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Economics and Hotel Financial Performance

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If Hotels are a Good Long-Term Investment, Why, and Where?

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Key Takeaways

- A hotel held for seven years or more that generates excess returns relative to the NCREIF hotel index makes a good long-term investment.
- The assertion that long-term investment in hotels catering to leisure travelers will offer excess returns is supported by continuation of substitution and income effects in the labor market.
- The innate desire to travel will likely more than ever be satisfied by leisure trips and hybrid business/leisure trips brought on by virtual work and enhanced telecommunication technology.
- Hotels in leisure destinations will likely generate the greatest long-term excess returns assuming an asset price bubble does not form in these properties.

A recent *Globe Street* article chronicles observations from industry professionals that hotels are now a 'hot' asset class and a good long-term investment due to a 'compelling growth story'.[1] This is excellent news for CBRE hotel clients who own or invest in hotel property if near-term economic problems do not become long-term ones. The headliners include historic inflation with associated interest rate increases and a slow-growth economy elevating recession probabilities. Erosion of savings and growing debt loads signal softening consumer discretionary spending while the latest earnings reports don't bode well for corporate travel budget health. The assertions in the Globe Street article may be correct although empty without the support of a well-reasoned growth story. I agree with the claim that hotels are a good long-term investment, and I have a growth story that supports the claim.

Short Term vs. Long Term

"A fact without a theory is like a ship without a sail; is like a boat without a rudder; is like a kite without a tail."

GEORGE SCHULTZ

No generally agreed on distinction exits between short-term and long-term investments. Under the U.S. tax code, long-term capital gain rates decline after taxpayers hold assets for more than one year. Stock market traders may hold securities for only a few minutes while investors may not sell shares for generations. Commercial real estate investors' holding periods are guided by transaction costs and property values driven by different economic conditions.[2] On average commercial real estate investors retain ownership for seven-to-10 years. An ownership period of seven years or more would normally be considered long term while ownership of four years or less defines short term.

A 'Good' Investment

A good investment is defined as achieving a return exceeding the cost of capital and beating the total return generated by collections of comparable assets - 'excess return!' Comparing property characteristics, local market forces, and other endemic factors is always an issue. Assuming the overarching objective is similar risk across the subject and a group of properties in an index, then the index would meet the qualification standard as an acceptable benchmark. Indexes of non-traded hotel property investments are scarce. The logical choice is the National Council of Real Estate Investment Fiduciaries (NCREIF) hotel index. The long-term (i.e., 25 years) total annual return on this index is 6.41%. The current one-year return is 9.97%. A 'good' hotel investment would be one that generates a total return greater than the NCREIF hotel index over a period of more than seven years.

The Reasons Hotels are a Good Long-Term Investment!

Consider the following propositions:

1. The total awake time available to households consists of two activities – work and non-work, often labeled leisure. The allocation between these activities has been changing rather dramatically in favor of leisure.

2. The reasons for the shift in household time allocation toward leisure are attributable to many factors including labor laws, productivity, work specialization and technological change. During recent decades technology has been a driving force. It will continue to be into the future.

3. Household incomes from labor, investments, and other sources such as rent have grown at a rapid pace offering more opportunities for discretionary spending. Travel continues to be a preferred option for consumer discretionary spending.[3]

[1] Paul Bergeron, "Hotels are 'Hottest' Asset Class so far in 2023," Globest.com, February 23, 2023.
[2] See D. Collett et al., 2003. 'Timing and the Holding Periods of Institutional Real Estate,' *Real Estate Economics* (Vol 31:2) p. 205.
[3] This is a long-run perspective assuming current economic conditions of dwindling consumer savings and increasing debt will not persist.

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4. Increasing leisure time has created many new and enhanced entertainment consumption opportunities, thus further enhancing leisure travel demand including mixing leisure with work from anywhere.

The Work/Leisure Tradeoff

> "The trend is your friend."
>
> WALL STREET LEGEND MARTY ZWEIG

The allocation of consumers' time from less work to more leisure during the past century is evidenced by various labor market indicators including number of hours worked by employees, number of people in the labor force, productivity, and disposable income. Figure 1 shows that the number of hours worked, while creeping up recently, is well below the 1950 level. The current trend among companies offering four-day work weeks to employees has positive implications for leisure travel. The low level of labor force participation during the early 1900s was due to fewer women working than today. The overall participation rate peaked around 2000 and now roughly equals that from the 1980s. The combination of fewer hours worked and fewer people working evidences a meaningful shift from work to opportunities for more leisure time activities.

Figure 1: Work/Leisure Time Indicators, Selected Years 1920-2022

Work Indicators	1920	1950	1980	2000	2022
Hours Work/Week	50	43	40	33	38
Participation Rate	N/A	59%	64%	67%	62%
Men	N/A	87%	83%	77%	68%
Women	N/A	33%	51%	59%	57%
Productivity -Output Per Hour (Index 2012 =100)	N/A	27	52	82	113
Real Disposable Income (Index 1959=100)	N/A	100	220	426	679

Source: FRED

Productivity growth in the U.S. economy is a hotly debated topic, but the productivity index numbers reported in Figure 1 clearly indicate a trend toward a more productive work force. Industrial age technological changes and those during the current digital era beginning during the late 1990s have been the main forces for productivity growth. Finally, the real disposable income growth index, which incorporates various income sources has demonstrated dramatic growth despite real wages and salaries barely keeping pace with inflation. Elevated household income causes the labor supply curve to bend backwards.

Backward Bending Labor Supply Curve

Economists who study consumer behavior have determined how choices are made between two competing goods. In an extension of this theory the two goods associated with how consumers use their time are work and leisure. Determining how much awake time is devoted to each is an important question because the answer contributes to the understanding of how wage rates are set, and resources are allocated to leisure activities. Work and leisure therefore are substitutes for one another. Thus, changes in technology that allow workers to achieve the same output in fewer hours means leisure time intrudes on what previously was work time – *a substitution effect*!

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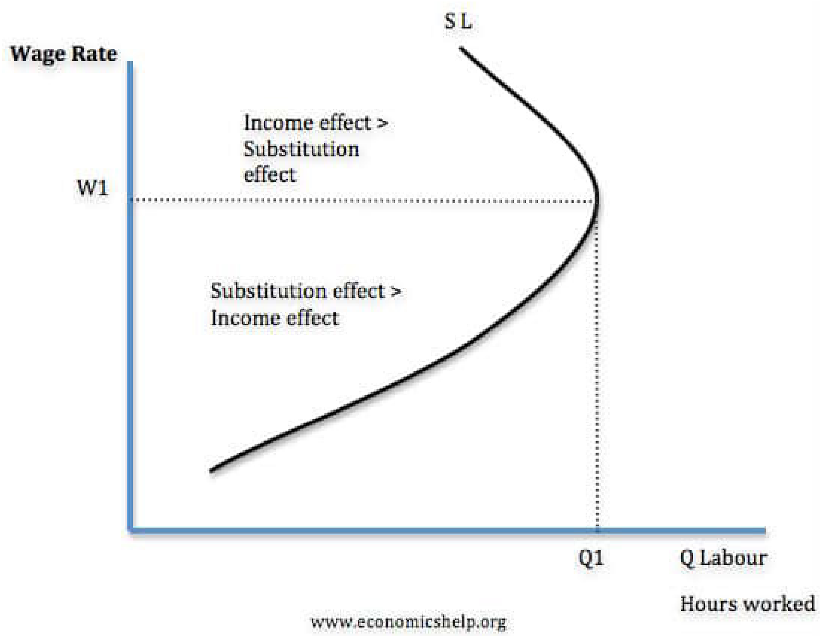
Figure 2 presents what happens to consumers' time allocations when wage growth results in high income levels.[4] This income effect results in the supply curve bending backwards. Consumers begin valuing leisure time more dearly relative to work when incomes cover expenditures on necessities by some margin.

Figure 2: Backward Bending Labor Supply Curve



The two effects operating together explain why consumer spending on leisure activities has accelerated this century. They give credence to the assertion that long-term investment in hotels catering to leisure travelers will generate excess returns.

Leisure Travel Stardom

It was no accident that the framers of the U.S. Constitution included a right to travel provision stating, 'The right to travel is a part of the "liberty" of which a citizen cannot be deprived without due process of law' (Fifth Amendment. Pp. 357 U. S. 125-127). Psychologists and academic travel experts have claimed for decades that people have an instinctive and innate desire to travel. That is, 'human beings are mobile animals…'[5]

The late-pandemic resurgence of domestic leisure travel suggests that these desires may be satisfied by a variety of non-business trips including *bleisure* trips and travel to rental accommodations (i.e., mobile office) seeking escapes from primary residence work environments. Leisure travel now constitutes a clear majority of all paid accommodations. The burning question is about the transitory nature of elevated levels of leisure travel.

[4] As noted above, most of the growth in consumer real income during the past century mostly comes from non-wage sources. Nevertheless, the propensity to choose leisure over work indicated by the backward bending labor supply curve holds regardless of income sources.
[5] I. Salomon. 1985. "Telecommunications and Travel: Substitution or Modified Behavior?" *Journal of Transport Economics and Policy* 19(3), 219-235.

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Differentiating between business and leisure travel within the available lodging data can be difficult because (a) travelers have not been consistently queried over time about why they made trips and (b) many trips have a dual-purpose.[6] Imperfect proxy measures emerged, such as examining occupancy data for weekdays vs. weekends, high-end and low-end hotels, various location identifiers, and booking channels commonly used by corporate and leisure travelers. Without reliable time-series data (i.e., definitionally correct and covering several cycles) on trip purpose, CBRE Hotels Research and other industry analysts are unable to prepare objective, statistical forecasts for these important demand segments.

It appears that a structural change has occurred in the composition of accommodations in favor of leisure stays. The innate desire to travel will likely more than ever be satisfied by leisure trips and hybrid business/leisure trips brought on by virtual work and enhanced telecommunication technology. Hotels in leisure destinations will likely generate the greatest long-term excess returns.

[6] See Sean McCracken, "Hotel Guests Continue to Blend Business and Leisure Trips, Regardless of Destination Type" *Hotel News Now*, July 11, 2022.

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