The Future of Full-Service Hotel Development

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The United States experienced substantial hotel development throughout the 1980s. Due to overbuilding, reduced lodging demand, and the "capital crunch," hotel values went into a freefall in 1990, and generally continued a decline through 1992. Hotel values were reduced in many markets to as little as 50% or less of replacement cost. With the recession behind us and some regional economies rebounding strongly, the question of when new hotel development may again be feasible becomes relevant. Hotel buyers are generally bullish about the prospects for the industry over the near term due to the virtual guarantee that there will be no additions to the competitive supply. As lodging demand expands and occupancy levels rise, hotel owners and investors hope to raise average rates to increase profitability and the value of their assets. Once profitability rises to the point where the financing of new development can be supported, new competition can once again be expected. As investors consider what to pay for a property, the specter of future competition becomes an integral component of the analysis.

Owners of existing full-service hotels, now pleasantly faced with a trend of increasing hotel values, may be considering when to sell to maximize profits or minimize losses. Once new hotel development is feasible, the attraction of buying existing, aging properties diminishes. As such, the prospect of new hotel development is also relevant in the timing of an exit from a hotel investment.

So exactly when might we expect development of new full-service hotels or the value of existing hotels to once again equal or exceed their replacement cost? The answer is, of course, very market specific. Some submarkets throughout the country are already evidencing occupancy and average rate levels capable of supporting new development.

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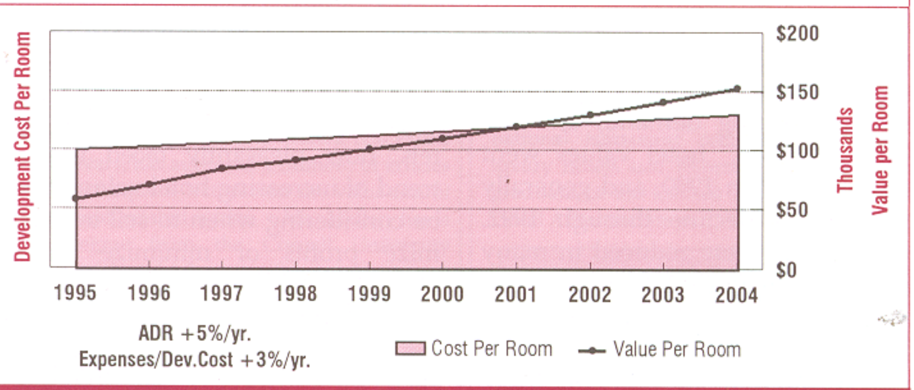
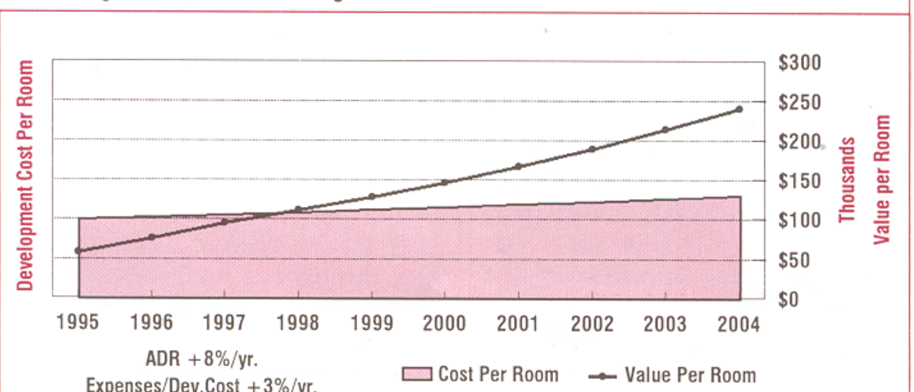
Some industry participants believe that the availability of capital, not market demand for hotel rooms, is what drives new hotel development. One can argue that no matter what drives development, capital must be available before we will see the opening of new full-service hotels. For capital to once again be attracted to the lodging industry, the economic underpinnings of hotel investments must greatly improve.

What are the variables which must change for new development to be feasible? Simply, the economic value of a project must exceed its development cost. Development costs generally rise with inflation. Consequently, the cost side of the equation is typically fixed, though tightly controlling costs always remains critical, particularly for full-service hotels which have historically been prone to construction cost overruns. On the other side of the equation, for the economic value of hotels to rise, net operating income must increase or the cost of capital must decline. While capital will no doubt become more available in the future, it is unlikely that the cost of capital will be significantly lower than it is today. For a hotel's net income to increase, either revenues must rise and/or operating expenses must decline. While we hear of hotel management companies continuing to re-engineer hotel operations, most of the major strides in reducing operating expenses have already been made. Operating expenses may already be as lean as possible without technological innovations, such as automated check-in, etc. As such, the final variable we can look to to improve hotel values is revenue, driven by average rate and occupancy.

Occupancy levels are rising in most markets throughout the United States today as lodging demand rebounds and supply remains stable. In some markets hotels have reached an optimal, maximum attainable occupancy which is now enabling gains in average rates. Hotel occupancies generally have a point of optimization, due to the characteristics and weekly and seasonal patterns of demand in a given market. If demand remains strong, average rates can often be raised above the rate of inflation.

Given that it will take improvements in revenue (average rate and occupancy) to make gains in hotel values, the question becomes what levels these two variables must reach for new development to be feasible, or for the value of existing hotels to once again equal or exceed their replacement cost. Smith Travel Research's HOST operating statistics for full-service hotels were utilized as the basis for this analysis. In 1993, full-service hotels attained an occupancy of 68.7% and an average rate of $76.80, with a net operating income of 17% (after an inputted 3% management fee and 3% reserve for replacement) and a net income per available room of $4,894. Assuming a 10% overall capitalization rate implies that the value of the average full-service hotel in the Smith Travel Research database equated to $48,940 per room in 1993. Inputing this historical operating statement into a fixed and variable model, it was assumed that occupancy levels would rise to 70% in 1995, to 72% in 1996, and to a stabilized level of 74% in 1997. This occupancy level is only an estimated representative maximum attainable occupancy, and specific market or product dynamics will clearly differ. Assuming a 3% annual increase in operating expenses throughout the forecast, and average





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annual rate gains of 3% in 1994 and 4% in 1995, "what ifs" were calculated to assess the level of average rate gain which would be necessary to attain feasibility. The development cost of this hypothetical full-service hotel was estimated to be $100,000 per room in 1995, reflecting an average between mid-rate, first-class, and luxury hotels.

Graph one sets forth the analysis assuming annual increases in average rate of 5% from 1995 forward; feasibility is not indicated until 2001, when an average rate of $110.25 and a net income of $11,926 per available room, equating to 27.4% of total revenues, are attained.

Graph two sets forth the most aggressive average rate forecast, 8% annual gains from 1995 forward, while still maintaining 3% annual increases in operating expenses. In this scenario hotel development is feasible in 1998, when a $103.64 average rate and a net operating income of $11,119 per available room, equating to 27.8% of total revenues, are attained.

Inputing annual average rate gains of 6% and 7% per year indicates feasibility in the years 1999 and 2000, respectively.

It is clear that it may be some time before new hotel development is feasible and the value of existing full-service hotels exceeds their replacement cost. Owners of existing hotels are likely to see the values of their assets rise as buyers continue to pursue purchasing lodging products below replacement cost.

To receive a copy of the income and expense forecasts and graphics supporting the preceding conclusions please contact Suzanne R. Mellen, Managing Director, HVS–San Francisco, (415) 896-0868. ❐