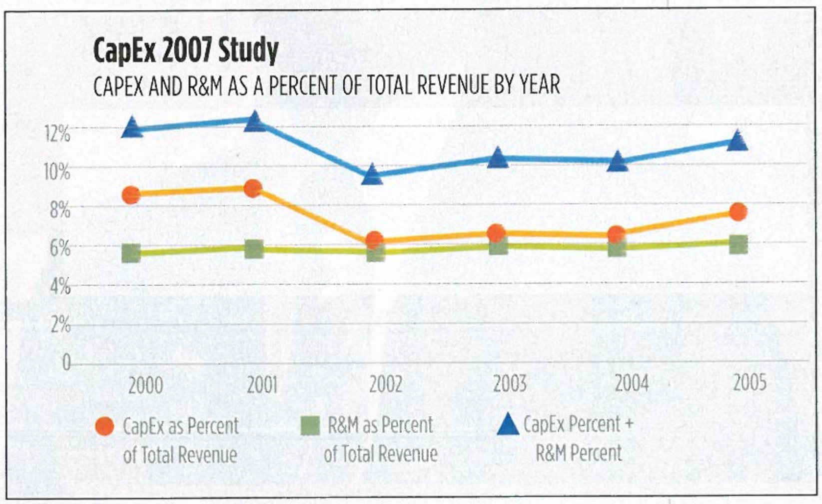
* Stephen Rushmore is president and founder of HVS, a global hospitality consulting organization with offices around the world. Steve has provided consultation services for more than 12,000 hotels throughout the world during his 35-year career and specializes in complex issues involving hotel feasibility, valuations, and financing. He can be reached at srushmore@hvs.com or 516 248-8828 ext. 204.

RUSHMORE

CAPEX IN CRISIS

Making the decision to renovate in the current economy is a difficult one. Due to limited capital expenditure dollars, hoteliers are faced with re-evaluating the previously recommended renovation cycles based on necessity. In the past, a hotel would be renovated based either on brand-mandated 'refresh' programs or on a renovation cycle based on the useful life of its systems and ff&e. Given the current state of the economy, today's decisions are driven by return on investment (ROI), occupancy and competition. It is important to understand the trends of capital expenditures, especially over the past few years when the market has taken a drastic turn, to know how to plan for and prioritize upcoming renovations.



The most recent capital expenditure study for the hotel industry was conducted in 2007 by the International Society of Hospitality Consultants. The study analyzed capital expenditure data from 2000 through 2005. During this period, the industry saw a sharp downturn due to the events of 9/11, followed by a gradual recovery beginning in 2003, then a boom in 2006 and 2007.

From 2004 through 2007, the hotel industry saw a swell of activity in both renovation and new construction, and with that increased activity came an increase in costs. Construction labor was expensive and hard to come by due to the number of projects underway. Energy costs were also on the rise, due to increased consumption, declining supply and natural disasters like Hurricane Katrina in 2005. Competition from overseas forced the prices of raw materials to soar. Prices for both steel and drywall rose 20 percent per year from 2004 to 2006, according to the AGC (Associated General Contractors of America). Due to material cost increases, inflation and labor costs, the average cost of hotel construction rose approximately nine percent in 2004, 10 percent in 2005 and seven percent in 2006, according to RSMeans, a construction cost information firm.

Although green design was receiving a lot of press, for most hotel owners, sustainable design initiatives were not economically feasible. Building green was viewed as an unwelcome addition of time and cost and a compromise of design because of limited material selections. Since many owners were renovating properties with the intention of selling again within a few years' time, the long-run savings incurred from green building practices weren't incentive enough to sell sustainable design. In the active market of 2005-2007, in which properties turned over frequently, building green just wasn't attractive.

Today's hotel industry is in a state of recovery similar to the one that occurred after 9/11. Construction projects were down nearly 35 percent between December 2007 and September 2009, and projects in the pipeline were reduced 26 percent during the same timeframe, according to Smith Travel Research. Capital expenditures are down due to a decline in RevPAR and the capital markets.

The upscale and luxury hotel sectors have been the hardest hit by revenue decline due to the negative publicity surrounding luxury spending in the recession. Consequently, luxury properties have been less apt to spend money on renovations. Limited-service properties, however, were the beneficiary of the cost-cutting trend and have continued to renovate, as they did during the years from 2002 through 2007. The limited service and economy sectors have kept closer to the normal renovation cycle during the economic downturn.

The decline in construction projects has also affected the cost and scheduling of construction. Projects that have been bid and constructed during this time have shown that construction costs were down 15 to 20 percent in the last quarter of 2009. Many projects are currently being bid by contractors and subcontractors at cost or even below, but this trend can't continue for too long. Labor prices are decreasing in non-union markets due to surplus supply. The South and Midwest are currently the hardest hit and are seeing the greatest reductions in labor costs. While the current trends have benefits on the cost side, scheduling of renovations can be tricky due to material lead times. Manufacturers of construction materials are drawing down inventories, so lead times have been increasing significantly. For FF&E, lead times are slightly increased due to slow recovery of the factory workforce.

According to many industry experts, the expectation is projects will return in the second half of this year, with an overload in 2012 similar to what happened during the post-9/11 recovery. This could also mean sustainable design projects have a promising future. While sustainable design was a burden that many owners could not afford to bear during the last decade, owners now seem to understand the value and importance of incorporating it into their projects. Over the past 10 years, more and more manufacturers have created eco-friendly products. This has made selection less of an issue and allows designers to fully express their creativity while creating a sustainable product. As jurisdictions begin to require sustainable design as part of their permitting processes, incorporating sustainable practices, and even seeking LEED certification, will evolve from a decision of conscience to a practical necessity.

As the market continues to stabilize and construction costs seem to fluctuate, a useful tool for any owner planning a renovation is an area-by-area guide to replacement costs for hotel systems and ff&e. In 2009, a comprehensive Hotel Cost Estimating Guide was established by Jonathan Nehmer + Associates and HVScompass to provide rule-of-thumb costs for various levels of renovation in five tiers: economy, extended stay, midscale, upscale and upper upscale. These ranges assist hoteliers in making informed decisions on capital expenditures.

Understanding the historical trends in hotel capital expenditures, using the post-9/11 recovery as a guideline, and utilizing all available resources in planning can make a hotel renovation possible, even when capital is tight. Experts from all sectors of the hospitality industry are urging owners to renovate while construction costs are low, and with good reason: A renovation while the cycle is down can position your property ahead of the competition and help your property become a leader in the recovery.

My column this month was made possible with the help of ***Jonathan Nehmer*** *and* ***Scott Rosenberg*** *of Nehmer + Associates and* ***Laura Kelly*** *of HVScompass. If you have any questions on your hotel's capital improvements and want to talk with an expert in hotel design and construction, drop me an e-mail at* ***srushmmore@hvs.com.***