Hotel Investment Strategies

Don't Overpay For Hotel Sites

Developing a new hotel is an exercise in balance. The cost of the land, building and furnishings must balance out with the ultimate value of the completed project. If one or more of the cost components is excessive, the entire hotel development might become unfeasible.

In a number of Asian cities, as well as Paris, London and New York, where land costs have been extremely high, it has often been difficult to justify new hotel development because the cost/feasibility balance is out of kilter.

What is meant by feasibility? To achieve economic feasibility, the hotel's value upon completion must be greater than the cost of developing the project. For example, if a 200-room hotel cost US$20 million to build, it would need a market value upon completion of more than US$20 million in order to be feasible. No developer would want to have to sell a hotel upon completion at a price less than the money expended to build it, plus a developer's profit.

The acquisition of the site is generally the first step in developing a hotel. Overpaying for land is one of the easiest ways to adversely affect the project's overall feasibility. For example, when the land component in Hong Kong represented more than 50% of the hotel project's cost, it should have been evident this type of improvement would not be viable.

There are ways to check to see how much a particular hotel project can afford to pay for land. The process starts with a calculation of the rooms revenue at the point in time when the hotel achieves a stabilized occupancy. Using the 200-room hotel example described above, it was estimated that this property would have reached a stabilized occupancy of 72% with an average room rate of US$85 by its third year of operation. This calculates to a total rooms revenue of:

200 rooms x 365 days/year x 72% x US$85 =
US$4,468,000 rooms revenue

The next step is to make a locational adjustment based on the desirability of the site's location. The following percentages provide a range of locational adjustments that will then be multiplied by the projected rooms revenue:

Highway Location 3% to 4%
Suburban Location 4% to 8%
Center City Location 5% to 9%
Trophy City Location 6% to 10%

Let's assume that the subject property is situated in a good center city location and the appropriate locational adjustment is 7%. The adjusted rooms revenue would be:

US$4,468,000 x 7% = US$313,000 adjusted rooms revenue

The land value is estimated next by dividing the adjusted rooms revenue by a percentage rate of return that generally approximates the interest rates for local hotel mortgages. In this example, the local hotel mortgage interest rates are 8%. The land value is calculated as follows:

US$313,000/.08 = US$3,900,000 land value

If the developer is able to acquire the land at a price either equal to or below this value, then the land component is in balance. The developer should proceed with caution if the cost of land is significantly above US$3,900,000.

A rough rule of thumb for full-service hotels: Land should not comprise more than 15% to 20% of the project cost. For some limited-service and extended-stay hotels, land can represent as much as 20% to 25% of the total cost. In this example, the land component is approximately 19% of the US$20 million cost, which is on the high side of the acceptable range.

As you can see, a hotel's rooms revenue is the deciding factor in this approach for balancing the land cost component. If a developer is faced with an out-of-balance land cost, the two logical options are to increase the number of rooms (if zoning and market conditions permit) or enhance the quality of the facilities and service so the property is able to achieve a higher average room rate (again if market conditions permit). These adjustments are evident in the Asian markets with their high land costs. There is an over abundance of 5-star hotels and practically no 2- or 3-star properties.

While location, location, location is considered one of the primary traits for a successful hotel, the economics of the land acquisition cost is an important factor that must be balanced before proceeding with a new hotel development. ◆

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