HOTEL HORIZONS®

PKF HOSPITALITY RESEARCH

SPECIAL REPORT

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OIL PRICES AND LODGING RISK

By John B. Corgel and Jamie Lane

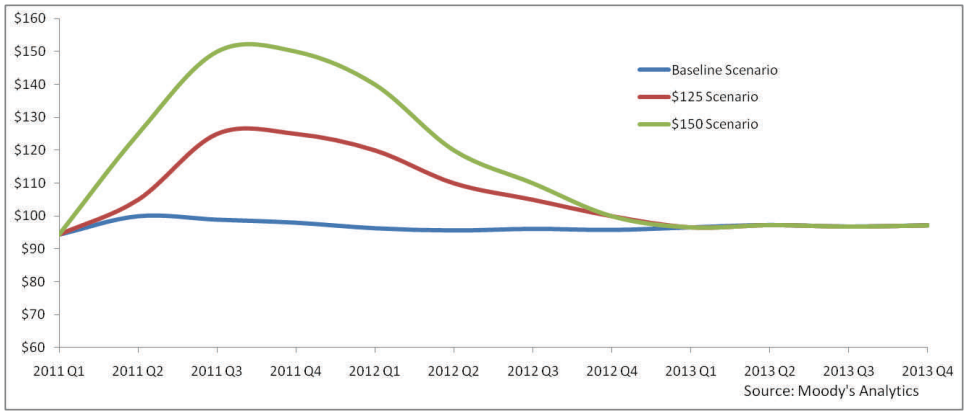
With the lodging industry recovery in full swing and strong tailwinds leading to much optimism among economists, there are still headwinds that could derail progress to recovery and send the industry back into the red. At PKF Hospitality Research (PKF-HR), we believe that oil prices could have a profound impact on future revenue and should be on everyone's radar when planning for the future.

Our research shows a direct economic relationship between oil prices and the U.S. lodging industry. The U.S. economy is highly dependent on a steady supply of affordable oil. When the price of oil increases beyond normal levels, the difference reduces individual consumer and businesses spending power, which in turn has a negative multiplying effect throughout the macro economy. Since the U.S. lodging industry depends on the health of the macro economy to sell their products: guestrooms, food and beverage services, and meeting rooms; oil prices should be a serious concern for hotel managers, investors, and developers. In describing the microeconomic effect of oil prices, Moody's states,

> "The most visible channel through which higher crude oil prices affect the U.S. economy is higher transportation costs. An increase in crude oil prices raises the price of gasoline and diesel. Higher crude oil prices also raise the cost of heating oil and propane, which are used by households in the Northeast and Midwest to stay warm during the winter. When petroleum prices rise, consumers have less money to spend on other goods or services, save, or pay down debt. Every $1 increase in the price of crude oil raises gasoline prices by 2.2 cents per gallon and cost consumers about $3 billion over the course of a year."

The *Hotel Horizons®* econometric demand model relies on economic data from Moody's Analytics to project future hotel demand levels. Looming as a possibility in the near future, the continued threat of political instability in oil producing nations, potential supply constraints driven by conflict and further increased demand from developing nations emerging from the global recession have the potential to keep oil prices at uncomfortably high levels. Moody's Analytics created two economic forecasts around a hypothetical future where oil prices increase to either a high of $125 or $150 by the fourth quarter 2011. While Moody's highlights the low probability of these Oil Spike scenarios, it is prudent to plan for unfortunate events. The

Chart 1 – Oil Spike Scenario effect on Oil Prices



baseline scenario (*i.e.* $98 per barrel for 2011) reflects Moody's modeled fundamental price of oil ($93.53) coupled with a premium of around $5 to account for the supply uncertainty. This baseline scenario assumes the Libyan conflict will be resolved over the course of the year. Chart 1 displays the oil assumptions in each of the three scenarios and Chart 2 shows how these new prices translate into macro GDP levels.

According to Moody Analytics, the U.S. economy could weather a rise in oil prices to $125 per barrel, but a surge to $150 would trigger a mild recession (*i.e.* traditionally defined as two successive quarters of negative GDP) . In the $150 per barrel scenario, Moody's forecast of real GDP growth falls by a maximum of 2.6 percentage points (Chart 2a) and 4.5 million jobs are lost by 2012 compared with the baseline forecast (Chart 2b).

The econometrically based *Hotel Horizons*® demand model relies primarily on changes in real personal income and total payroll employment. By introducing Moody's Oil Spike scenario for economic growth into our models, we receive a vastly

Chart 2a – Oil Spike Scenario effect on GDP (ΔGDP)

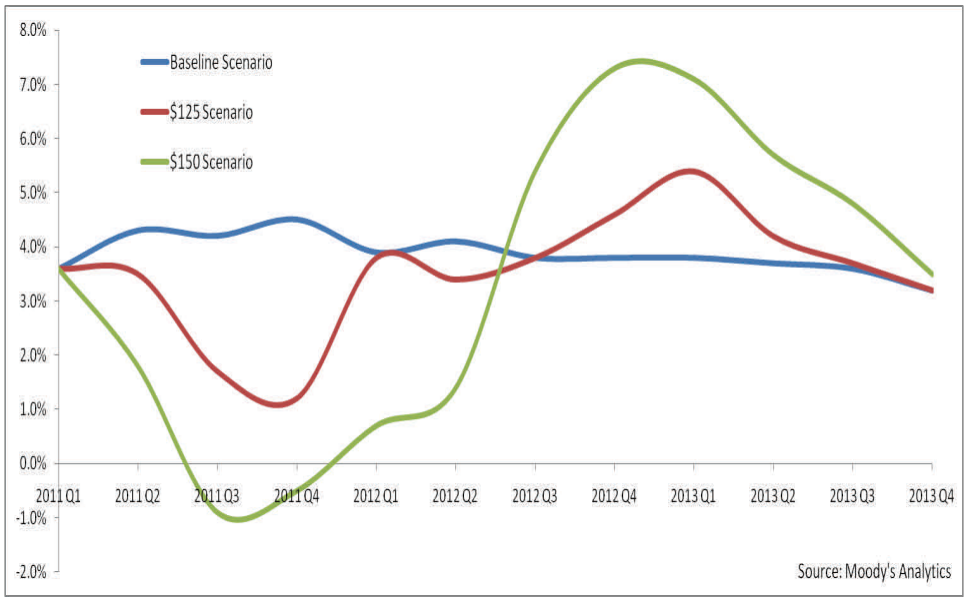
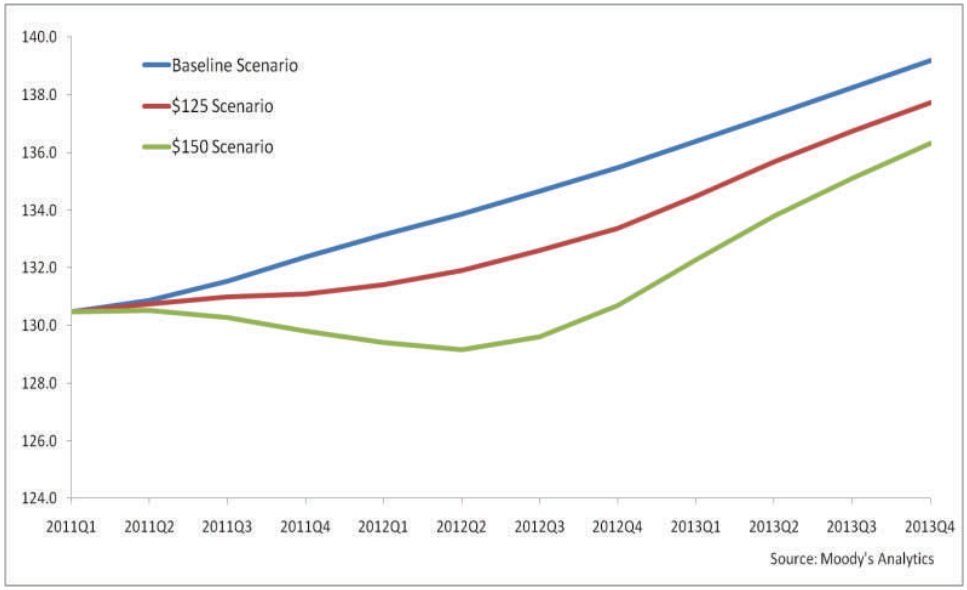


Chart 2b – Oil Spike Scenario effect on Employment (Millions of Jobs)



different view of the next 5 years. Chart 3 below plots our current Revenue per Available Room ("RevPAR") forecast as compared to the Oil Spike forecast prepared by Moody's Analytics.

Chart 3 – U.S. Hotel RevPAR

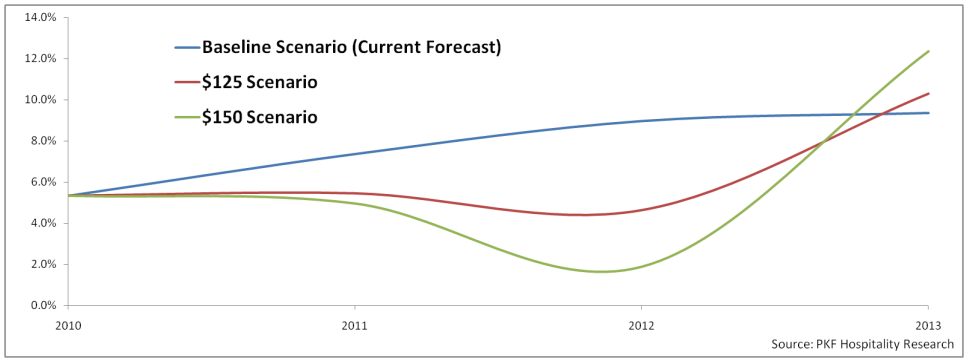
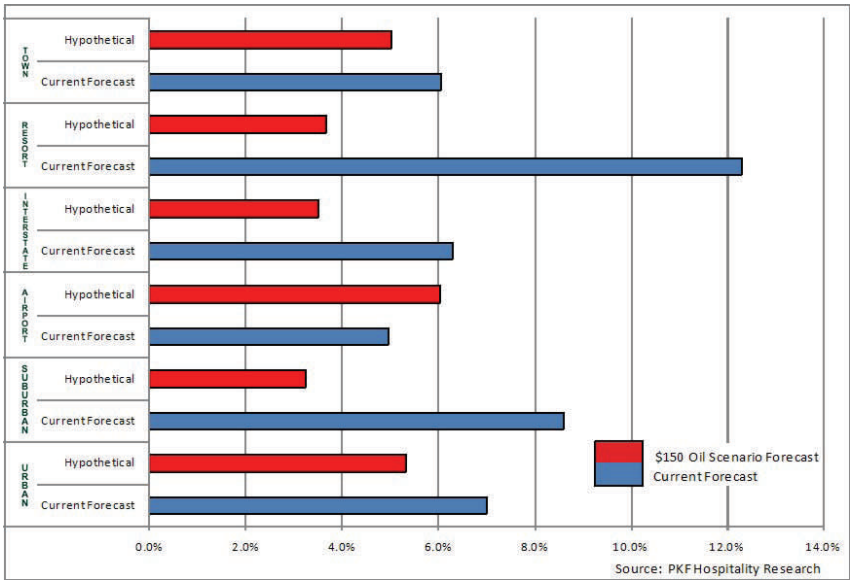


Chart 3 illustrates oil's hampering affect on RevPAR growth as compared to the baseline forecast. RevPAR gains observed in the beginning of 2011 will not continue if oil prices move as scripted in both Moody's Oil Spike scenarios. These high oil prices have the potential of halting the economic recovery as shown in Chart 2a/2b, and given lodging's dependence on macro economic health, we expect the declines in economic production to flow through to lodging demand. In the $150 per barrel scenario, the 2 percent RevPAR increase in 2012 will be entirely driven by a 2 percent increase in demand as Average Daily Rate ("ADR") levels remain flat. As inflation powers forward, ADR fails to keep up which results in real ADR declines.

This trend is generally seen through all types of locations and chain scales. Looking specifically at location segments, we then tested which ones are more susceptible to an increase in oil prices. Historically oil prices have had a 99 percent correlation with gas prices and, since hotels are travel destinations, one could assume an increase in the price of getting to the destination could potentially decrease the demand. Not surprisingly, we anticipate that hotels with "drive to" business will see the first impacts of increased oil prices; this includes interstate, suburban hotels, and resort locations near major metropolitan areas. We then expect declines to migrate to "fly to" resort locations once other hedging strategies, i.e. taking the train, reducing other vacation expenditures, etc. run out.

To test this theory, we inserted Moody's $150 oil price scenario into our models for each location. The results (see Chart 4) show the average RevPAR change for 2011-2012. The two bars for each location represent the current forecast (blue) contrasted with our hypothetical ($150) scenario forecast (red). The location segment expected to see the bulk of the damage is resort, where RevPAR could fall from an average increase of 12.3 percent down to 3.7 percent. These results confirm that location segments exposed to leisure/destination travel demand could see the largest declines in future growth.

Chart 4: Hypothetical $150 Oil Price Impact on U.S. Hotels Location Segments; 2011– 2012 RevPAR Change



As long as oil prices continue to stay high, they remain a concern and warrant continual monitoring. While we stress the scenarios presented above have a low probability of occurrence, many of the drivers will have a greater influence in our models as situations abroad unfold. PKF-HR continues to perform research on the subject and, until we see strong evidence to the contrary, we maintain our robust outlook for 2011 and 2012.

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