

Hospitality

HEALTH CARE LEGISLATION: Which Hotels Might Get Sick?

By Robert Mandelbaum and Taylor Beauchamp

In 2009, the U.S. lodging industry is projected to experience the greatest annual decline in revenue since 1932. In August 2009, PKF Hospitality Research (PKF-HR) released its quarterly econometric hotel forecast, *Hotel Horizons*®, and is forecasting that the average property will suffer an 18.5 percent decline in rooms revenue per available room (RevPAR) during the year, which will contribute to an estimated 16.8 percent fall off in total hotel revenues.

In this challenging market, hoteliers are concentrating on salvaging short term profits by driving revenues and trimming expenses. While the industry is very focused on the short term, the debate in Washington has focused on a topic that may have far reaching impacts on the industry's long term profitability – health care reform.

Health care reform is an important topic for the hotel industry because it is directly related to labor costs. Labor costs are usually the largest operating expense for a hotel. In 2008, total hotel labor costs equaled 32.9 percent of revenue and 45.8 percent of all operating expenses. Labor costs also tend to be one of the most controllable costs for a hotel. An analysis of historical annual changes in total revenue and labor costs finds an extremely close correlation.

In health care reform, the hotel industry has much to gain or lose depending on the specifics components of any final legislation. Proponents of health care reform focus on achieving two primary goals:

1. Decreasing the rate of health care inflation
2. Reducing the ranks of those who do not have health insurance

The Good: Curbing Health Care Inflation

Hotel labor costs (as defined in the 10th edition of the Uniform System of Accounts for the Lodging Industry (USALI)) are made up of salaries, wages and bonuses; and payroll related expenses. Payroll-related expenses consists of both government mandated costs (i.e. FICA, FUTA, SUTA, SDI), as well as employer optional benefits (i.e. vacation pay, employee meals, pension plan, health insurance). Prior editions of the USALI referred to most of these payroll-related expenses as “employee benefits.”

During the past few years, PKF-HR has noticed that payroll-related expenses have grown at a greater pace than salaries, wages, and bonuses. As an example from 2007 to 2008, hotel managers were able to reduce salaries, wages, and bonuses 0.2 percent. While those direct payments received by employees were decreasing, the payroll-related employee benefits actually increased 2.4 percent. While we cannot isolate the specific impact, it is likely that increases in health insurance costs were a major factor in the increased employee benefit costs.

Unless there is action to reign in health care spending, the hotel industry will almost certainly see continued increases in the cost of health insurance premiums well above the changes in salaries and wages. In addition, without action to control costs, the Medicare program faces funding challenges that may require increases in the Medicare payroll taxes paid by both employers and employees.

Hard Medicine: Mandated Coverage

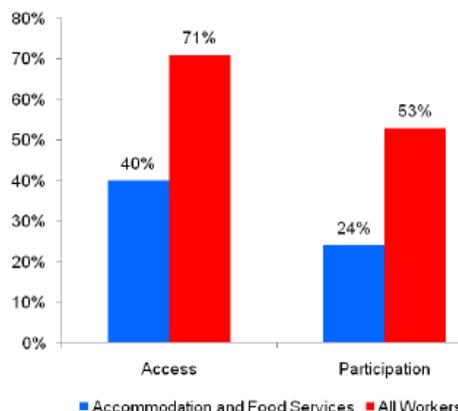
On the other side, the industry faces the potential for cost increases stemming from efforts to reduce the number of uninsured in the country. Most of the proposals under review call for additional taxes or penalties on employers who do not offer subsidized health insurance to their employees.

Employers in the hospitality industry are much less likely to offer their employees health insurance than other industries. According to the March 2008 National Compensation Survey of the Bureau of Labor Statistics (Exhibit 1), 40 percent of employees working in the accommodation and food service industries have access to an employer based health insurance plan. This compares to a national average of 71 percent for all workers in all industries. Any legislation that penalizes companies that do not offer medical insurance will have a disproportionate impact on the hotel industry.

Which Hotels May Get Sick?

To assess the potential impact of the versions of health care legislation, PKF-HR and Hotel Effectiveness, LLC have analyzed labor cost data contained in PKF-HR's *Trends® in the Hotel Industry* database of 6,000 hotel financial statements.

Exhibit 1
Comparison of Health Care Coverage Access and Participation
Hospitality Industries vs All Industries



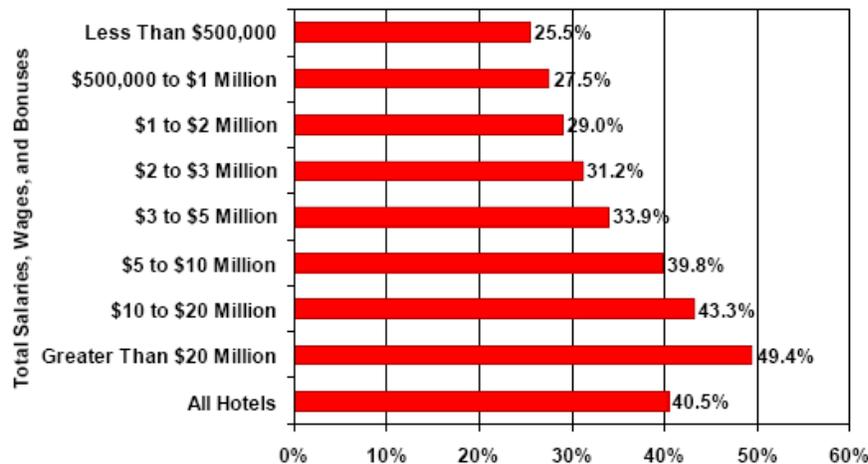
Source: National Compensation Survey, Bureau of Labor Statistics, March 2008

The determination of which hotels might be impacted by any health care legislation will likely depend on three factors:

1. Is the hotel's annual gross wages above or below the threshold required to offer insurance?
2. Does the hotel currently offer health insurance to all of its employees?
3. If it does offer health insurance, does it pay at a minimum the portion of the cost that the government mandates?

When analyzing the *Trends®* data to measure the potential "threshold impact" of the proposed health care legislation, we observed a strong relationship between payroll size and cost of benefits. As the payroll increases, the cost of a hotel's payroll-related benefit costs grows with it. For example, hotels with less than \$500,000 of payroll per year spend only 25.5 percent of their salaries, wages, and bonuses on other payroll related employee benefits. Compare this to a hotel with an annual payroll of \$20 million or more that spends over 49 percent of its salaries, wages, and bonuses on other payroll-related expenses.

Exhibit 2
2008 Payroll-Related Costs
Percent Of Salaries, Wages, and Bonuses



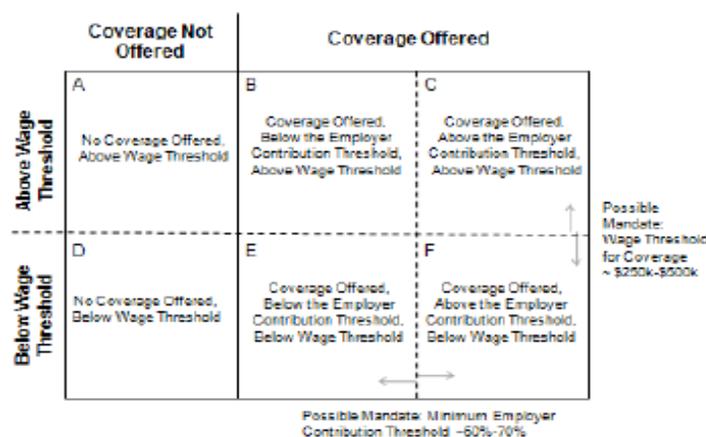
Source: PKF Hospitality Research, 2009 edition - *Trends® in the Hotel Industry*

The payroll-related ratios in Exhibit 2 support anecdotal reports that larger employers typically offer more generous benefits (i.e. health insurance) than smaller employers. Therefore, using the payroll threshold portion of the litmus test, it can be assumed that properties with a total salaries, wages, and bonuses expense in the mid-range are most susceptible to a cost impact from new health care legislation. Profiling the hotels that have total gross wages between \$500,000 and \$2 million, we find that 90 percent of the properties operate in the midscale and upscale chain-scale segments. These segments include many of the limited- and select-service brands that are so popular today with hotel developers and consumers.

In addition to meeting a total payroll threshold, companies that do not pay a minimum portion of the cost of the insurance (e.g. 60% to 70%) will be required to do so. This too will contribute to a rise in payroll-related expenses, even for those properties that are currently offering some degree of subsidized employer-based health insurance.

Exhibit 3 summarizes the various criteria that might dictate whether or not a hotel will be impacted by any proposed health care legislation. Properties that meet the criteria contained in categories A and B are mostly likely to be effected.

Exhibit 3 Health Care Coverage Determination Criteria





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Even hotels that do not see a direct cost increase could be impacted from this legislation. Today, some operators position health care as a recruiting differentiator to attract talent. As health care becomes more common, its value in the market may diminish. It transforms health care coverage from a competitive recruiting advantage to a cost of doing business.

Any changes to an area as large and important as health care are certain to cause big impacts on the hotel industry. The good news for hoteliers is that most of the proposals are expected to be phased in over a number of years. Even so, the wise operator should be considering these changes in planning labor costs at both current and planned properties.

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