. The economic, regulatory and competitive environment of financial institutions.**
- 2. The structure of the lodging industry.**
- 3. The operating and investment performance of the lodging industry.**
- 4. The lodging industry’s need for capital.**
- 5. The role of financial institutions as suppliers of capital to the lodging industry.**

## CATEGORY 1

### IN THE YEARS 2000 AND 2005 WHAT WILL BE?

**The economic, regulatory and competitive environment of financial institutions.**

Category 1 asks you to make predictions about the scenario in years 2000 and 2005 about the **General Economic Environment** and the **Specific Environment** related to the regulatory and competitive environment of financial institutions.

### GENERAL MACROECONOMIC ENVIRONMENT

#### 1 A

Please pick a number from the scale below to estimate the economic climate in the future, as compared to the current period (End 1997 to Early 1998). Write your responses in the space provided. **Please refer to page 1 of the compendium for historic information.**

#### Scale

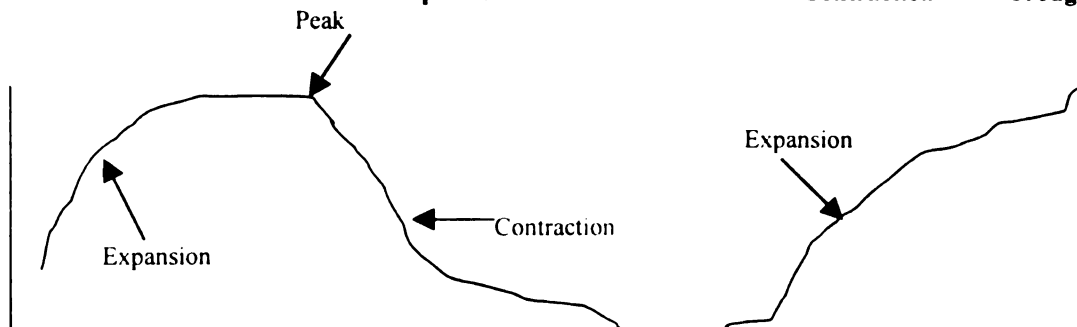
**1=Very Favorable, 2=Favorable, 3=About the same as today, 4=Unfavorable, 5=Very Unfavorable**

ECONOMIC CLIMATE	YEAR 2000	YEAR 2005
Personal income tax rate		
Corporate income tax rate		
Federal deficit		
Personal savings rate		
Disposable income		
401 (K) plans		
Investor attitude		
Lender attitude		

#### 1 B

The graph below depicts the typical phases in the business cycle. Select a phase from the cycle as your estimate of the current status of the US economy and in the years 2000 and 2005. Respond by circling the appropriate phase below.

Years	Phases (Circle your selection)			
1998	Expansion	Peak	Contraction	Trough
2000	Expansion	Peak	Contraction	Trough
2005	Expansion	Peak	Contraction	Trough



## 1C

Please pick a number from the scale below to estimate the future trend of key economic indicators, as compared to the current period (End 1997 to early 1998). **Please refer to page 1 of the compendium for historic information**

### Scale

**1=Very Favorable, 2=Favorable, 3=About the same as today, 4=Unfavorable, 5=Very Unfavorable**

ECONOMIC INDICATOR	1997	YEAR 2000	YEAR 2005
Real GDP (%change previous year)	3.6		
CPI (% change previous year)	2.5		
10 year T Bond (%)	6.8		
30 year T Bond (%)	7.7		
Unemployment rate (%)	4.9		

## REGULATORY ENVIRONMENT OF FINANCIAL INSTITUTIONS

### 1 D

Please pick a number from the scale below to show how much you agree or disagree with each statement and write them in the space provided under each of the prediction periods.

### Scale

**1 = Strongly agree, 2 = Agree, 3 = Undecided, 4 = Disagree, 5 = Strongly Disagree**

EVENT STATEMENT		
	2000	2005
1. Overall, financial institutions will operate in a more deregulated environment, as compared to the current period.		
2. The provision of the Glass Steagall Act that separates commercial banking and investment banking activities will be repealed.		
3. The regulations that separate the financial institutions based upon the financial products and services that they are allowed to sell, will disappear.		
4. The regulatory agencies that monitor financial institutions will merge.		
5. Overall, regulatory differences between financial institutions (such as banks and finance companies), will be lower than the current period.		
6. There will be no (or very minimal) restrictions on financial institutions to expand their operation to any part of the United States.		
7. U.S. restrictions on foreign financial institutions wishing to operate in the United States will decrease.		
8. In general, U.S. financial institutions will be able to operate globally, with lower restrictions than currently.		
10. There will be an increase in government backed financing programs, such as the SBA		
11. Overall, there will be tax advantaged legislation for real estate investment that provides an impetus for financial institutions to increase real estate lending/investments.		

## 1E

Please pick a number from the scale below to estimate the level of regulation in the future for each of the financial institutions, as compared to the current period (End of 1997 to Early 1998) and write them in the space provided.

### Scale

**1= Much Higher, 2=Higher 3=About the Same as today, 4=Lower 5= Much Lower**

FINANCIAL INSTITUTIONS	YEAR 2000	YEAR 2005
Commercial Bank		
Thrift Institution		
Finance Company		
Pension Fund		
Life Insurance Company		
Investment Company (mutual funds)		
Conduit		
Investment Banks		

## COMPETITIVE ENVIRONMENT OF FINANCIAL INSTITUTIONS

## 1 F

Please pick a number from the scale below to show how much you agree or disagree with each of the statements and write them in the space provided under each of the prediction periods.

### Scale

**1= Strongly agree, 2 = Agree, 3 = Undecided, 4 = Disagree, 5 = Strongly Disagree**

EVENT STATEMENT	2000	2005
1. The share of total assets held by commercial banks will continue to decrease in relationship to other financial institutions		
2. Banks and thrifts will merge into one type of financial institution.		
3. Many of the investment banks and money center banks will merge into one institution.		
4. There will be fewer financial institutions as compared to the current period.		
5. The size of the average financial institution will be larger than the current period.		
6. There will be an increase in the number of financial institutions selling multiple financial products (For example: mutual funds, insurance, mortgages, in a "one stop shopping" model)		
7. Financial institutions will narrow their products and specialize in a few niche products.		
8. Most financial institutions will compete for similar products		
9. There will be an increase in corporate customers raising capital directly, versus relying on financial intermediaries for capital.		
10. There will be an increase in foreign financial institutions operating in the USA		

**1 G**

**Please select a type of financial institution(s), that you are most familiar with, from page 1 of the compendium. Based on your knowledge of the various issues (such as regulatory, competitive) that are currently impacting this institution, what are your predictions with regard to this institution, as a source of capital in the years 2000 and 2005.**

## CATEGORY 2

### IN THE YEAR 2000 AND 2005 WHAT WILL BE?

The structure of the lodging industry

#### 2 A

Please estimate the percentage change in the number of rooms, for each of the lodging industry tiers listed. Write your response for years 2000 and 2005. **Please refer to page 2 in the compendium for historical data from Smith Travel Research.**

TIERS	% CHANGE 1996-1997	2000 %Change	2005 %Change
Upper Upscale	12%		
Upscale	10		
Midscale with F&B	4		
Midscale w/o F&B	37		
Economy	28		
Budget	18		
Independent	-6		

#### 2 B

Please estimate the number of rooms in the lodging industry, for each of the locations listed. Write your response for the years 2000 and 2005. **Please refer to page 2 in the compendium for historical data from Smith Travel Research.**

LOCATION	% CHANGE 1996-1997	2000 %Change	2005 %Change
Urban	1.9		
Suburban	5.1		
Airport	1.7		
Highway	3.2		
Resort	1.8		



## 2C

Please estimate the share of lodging room supply in years 2000 and 2005, for each of the regions listed. The current share is indicated for your reference. **Please refer to page 2 and Appendix A in the compendium for historical data and a Map, from Smith Travel Research.**

REGIONS	ROOMS January 1998	January 1998 Percentage distribution of rooms	2000 Percentage distribution of rooms	2005 Percentage distribution of rooms
New England	142,989	3.9%		
Mid Atlantic	307,701	8.6		
South Atlantic	860,843	24.0		
E. North Central	425,966	11.9		
E. South Central	228,921	6.4		
W. North Central	247,298	6.9		
W. South Central	367,149	10.2		
Mountain	436,006	12.1		
Pacific	576,637	16.0		
Total	3,593,510	100%	100%	100%

## 2D

Please estimate the **average selling price** (price per room) for each Tier of hotels listed for the prediction periods. Write your response for the years 2000 and 2005. **Please refer to pages 6 and 7 in the compendium for historical data from National Hotel Realty (Lodging Econometrics) and Hospitality Valuation Services.**

TIERS	1997 Ytd 3 <sup>rd</sup> Qtr	2000	2005
Budget	\$13,481		
Economy: Limited Service	24,270		
Economy: Full Service	35,019		
Mid-Market: Limited Service	42,147		
Mid Market: Full Service	46,453		
First Class: Upscale	97,121		
Luxury	248,317		

## 2 E

Please estimate the average replacement cost (price per room) for each type of hotel listed for the prediction periods. Write your response for the years 2000 and 2005. **Please refer to Appendix B in the compendium for historical replacement cost trends from Hospitality Valuation Services.**

TIERS	2000	2005
Budget		
Economy: Limited Service		
Economy: Full Service		
Mid-Market: Limited Service		
Mid Market: Full Service		
First Class: Upscale		
Luxury		

## 2F

From the list provided please rank the top ten owners of hotels in years 2000 and 2005. **Please refer to page 8 in the compendium for some background information.**

### Scale

1= Most hotel rooms

10= Least hotel rooms

HOTEL OWNER	RANKING YR 2000	RANKING YR 2005
Equity REIT (public)		
C-corp		
S-Corp		
Partnership		
Individual Investor (US)		
Institutional Investor (US)		
Individual Investor (Foreign)		
Institutional Investor (Foreign)		
Opportunity Fund		
<b>Other: Please specify</b>		

## 2 G

Based upon your knowledge of the structure of the lodging industry, please provide your predictions for years 2000 and 2005 for each of the issues listed below. Please write your views on the next page.

ISSUES RELATED TO STRUCTURE OF LODGING INDUSTRY
1. Industry consolidation.
2. Strategic alliances.
3. Ownership profile of lodging industry (Private to Public).
4. The type of hotels being developed.
5. The age of room inventory.
6. Segmentation of the Industry (branding issues).
7. International expansion.
8. The creation and growth of new type of lodging products. (Time-share, assisted living, extended stay).
9. The status of independents (rate of conversion to franchise).
10. Industry competition.
11. Any other key issue related to lodging industry structure.

### CATEGORY 3

#### IN THE YEAR 2000 AND 2005 WHAT WILL BE?

**The operating and investment performance of the lodging industry.**

**Category 3 asks you to make predictions about the operating and investment performance of the lodging industry in the years 2000 and 2005.**

#### 3 A

Please estimate each of the lodging industry performance indicators for each of the tiers listed. Write your response in the space provided. **Please refer to page 9 in the compendium for historical data from Smith Travel Research and BT Alex Brown.**

<b>BUDGET</b>	1996	2000	2005
Occupancy (%)	61.1		
Average Daily Rate (\$)	39.87		
Revpar (\$)	24.36		
Pre-Tax Income (%)	NA		

<b>ECONOMY</b>	1996	2000	2005
Occupancy (%)	61.3		
Average Daily Rate (\$)	49.46		
Revpar (\$)	30.33		
Pre-Tax Income (%)	3.7		

<b>MIDSCALE</b>	1996	2000	2005
Occupancy (%)	65.5		
Average Daily Rate (\$)	64.20		
Revpar (\$)	42.03		
Pre-Tax Income (%)	12.9		

<b>UPSCALE</b>	1996	2000	2005
Occupancy (%)	67.6		
Average Daily Rate (\$)	84.28		
Revpar (\$)	56.96		
Pre-Tax Income (%)	15.7		

<b>LUXURY</b>	1996	2000	2005
Occupancy (%)	74.2		
Average Daily Rate (\$)	121.86		
Revpar (\$)	90.40		
Pre-Tax Income (%)	22.1		

### 3 B

Based upon the total returns expected, in the years 2000 and 2005, for each of the investment categories listed, rank them from highest to lowest. **Please refer to page 11 in the compendium for historical rates of return.**

**Scale**  
**1= Highest**

TYPE OF INVESTMENT (Direct investment)	1997 Total return	2000	2005
Hotel Real Estate	NA		
Office	17.35%		
Retail	8.39		
R&D	26.00		
Warehouse	13.76		
Apartment	12.76		

### 3 C

Based upon the total returns expected, in the years 2000 and 2005, for each of the investment categories listed, rank them from highest to lowest. **Please refer to pages 11-13 in the compendium for historical rates of return.**

**Scale**  
**1= Highest**

TYPE OF INVESTMENT (Purchase of Common Stock)	2000 Percentage	2005 Percentage
Hotel C-Corp (large cap)		
Hotel C-Corp (small cap)		
Hotel C-Corp (extended stay)		
Equity REIT (Regular)		
Equity REIT (Paired -Share)		

## CATEGORY 4

### IN THE YEAR 2000 AND 2005 WHAT WILL BE?

#### The lodging industry's need for capital

Category 4 asks you to make predictions related to the lodging industry's need for both debt and equity capital in years 2000 and 2005.

#### 4 A

Pick a number from the scale below to estimate the future demand for capital for each of the listed financing activities, as compared to the current demand. Write your response in the space provided.

##### Scale

1=Much higher, 2=Higher, 3=About the same, 4=Lower, 5=Much Lower.

FINANCING ACTIVITY	2000	2005
Construction		
Conversion		
Mergers and Acquisitions (corporate)		
Acquisition of individual hotels		
Acquisition of portfolio of hotels		
Expansion overseas: Acquisition		
Expansion overseas: Construction		
Renovation/upgrading		

#### 4 B

Pick a number from the scale below to estimate the future demand for capital for each of the listed lodging tiers, as compared to the current demand. Write your response in the space provided

##### Scale

1=Much higher, 2=Higher, 3=About the same, 4=Lower, 5=Much Lower.

TIERS	2000	2005
Upper Upscale		
Upscale		
Midscale with F&B		
Midscale w/o F&B		
Economy		
Budget		
Independent		

#### 4 C

Pick a number from the scale below to estimate the future demand for capital for each of the listed location types, as compared to the current demand. Write your response in the space provided.

##### Scale

**1=Much higher, 2=Higher, 3=About the same, 4=Lower, 5=Much Lower**

LOCATION	2000	2005
Urban		
Suburban		
Airport		
Highway		
Resort		

#### 4 D

Pick a number from the scale below to estimate the future demand for capital by each type of owner listed, as compared to the current demand. Write your response in the space provided.

##### Scale

**1=Much higher, 2=Higher, 3=About the same, 4=Lower, 5=Much Lower.**

OWNERS	2000	2005
Equity REIT (Public)		
C-Corp		
S-Corp		
Partnership		
Individual Investor (US)		
Institutional Investor (US)		
Individual Investor (Foreign)		
Institutional Investor (Foreign)		
Opportunity Fund		
Other: (Specify)		

## CATEGORY 5

### IN THE YEAR 2000 AND 2005 WHAT WILL BE?

#### The role of financial institutions as suppliers of capital to the lodging industry

Category 5 asks you to make predictions about the role of financial institutions as suppliers of debt and equity capital to the lodging industry.

#### 5 A

For each of the financial institutions listed, what is the percentage of total equity capital that each will provide to the lodging industry in the years 2000 and 2005. Please ensure that sum of entries in each column totals 100%. **Please refer to pages 14 and 15 in the compendium for base statistics.**

#### Equity Capital = Direct investment in real estate

INSTITUTION	2000 (PERCENTAGE)	2005 (PERCENTAGE)
Commercial Bank		
Thrift Institution		
Finance Company		
Pension Fund		
Life Insurance Company		
Investment Company (mutual fund)		
Conduit		
Investment Bank		
	100%	100%

#### 5 B

For each of the financial institutions listed, what is the percentage of total equity capital that each will provide to the lodging industry in the years 2000 and 2005. Please ensure that sum of entries in each column totals 100%. **Please refer to pages 14 and 15 in the compendium for base statistics.**

#### Equity Capital = Investment in Lodging Stock

INSTITUTION	2000 (PERCENTAGE)	2005 (PERCENTAGE)
Commercial Bank		
Thrift Institution		
Finance Company		
Pension Fund		
Life Insurance Company		
Investment Company (mutual fund)		
Conduit		
Investment Bank		
	100%	100%

### 5 C

For each of the financial institutions listed, what is the percentage of total debt capital that each will provide to the lodging industry in the years 2000 and 2005. Please ensure that sum of entries in each column totals 100%. **Please refer to page 14 in the compendium for base statistics.**

**Debt Capital = Direct Mortgage Loans for lodging construction or acquisition**

INSTITUTION	2000 (PERCENTAGE)	2005 (PERCENTAGE)
Commercial Bank		
Thrift Institution		
Finance Company		
Pension Fund		
Life Insurance Company		
Investment Company (mutual fund)		
Conduit		
Investment Bank		
	100%	100%

### 5 D

For each of the financial institutions listed, what is the percentage of total debt capital that each will provide to the lodging industry in the years 2000 and 2005. Please ensure that sum of entries in each column totals 100%. **Please refer to page14 in the compendium for base statistics.**

**Debt Capital = Purchase of Debt Securities**

INSTITUTION	2000 (PERCENTAGE)	2005 (PERCENTAGE)
Commercial Bank		
Thrift Institution		
Finance Company		
Pension Fund		
Life Insurance Company		
Investment Company (mutual fund)		
Conduit		
Investment Bank		
	100%	100%



## 5E

For each of the financial institutions listed please estimate the future lending criteria and terms, for direct single hotel mortgages. Write your responses in the space provided. **Please refer to pages 15 and 16 in the compendium for current and historical lending terms.**

**DSC = Debt service coverage**

**LTV = Loan to value**

LENDER	DSC		LTV		Loan Term		Amortization Period
	2000	2005	2000	2005	2000	2005	
			(PERCENTAGE)		(YEARS)		2000      2005 (YEARS)
Community Bank							
Regional Bank							
Money Center Bank							
Thrift Institutions							
Finance Company							
Conduit							
Pension Fund							
Life Insurance Company							
Investment Bank							

## 5 F

For each of the financial institutions listed estimate of the future cost of debt capital and size of loans for direct single hotel mortgages. Write your response in the space provided. **Please refer to pages 15 and 16 in the compendium for current and historical lending terms**

LENDER	INTEREST RATE		LOAN SIZE	
	2000 (%)	2005 (%)	2000 (MIN-MAX) (\$MILLIONS )	2005
Community Bank				
Regional Bank				
Money Center Bank				
Thrift Institutions				
Finance Company				
Conduit				
Pension Fund				
Life Insurance Company				
Investment Bank				

## 5 G

For each of the financial institutions listed in what Tier of hotel product will they prefer to invest or make single mortgage loans in the future? Select a number from the scale provided to indicate the probability and write it in the space provided

### Scale

**1=High probability, 2= Moderate probability, 3=Low probability, 4=Not probable.**

LENDER	LUXURY		UPSCALE		MIDSCALE		ECONOMY	BUDGET	EXTENDED STAY
	2000	2005	2000	2005	2000	2005	2000 2005	2000 2005	2000 2005
Community Bank									
Regional Bank									
Money Center Bank									
Thrift Institutions									
Finance Company									
Conduit									
Pension Fund									
Life Insurance Company									
Investment Bank									

## 5 H

For each of the financial institutions listed, in what type of hotel products will they prefer to invest or make single mortgage loans? Select a number from the scale provided to indicate your choice and write it in the space provided.

### Scale

**1=High probability, 2= Moderate probability, 3=Low probability, 4=Not probable**

LENDER	CONVENTION		CASINO	RESORTS	ALL SUITE	HOTELS	MOTELS
	2000	2005	2000 2005	2000 2005	2000 2005	2000 2005	2000 2005
Community Bank							
Regional Bank							
Money Center Bank							
Thrift Institutions							
Finance Company							
Conduit							
Pension Fund							
Life Insurance Company							

## 5 I

For each of the financial institutions listed, what type of (single direct mortgage) financing are they most likely to be primary providers in the future? Select a number from the scale provided to indicate the probability and write it in the space. **Exact definitions of these loans are provided on page 17 in the compendium.**

### Scale

**1=High probability, 2= Moderate probability, 3=Low probability, 4=Not probable.**

LENDER	CONSTRUCTION	MINI-PERM	TERM/BULLET	PERMANENT
	2000 2005	2000 2005	2000 2005	2000 2005
Community Bank				
Regional Bank				
Money Center Bank				
Thrift Institutions				
Finance Company				
Conduit				
Pension Fund				
Life Insurance Company				
Investment Bank				

## 5 J

For each of the financial institutions listed, what stage of financing will they be primarily involved in the future? Indicate your selection by placing an "X" in the space provided.

FINANCIAL INSTITUTION	ORIGINATION	SERVICING	UNDERWRITING	CONDUIT PROGRAMS	ASSET MGT.
	2000 2005	2000 2005	2000 2005	2000 2005	2000 2005
Community Bank					
Regional Bank					
Money Center Bank					
Thrift Institution					
Finance Company					
Conduit					
Pension Fund					
Life Insurance Company					
Investment Bank					

**You have made various predictions (in the preceding 5 categories) about the future, with regard to the environment of financial institutions, the structure of the lodging industry, the industry's operating performance, it's relative attractiveness as an investment, its need for capital and finally the role of financial institutions as suppliers of capital to the lodging industry.**

**In the space provided, please write your views on the availability or lack of availability of capital for the lodging industry in years 2000 and 2005.**

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