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FUTURE FIGURES:
U.S. Hotel Budgeting 2023

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contents

Future Figures: U.S. Hotel Budgeting 2023

FORECASTING: SCIENCE OR FAITH

Budgeting is a necessary though time-intensive period in which a hotel assesses the upcoming year's goals, threats and opportunities, diluting it all down into a prediction of revenue against expense.

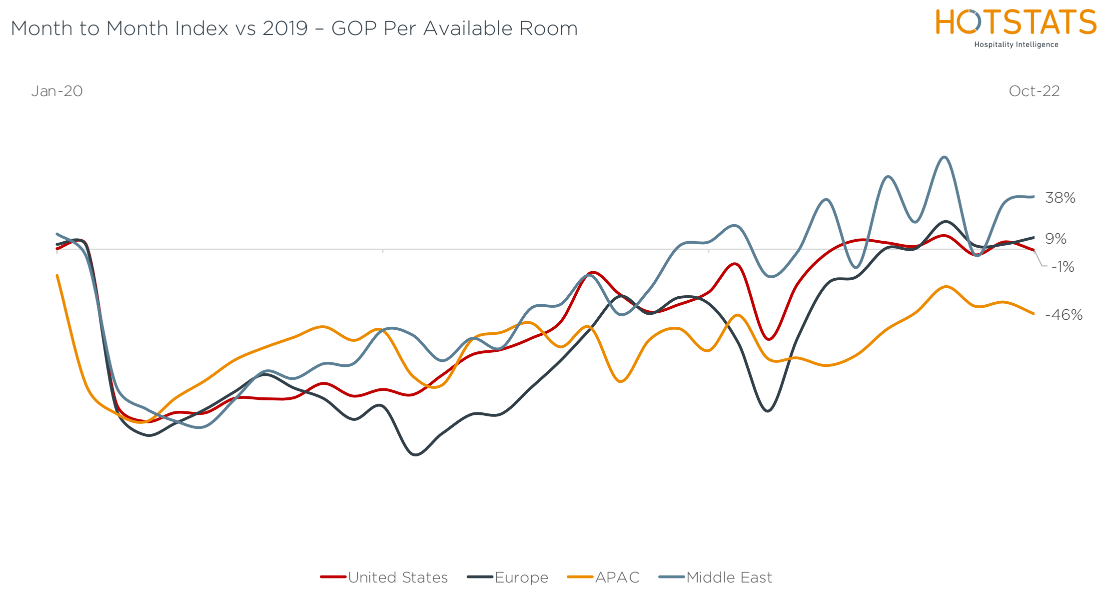
It's not always an exact science. An element of assumption is part of the exercise, but richer data that goes well beyond RevPAR is available to help hoteliers make shrewder budgetary calls.

Turning the page on COVID has proved onerous. Hoteliers have been reissued new obstacles to face down that muddy the budgeting process even further. Budgeting for 2023 is particularly fraught with uncertainty due to the soaring cost of virtually all expense items and the specter of recession, which could put a crimp on demand. The tenuous macro-economic climate is impacting almost all facets of the hotel P&L: energy costs are surging in Europe, aggravated by war in Ukraine; a shrinking pool of available labor is putting upward pressure on wages and salaries; and central banks are desperate to assuage inflation by raising interest rates to cool the economy, which at the same time increases the cost of capital and debt.

The one silver lining of the pandemic was the resiliency of leisure travel that undergirded much of the industry, fulfilling the role of stopper until the strengthening or complete return of corporate and group business. Concurrently, hoteliers showed acuity and kept average daily rates at pre-pandemic levels, in some cases higher. Above all, they decided against discounting, a mistaken strategy undertaken during past crises. This approach helped fuel total revenue, especially at resort properties and extended-stay hotels, asset classes that proved resilient during the pandemic.

In the post-COVID years, hoteliers have become more focused on the bottom line, with once passive owners instructing their management companies to be more cognizant of expenses and flow through. In some cases, hotels have adopted zero-based budgeting, a no-nonsense approach to scrutinizing every facet of a hotel's operations.

Hotels also comped performance against 2019—the last year of normalcy. But as the fourth year of living with COVID approaches, reaching back to 2019 is no longer a viable approach. Hoteliers are more inclined to normalizing the temporal nature of budgeting, but with a twist: the lens on



generating revenue, containing expense and pumping out profit has never been more magnified.

A surfeit of revenue and expense data now exists that allows hoteliers to budget for each operated and undistributed department, something that was made even more necessary when hoteliers were forced into break-even exercises in the wake of the pandemic.

Budgeting will never be an exact science, but the tools of the trade are available to make it more precise.

BUDGETING APPROACH

A cross-section of the U.S. hotel industry agrees that organizations are transiting from using 2019 as a benchmark year toward referring to prior-year results. In general, year-on-year results are being used in leisure markets, which recovered strongly in 2020-21, whereas some urban markets, which are just beginning to bounce back, are still using 2019 results as a reference point.

Meanwhile, despite rising inflation and interest rates, the risk of recession and the war in Ukraine, the overall budgeting sentiment for 2023 is one of confidence but also wariness. Consider energy costs: The cost is a primary concern in Europe, where it is feared that it could triple for the coming year. U.S.-based operators, meanwhile, are less concerned with energy-cost increases, noting that it only amounts to around 3% to 4% of total expense.

One thing is certain: shrewd hotel operators no longer can count on fixed, legacy adjustments to forecast revenue and expense. That approach would discount the myriad, comprehensive data points now available to hoteliers to assist with well-informed budgeting decisions. Savvy hoteliers should be making every effort to maximize revenues and minimize costs, which can be accomplished by looking beyond one's own operation and at external data to ensure a property is equal to or besting market norms.

Pittsburgh-based North Star Lodging, which specializes in the development and management of limited-service and extended-stay hotels, is taking a more indiscriminate approach to budgeting for 2023, rather than a purely historical one.

"Rather than taking a standard percentage approach to revenue, we will be assessing the increase in our operating expenses over the past year caused by current economic conditions, such as inflation," said Jack Macioce, the company's CFO. "We will use this assessment to assist us with determining our revenue projections. Our goal with this exercise is to maintain consistent profitability."

It's a similar exercise for Commonwealth Hotels, a Kentucky-based operator of more than 45 hotels, primarily in the Midwest. "We are taking nothing for granted with rising costs, increasing wages and changing mix of business," said the company's president, Brian Fry. "We are reconsidering all inputs for this year's plans and not simply growing from prior year or returning to a 2019 baseline, but considering elements of both methodologies."

Navroz Saju, the founder of Ocala, Fla.-based management company HDG Hotels and 2023 IHGOA chair, said that hoteliers are taking a different approach to budgeting due to the capricious nature of the macro environment. "Unlike pre-COVID years, hoteliers are using shorter periods of history to forecast the future due to operational volatility, in particular in the cost lines," he said. "Cost-cutting measures evident in 2021 and some of the beginning of 2022 will be unsustainable going into 2023,

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Brian Fry, President, Commonwealth Hotels

especially with inflation at the level it has reached as of Q3. This needs to be considered when budgeting for full-year 2023."

Tim Ross, Assistant Corporate Controller, Northpointe Hospitality Management, a hospitality management and development group based in Sugar Hill, Ga., budgets based on current trends in the market and then makes estimations off those. "Once we have an idea of where the market will be for the year, we look at our month-to-month historical indices to calculate our occupancy and ADR by month," he said.

According to Sourav Ghosh, CFO of Host Hotels & Resorts, the world's largest lodging REIT, the company will be looking increasingly at YOY comparisons for the 2023 budget cycle, whereas in the prior two years, comparisons were based on 2019. However, 2019 is still taken as a reference point for some recovering urban markets. In addition, the period impacted by the omicron variant in early 2022 will be taken into account for the 2023 budgeting exercise.

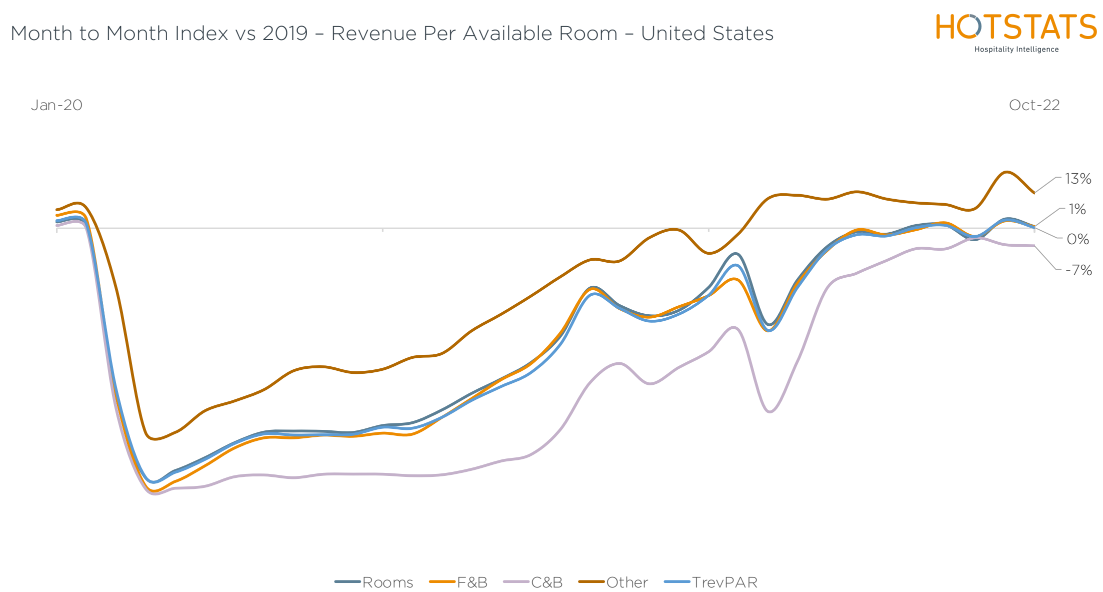
Added Macioce, "Current economic conditions will require us to not just take an analytical approach."

The fluidity of the current market is convincing some hoteliers to build in a pinch of flexibility into budgets, such that they can lean into any unexpected vacillations. Greg Miller, Vice President of Lodging and Experiential Leisure Equity Research at Truist Securities, expects this, citing cost structures that are more flexible through outsourcing and cross training between roles in a hotel and between hotels in the same market under the same ownership.

One clear trend is toward consolidating management at the property level, where headcounts have been significantly reduced. In some cases, cluster management has been used to consolidate management functions over multiple hotels in the same market.

"Hotel owners will keep rates up even at the risk of lower occupancy due to a flexible cost base, which allows profit to fall to the bottom line," Miller said.

For Host, the budget is fixed for the year and then updated with forecasts as the year moves forward. Host already raised wages substantially before COVID, Ghosh said. Wages are up 4% to 5% in 2022 and Ghosh expects a single-digit rise for 2023. Overall, Host was operating at a staffing level of 97% prior to COVID; currently, the figure is 94%. "We little trouble attracting talent since pay and benefits are above industry averages," Ghosh said.



Meanwhile, North Star, according to Macioce, will be more flexible with salaries and wages due to the volatility of the labor market and significant turnover in our industry. All other operating costs, both fixed and variable, will be adjusted for inflation, but "we will still hold the line based on projected occupancy levels."

There are about 100,000 unfilled travel and hospitality positions in the U.S. hotel industry, according to statistics from the Bureau of Labor.

The world was forced to pivot in the wake of COVID; that extended to hotels, which, in the blink of an eye, saw their business change potentially forever. The pandemic in short term depleted revenue, dried up profit and magnified cost inputs.

Budgeting approaches in the proceeding years took a turn, too. In traditional budgeting, the previous year's budget is taken as a base for the preparation of a budget; whereas, each time the budget under zero-based budgeting is created, the activities are re-evaluated and thus started from scratch.

Some hotel companies took the latter approach. Miller noted that zero-based budgeting has become more prevalent since COVID and considering further, more contemporary cost pressures. "Justifying additional costs is more heavily scrutinized," he said.

Host Hotels resorted to zero-based budgeting at the beginning of COVID and built back a revised cost structure so prior-year cost figures can be used as a basis for full-year 2023.

Others, like Northpointe, have eschewed zero-based budgeting and relied on past years to inform the next. "We have year-over-year trend data where we are look line-by-line at our POR (per occupied room), PAR (per available room) percent, etc., to get to accurate numbers," Ross said.

PROFIT PITFALLS

Operational profit is contingent on the optimal mix between revenue and expense. One comes with the other and it's the job of intelligent, savvy operators to smartly steer the ship and lead on both. The U.S. hotel industry has seen its share of headwinds that are doing their best to curtail profit. One of the ways hoteliers have been able to keep the ship afloat is through rate. The kneejerk reaction, which typified the aftermath of 9/11 and Global Financial Crises, is to drop rates in the face of calamity to excite demand. There may be a short-term bump, but the strategy usually backfires long-term, since getting rates back up to previous levels or higher is an arduous battle.

The one silver lining of COVID was that hoteliers really didn't have to decide to drop rates for one simple reason: high ADR or low ADR, in the ensuing days of the pandemic, occupancy rates weren't going to budge. In many cases, hotels, if they were still open, were not used for travel but for refuge. Now that the industry has roared back, rates remain high comparable to 2019.

Any retrenchment in rate could be a blow, especially if the expense trajectory grows. "If ADR was to drop year-over-year it would negatively impact the operating profit for 2023 as labor costs are not going to go down. Rate must hold," said Ross.

Commonwealth's Fry similarly points to labor as the chief concern, especially as day-to-day operations normalize but costs grow. "Our hours are normalizing as service continues to elevate but wages have increased dramatically," he said. "Unlike in 2021 and 2022, we believe wage pressures will vary by market."

Incoming IHGOA Chair Saju is confident that expenses might now be stabilizing, but leveling off higher than ever

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before. "Energy prices and supply costs seem to be stabilizing, maybe even falling slightly, but they are likely to stabilize at a higher level than before—above and beyond national inflation," he said, adding that things like lawsuits and property insurance costs have also seen substantial increases recently, adding to operational cost pressures.

For Host, the greatest risk factor for 2023 is a recession and how that could impact the recovery of business travel. Inflation is also a key risk factor, Ghosh said.

At North Star, the greatest risks included a shortage of experienced personnel combined with new labor regulations and economic volatility.

METRIC MOVES

In the ongoing battle between revenue and expense, both have showed their worth. In the U.S., operating margins, with the exception of F&B, had basically caught up to 2019 levels by spring 2022. However, by September 2022, GOPPAR had still not quite caught up with 2019 levels, evidenced by a $20 delta between September 2022 TRevPAR and its September 2019 counterpart.

On the expense side, costs such as utilities are up slightly over 2019 levels, though largely offset by higher TRevPAR.

On a rolling-three-month basis, housekeeping labor on a per-occupied-room basis between May and July 2022 was up 19% versus the same period in 2019.

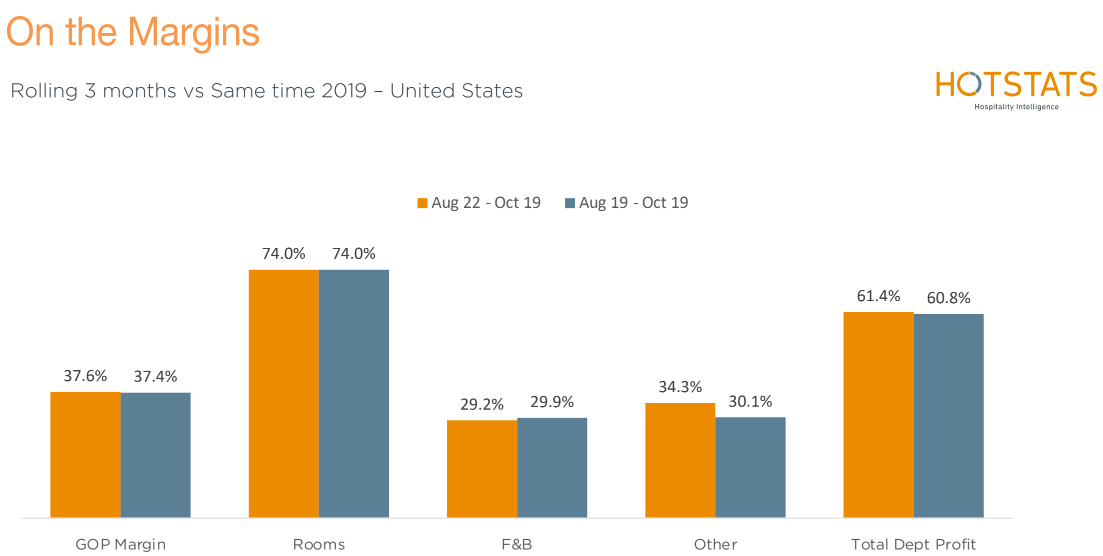
% Change POR – Rolling 3 Month 2022 vs S/T 2019 (May – July) – United States

Housekeeping labor (POR)	+19%
Rooms Labor Margin (%Rev)	+10%
Booking Costs (POR)	+7%

Source: HotStats

"Changes in brand standards, supply-chain disruptions and inflation will require us to modify our analytical approach," said Macioce. "While we will still use historical CPOR (Costs Per Occupied Room), major operating expenses, such as guest supplies, will be scrutinized further."

Leisure travel has been the one sector that has allowed hoteliers to turn a profit in the face of the difficult macro challenges. According to Truist's Miller, the return of corporate transient business is the biggest concern with arrivals 15% to 25% below 2019 levels; however, drive-to properties are doing better. "Ongoing rate negotiations between chains and



travel management companies for 2023 will likely yield high single-digit to low double-digit rates above the 2019 level," Miller said.

In the wake of the pandemic, many hotels cut services, such as daily housekeeping and F&B services, all the while keeping rates up. That doesn't cut it anymore. "With the ADR we are charging, we feel it is important to keep guest expectations in mind when looking at these services. We have not cut back and will continue to provide them in 2023," said Ross.

Still, Miller noted that some services, such as daily room cleaning, have been reduced in hotels below the luxury level, especially in select-service properties.

At some of Host's properties, daily room cleaning, especially in urban areas serving business travelers, has been cut back. In some cases, customers are given the choice to decline daily cleaning.

Host is also experimenting with vacuum cleaner robots for common areas. It is also taking steps to automate the check-in process, offering the customer a choice of methods, such as scanning a QR code and digital keys.

"Yes, changes made during the pandemic are still in place. We will be adhering to brand standards," said North Star's Macioce.

In order to achieve or maintain revenue, Commonwealth Hotels is staying atop travel trends, and making sure their business strategy matches. "We are considering alternative mixes of business and marketing for blended business/leisure travelers," said Fry.

Part of the worry for hoteliers is sustaining higher average daily rates. As occupancy comes back, rates could fall back. "It depends on the market, but we feel overall the occupancy rate will increase more than ADR next year," Northpointe's Ross said. "ADR is currently higher than 2019 levels, but, in general, the same cannot be said for occupancy percentage."

According to Miller, rate will be the most important factor in 2023, while Host's Ghosh said that occupancy should be the key driver in 2023. Rates in some high-end leisure markets, which boomed in 2022 to levels well above those of 2019, could decline a bit in 2023, as Americans travel abroad more. Meanwhile, some urban markets are likely to see rising rates, as they recover in 2023.

HDG's Saju is focusing on three key initiatives in order to maintain margins and grow business: 1) optimizing booking channels to manage cost of customer acquisition; 2) leveraging technology advancements to support operational challenges and streamline processes; and 3) green strategies to fend off energy cost increases.

FOOD FOR THOUGHT

Food cost of sale as a percentage of revenue is up 6% in the U.S. on a rolling-three-month basis for the period May-July 2022 vs. 2019 at the same time. Budgeting for the food and beverage side of the ledger has seen post-pandemic changes. "We typically budget the expense side as a percentage of the revenues and look at our prime cost," said Ross. Prime cost in a restaurant is the total of cost of goods sold and labor costs. "We have to look at the banquet business on the books now with our current groups," Ross added.

The good news is that as group business returns, so too are banqueting and events, which are crucial to a property's total revenue. Currently, they are running 20% to 50% below 2019 levels, "but should work back toward 2019 levels over the coming year," Miller said.

Like hotel rates, food prices are moving higher, a victim of inflation. "We adjust our menu pricing regularly to stay in line with the rising costs of food and beverage, so we will keep

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our percentages in line with current budget standards," Ross said.

Hoset's food cost ratio did not increase much in 2022,due to dynamic menu pricing (adjusting prices based on customer demand), according to Ghosh, who said it should be around 22% of total revenue in 2023.

UNDISTRIBUTED COST AND CUTS

Beyond rooms and food and beverage, costs within the undistributed departments are a mixed bag. Clustering has helped deflect some expense and some units, such as in accounting, have been cut back on in order to save.

Miller noted that there will be more cluster management and less managerial staff at the property level moving forward.

Over the last two years, Host has created a new slimmed-down operating model which, Ghosh said, is reducing overall costs. For instance, managerial headcount at the property level has been reduced overall by 20% to 30% through consolidating functions. Instead of having a head of rooms division and a head of F&B, now there is only a manager of operations.

The REIT has also pushed back on some brand-related costs on a property-by-property basis. Various service fees charged by the chains, such as for digital marketing or HR, have been reduced by making them optional for the hotel property (opt-in, opt-out), Ghosh said.

Furthermore, there has been review of brand standards with chains like Marriott International and Hyatt Hotels Corp., which is resulting in lowering costs for the properties. Examples include the digitization of in-room compendiums, menus, other collateral and more efficient phone-call-answering standards using AI-enabled intelligent voice response to answer questions and route calls.

In addition, some fees are now charged on a variable rather than fixed basis; for example, digital marketing fees are paid based on the ROI generated by the service.

Across the U.S., property and maintenance and utility costs per available room are going up in the U.S., but sales and marketing costs, as well as the cost of undistributed department labor and cost of labor per available room, are going down.

Some companies are reevaluating the need for a chief engineer at each property and deferring certain projects that are deemed not necessary.

Rolling 3-month basis for the period May-July 2022 vs 2019 at the same time in the US

Property & Maintenance Costs (PAR)	+22%
Utilities Costs (PAR)	+12%
Sales & Marketing Costs (PAR)	-7%
Undistributed Dept Labor (PAR)	-6% (0.5pp)
Total Labor (PAR)	-7% (0.5pp)

Source: HotStats

Like many companies, hotel companies are also pulling back on travel and expense spend, for now. "We will cut spending on travel, as a lot of our sales functions occur remotely rather than meeting in person," Macioce said, adding that North Star consolidated its director of sales and revenue management positions to handle more than one hotel. "With this approach, we will be leveraging technology and online communications," he said.

On the utilities side, unlike the spikes in Europe, energy

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Jack Macioce, CFO, North Star Lodging

doesn't seem yet to be a large concern for Host. It accounts to about 3% to 4% of total expenses, Ghosh said.

Meanwhile, Macicoe said he's seen energy rise by almost 20%, but cited that locking into long-term supply contracts has helped to minimize the risk of further increases.

CONCLUSION

It's clear that hoteliers are approaching the budgeting exercise for 2023 with more confidence than in the prior two years, despite multiple uncertainties. Operators are increasingly referring to year-on-year results for budgeting purposes, as opposed to those of 2019 and there is a trend toward reducing managerial headcount at the property level in order to reduce costs. Rooms and other operated departments have bounced back to the 2019 level or above, but F&B and C&B continue to lag. Meanwhile, operators are applying new technologies to increase productivity and to better benchmark their properties.

The year ahead is undoubtedly paved with some peril, including what many say is an imminent recession. In the face of calamity, hoteliers are more and more turning to data to allow them to see the bigger picture and make strategic decisions that will allow their business to not just stay afloat, but to thrive. "In this environment, access to information helps us be nimbler, to act quickly as situations evolve and allows us to control what we can," said Commonwealth's Fry.

One thing is certain: the hotel industry has endured the worst that can be thrown at it and has come out the other side still breathing and prepared to contend with whatever 2023 throws its way.

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