LODGING

PIPs in Perspective

Costlier projects negatively affecting economy sector

By Chris Guimbellot, President & CEO, hihotels by Hospitality International
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Chris Guimbellot

Property Improvement Plans, or PIPs in industry parlance, can be a sore spot in the relationship between franchisors and franchisees. While auspiciously meant to keep property standards up with changing guest expectations, they can create a slippery slope for the franchisee in terms of amenity creep and be an expensive undertaking with a questionable return. In no area is this more apparent than the economy segment of the market.

PIPs are Growing More Expensive

Historically, hoteliers could expect to spend about 7.5%-8% of revenue on a PIP, with a PIP being issued every 10 years or so, but no more. There are a few reasons for this:

• Brands are issuing PIPs on a more regular basis. Wholesale PIPs of seven years or even less are not uncommon. Also, keep in mind that when an owner sells, the property will be subject to a PIP in order to transfer the franchise to the buyer.

• Many brands are raising standards so high, they are effectively moving properties into higher segments (for example, from economy to midscale). The old adage of amenity creep has been replaced, in some circumstances, by segment creep.

• Inflation and the associated high costs of construction have made for much higher investments to complete a PIP. Overall inflation reached a peak in June of 2022 at 9.1% but the Bureau of Labor Statistics' Producer Price Index, which speaks more to the cost of things like FF&E and soft goods, was up 19.6% in 2021. A recent call to a hospitality vendor confirmed price increases of 90%-300% on an assortment of products with the highest increases in lower margin products - those typically ordered by economy hotels. Finally, the Nehmer and HVS Hotel Cost Estimating Guide shows a more conservative number of 13% when comparing 2022 over 2021 – but that report was written in January, well before inflation peaked in June.

• Finally, the cost of capital has risen substantially in the last 12 months. A quick search of Lending Tree shows that current SBA 7(a) loans over $50,000 can be found for 9.25%. A year ago, that number would have been around 5.5%.

Clearly, when higher standards, inflationary prices and the cost of capital are factored in, the cost to complete a PIP has risen dramatically in the last 18 months.

For some real-world examples of current trends in the PIP space, a brief poll of my development team revealed the following:

• A $500,000 PIP for a 50-room hotel in Montana that required, among other things, a change from carpet to LVT, even though in that area of the country carpet makes the rooms more comfortable while also lowering energy bills.

• A brand requiring all room upgrades to be done before conversion vs. the common practice of allowing renovations to be completed over time.

• Some brands requiring PIP items to be purchased from selected vendors. Those vendors may or may not offer the best prices.

• One company's brand standards do not permit an owner operator to live on property. This represents a break from historical norms for many property owners in the economy segment and has an impact on the profitability of the operation as a whole.

Some of these examples show what happens when PIPs go beyond the intended purpose of increasing standards to match guest expectations. An old tactic, still in use by some brands, is to use the PIP in an effort to force older properties out of the system. If the franchisee can't afford to complete the PIP, the franchisor may have the right to kick the property out of the system. The reason a brand might do this is to remove any area of protection restrictions the current franchisee has and free up the territory to sell a new franchise. It's an ugly practice and invariably affects older properties in the economy segment disproportionately.

Why Now?

During COVID, hotel revenue took a turn downward to the tune of 50% for the year 2020. 2021 was better, but still lower than 2019. During this time, hotels were struggling to stay afloat. From the franchisor's end, it was a time where priority one was to save existing franchisees. Revenues were down across the board for both franchisor and franchisee. Naturally, it was not the time for a reimaging of brand standards and the associated PIPs.

While many areas of the country are back above the pre-pandemic levels of 2019, there are many secondary and tertiary markets where revenues have not yet climbed back out of the hole. Those markets are disproportionately represented by economy hotels. Per STR and Tourism Economics, the industry may not totally rebound until sometime in 2025.

In addition, hoteliers are struggling to rebuild the $111.8 billion in room revenue lost during the pandemic. These two factors indicate it is not a good time for economy hoteliers to be subject to higher PIPs as described in the previous section. Why some brands have chosen now to stick it to franchisees is anyone's guess.

What to do About High PIPs

While there is nothing that can be done about inflation or the cost of capital, economy hoteliers owe it to themselves and their profitability to do the following:

Negotiate

When it comes to PIPs, it's important to know they are not set in stone. While the brands will want to keep standards high, they are more than likely to be flexible with some items of the PIP. Here are some options for hoteliers to consider:

• Try to negotiate to do the completion of guest-facing items first. These will have the highest effect on ADR and occupancy, which can help finance the revenue of the other items to be performed later.

• Along similar lines, try to restrict and/or remove items that don't affect the guest experience. Changing furniture that is in perfect shape to meet a brand's color guidelines is not the best use of funds.

• Ask to stretch the time allowed to complete items. This allows for cash flow to be managed better. Similarly, request that work be done in the offseason to minimize revenue impact.

During the negotiations, it is important to understand the value of the hotel to the brand. If the brand has many properties in the market area, it may be more willing to let the franchise go. That may affect negotiation position.

Calculate ROI

Property renovations typically should increase the value of the hotel, subsequently generating more revenue. When considering whether to undertake completion of a PIP, it is important to calculate the return on investment and payback period of the effort. In the example of the $500,000 PIP on a 50-room hotel, if, after the PIP, ADR raises $5 and occupancy increases 5% (a lofty assumption), the payback period on the cost of renovation would be 5.81 years. This doesn't even take into account the lower ADR and occupancy that can be expected during the renovation itself. When PIPs can appear as often as every seven years, it is clear that completing the PIP is not always a good investment.

Evaluate Options

If there is a positive ROI on completing the PIP, then it makes sense to stay with a brand and perform the renovations. However, if the ROI doesn't make sense or the payback period is too long, the choices are to sell the hotel or switch to another brand. Keep in mind, when selling, the PIP will have to be performed anyway by the buyer should they want to stick with the brand. Switching brands may be more palatable, as it may be possible to find a brand that has more sensible standards, which will not require such a high PIP and may still provide the same level of brand contribution.

Conclusion

When it comes to renovations, it is important to keep in mind the goal of the PIP, and that is to ensure a hotel meets the expectations of its guests. If a franchisor is trying to remake its image to a higher sector, it may be leaving some of its hotels in the dust. In this situation, switching brands may be a good option. If the decision is made to pursue a PIP, try to lower the cost as much as possible. This will allow for extra money to make the renovations that best fit the hotel and its guests.