

Hotel Investment Strategies

Development Cost Can Determine Feasibility

One of the least understood terms in the hotel/real estate business is "feasibility." What makes one proposed hotel feasible and another not feasible? Some analysts evaluate feasibility by calculating an internal rate of return (IRR) and seeing if the resultant return is sufficient to account for the potential risks. An easier procedure is to compare the economic value of a proposed hotel upon its opening to its total development cost. If it cost more to build than it is worth, then the project is not feasible. When a hotel opens and its value is greater than the cost to build it is considered feasible.

A developer wants to sell the completed hotel for a price that actually exceeds the development cost so a profit can be realized. This profit factor is called a "developer's profit," which typically ranges from 10% to 25%. Considering that most people want to make a profit for their effort, it is normal to include a developer's profit on top of the total development cost when evaluating feasibility.

The two key ingredients to a feasibility study are the total development cost and the economic value. This month's column will focus on the total development cost and a future column will consider economic value.

The process of developing a hotel requires packaging five components—land, improvements, furniture and equipment, pre-opening and operating capital—in a manner that meets the needs and desires of travelers visiting the marketplace. This delicate balancing act requires precise coordination of design, function and cost.

The hotel development process starts with the land acquisition. Generally, the land component cost represents between 10% to 15% of the total project cost. When land cost exceeds 20%, project feasibility could be in doubt.

The improvements represent the actual building with all its mechanical, electrical and plumbing systems. The cost of the improvements is directly related to construction quality, spatial utilization, design consideration and the local development cycle. During the building boom of the late 1980s and, to a lesser extent, today increased construction activity produces a more rapid rise in building development costs.

The large amount of furniture and equipment within a hotel is unique to this form of commercial real estate. Depending on whether the property has foodservice or not, the furniture and equipment component generally represents between 10% and 20% of the total project cost. As hotels start installing more expensive technology, expect these percentages to increase, which could affect the balance between cost and value.

Another two components unique to the hotel industry are pre-opening expenses and operating capital. Pre-opening costs include items such as initial marketing, recruiting and training.

For large convention hotels, these activities can occur years before the property opens and often represent a significant expenditure. Operating capital is the money needed to purchase inventories and supplies. Once a hotel becomes operational, its actual working capital diminishes.

HVS International constantly tracks hotel development costs to evaluate feasibility. Elaine Sahlins and Suzanne Mellen of HVS in San Francisco compiled the following table showing per room hotel development costs for three classes of hotels. This information is part of our annual Hotel Development Cost Survey which can be found on the Internet at www.hvsinternational.com.

HVS Hotel Construction Cost Survey

Budget/Economy	Land	Building and Site Improvements	Soft Costs	FF&E	Pre-Opening and Working Capital	Total
Average	\$7,200	\$31,700	\$1,200	\$6,400	\$2,400	\$48,900
Average/Allocation	15%	65%	2%	13%	5%	100%
Midscale without F&B						
Average	\$12,100	\$53,900	\$7,800	\$10,000	\$3,200	\$87,000
Average/Allocation	14%	62%	9%	11%	4%	100%
Extended-Stay						
Average	\$15,300	\$65,800	\$9,500	\$11,900	\$3,200	\$105,700
Average/Allocation	14%	62%	9%	11%	3%	100%
Midscale with F&B						
Average	\$13,800	\$76,800	\$10,100	\$11,600	\$4,000	\$116,300
Average/Allocation	12%	66%	9%	10%	3%	100%
Full-Service						
Average	\$19,500	\$110,100	\$16,100	\$20,200	\$6,200	\$172,100
Average/Allocation	11%	64%	9%	12%	4%	100%
Luxury and Resorts						
Average	\$48,500	\$202,100	\$60,500	\$52,000	\$12,400	\$375,500
Average/Allocation	13%	54%	16%	14%	3%	100%

Note: U.S. dollars

Source: HVS International

As you can see, balancing these five components in a way that design, function and cost are always in sync can be a complex exercise. Success is measured by the amount of developer's profit remaining when you deduct the total development cost from the hotel's economic value on opening day. ♦



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