# Hotel Investments Handbook

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WEST
GROUP

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## DIRECTORIES

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# APPENDIXES



# DIRECTORIES

CHAPTER 1

# Overview of the U.S. Lodging Industry



## ¶ 1.01 THE LODGING INDUSTRY

An investment in the lodging industry, whether it be for the purpose of acquiring an existing facility or developing a completely new one, requires a certain amount of research regarding both the industry as a whole and the investment itself. *Hotel Investments Handbook* presents the necessary information and analytical methods in the sequence in which they are used in order to make a prudent investment. Before embarking on a hotel investment, a prudent investor gains a general knowledge of the hotel industry and the ways in which it works. Chapters 1 through 4 provide an overview of the industry and discuss the forces that affect it.

### [1] History

The evolution of the lodging industry in the United States is, of course, closely related to the economic history of the country. Usually, the health of the industry can be gauged by the condition of the economy as a whole. Prosperous times for the nation typically mean increased room and occupancy rates and the construction of more lodging facilities. When the economy falters, leisure and business travelers tend to stay home or spend less on accommodations when travel is necessary.

Internal industry cycles also have a strong effect on the lodging industry. The most important of these is the continually changing relationship between room demand and room supply. For example, hotel construction is fueled by several factors other than simple demand. The availability of funds is often a determining factor. Oversupply, often the result of periods of increased construction activity, has meant stagnation for the industry, even when the economy as a whole performs well. This was the case in the late 1980s.

Along with the evolution of lodging products and the identification and pursuit of specific segments of the lodging market, the ownership and management of lodging facilities have undergone many changes. The industry, which began with entrepreneurs who owned and managed individual properties, has come to be dominated by national and international chains. At one time, the chains built and owned the properties on which their names were displayed, but the trend in the industry is for many of the major hotel chains to develop and manage properties for outside investors. This fundamental change has dramatically increased the number of individuals and corporate entities involved in hotel projects.

Chapter 2 traces the development of the lodging industry in the United States from colonial days to the present. Along the way, it points out the major developments that have affected the industry, such as franchising, new financing methods, and product and market segmentation. This chapter also introduces the reader to the hotel industry as it exists today.

### [2] National Supply and Demand

In addition to a familiarity with the basic elements of the lodging industry and the economic trends that affect it, an understanding of the nature of the national supply of lodging and the national demand for lodging is essential in order to correctly make the crucial decisions affecting an investment, such as the choice of a particular market or product. Chapter 3 describes the various types, classes, and locations of facilities that make up the national supply of lodging as well as the characteristic operating results of the various kinds of facilities. Chapter 4 identifies the sources of data by which present demand can be quantified and future demand projected.

## ¶ 1.02 PLANNING A HOTEL INVESTMENT

Whether a hotel investment entails the development of a new property or the acquisition of an existing facility, proper planning is necessary for success. The following lists outline the steps that must be taken to acquire or develop a lodging facility. Some of the steps are appropriate for both the development and acquisition process, while others are unique to only one. The order of the various steps is not fixed and some may be performed concurrently.

☐ **Hotel Acquisition:**

- *Planning stage:*
  - —Select a region of the United States.
  - —Narrow the selection to several cities or market areas.
  - —Look for a market niche.
  - —Look for a product (i.e., available properties).
  - —Perform a preliminary economic market study and appraisal.

- *Implementation stage:*
  - —Tie up the property with a letter of intent, option, or contract.
  - —Negotiate the terms of the sale.
  - —Go to contract on the property.
  - —Line up an operator.
  - —Line up a franchise.
  - —Commission a formal economic market study and appraisal.
  - —Line up mortgage financing.
  - —Line up equity financing.

☐ **Hotel Development:**

- *Planning stage:*
  - —Select a region of the United States.
  - —Narrow the selection to several cities or market areas.
  - —Look for a market niche.
  - —Look for a product (i.e., available sites).
  - —Perform a preliminary economic market study and appraisal.
- *Implementation stage:*
  - —Tie up the property with a letter of intent, option, or contract.
  - —Obtain zoning and permits.
  - —Assemble the project team.
  - —Line up an operator and franchise.
  - —Prepare architectural plans and estimate project costs.
  - —Commission a formal economic market study and appraisal.
  - —Line up a mortgage.
  - —Line up equity capital.

Chapters 5 through 13 describe the essential steps in planning a hotel investment, particularly the evaluation of markets, sites, and products in order to determine a viable location; the type and class of facility that would best utilize the attributes of the location and opportunities afforded by the local market area; and the financial results that can be expected from the proposed facility. Appendix 1 contains a data collection checklist covering many of the topics described in these chapters.

Chapters 5 through 13 feature case studies developed to illustrate the concepts presented in the text. A proposed hotel (as opposed to an existing facility) was selected as the subject in order to demonstrate how a market study and appraisal can be performed without the benefit of historical operating data. The case studies are designed to be realistic, but the data is hypothetical.

## [1] Selecting a Lodging Market

The first step in both hotel acquisition and development planning is to determine where to begin the search for suitable hotels to acquire or sites to develop. Chapter 5 shows how investors should evaluate various regions of the country, using data and analytical techniques to determine whether they should be considered further or rejected. Some of the important factors that investors should consider are the following:

- *Proximity to home office.* Hotels are labor-intensive businesses that require constant supervision and direction. When acquiring or developing a lodging facility, investors are well-advised to keep it close to home so that it can be given their full attention. Supervising lodging operations scattered over a wide geographic area is of course possible, but to do so requires a level of expertise that can be gained only through significant industry experience.
- *Signs of economic growth.* Regions of the country exhibiting strong growth trends are generally better suited for hotel investing than are regions that are economically stagnant.
- *Competitive environment.* The hotel investor should carefully evaluate the regional supply of competitive lodging facilities in conjunction with his study of economic growth. Even if economic trends are favorable, an adverse competitive environment brought about by the oversupply of hotel rooms can make a region an undesirable location for acquiring or developing a lodging facility.

Once the investor has selected a particular region, he should use similar criteria to choose specific market areas in which to focus his investigations. The demand for transient accommodations and the competitive supply are once again the key factors to be considered when analyzing potential market areas.

After the market area has been determined, the next step is to find a market niche, which is a unique market position or a particular market for which a product may be suited. When evaluating a market area, the hotel investor first looks for situations that exhibit a need for a specific hotel product. At the same time, consideration is also given to protective characteristics known as barriers to entry, which might include restrictive zoning or license approval processes, limited suitable land or acquisition opportunities, rapidly escalating construction costs, and the unavailability of an appropriate chain affiliation or management company. A unique market position may quickly change to an overbuilt position if no barriers to entry exist and other competitive products can enter the market without much difficulty.

Finding the appropriate market niche not only is an important consideration for a proposed hotel development but can be equally critical when it becomes necessary to reposition an existing property. A hotel can be repositioned through a renovation or upgrading, change of franchise affiliation, or the introduction of new management.

## [2] Property and Site Selection

Once the type of hotel has been determined on the basis of the evaluation of market niches, the investor must start to look for available hotels if an existing property is desired, or suitable sites if a new development is desired.

Real estate brokers are the best source of information regarding the availability of property for sale. When looking for an existing hotel, investors often use the services of a broker whose practice is concentrated in the lodging industry. A knowledgeable hotel broker can save considerable time and effort by showing only properties that meet the investor's particular criteria. When looking for potential hotel sites, it is best to use a land broker familiar with the local area—particularly the zoning regulations, building codes, and related laws. One of the most difficult aspects of accomplishing a hotel development is obtaining the necessary zoning changes and variances. A knowledgeable land broker understands these issues and can direct the developer to suitable sites requiring minimal zoning changes and approvals. Brokers are compensated by the seller with commissions based on a percentage of the sales price—generally 1 percent to 4 percent for existing hotels and 4 percent to 10 percent for vacant land.

Real estate brokers are agents for the seller; as such, they work for, are loyal to, and are paid by the property owner. Sometimes buyers of existing hotels or developable sites find it advantageous to employ either a broker or a property search firm to research potential investment opportunities. This alternative is sometimes effective, because a search firm is often able to obtain leads on hotels for sale before they actually go on the market. The same hotel knowledge and experience is necessary for a hotel search firm as a hotel broker. The fee arrangement for a hotel search depends largely on the area covered; sometimes fees are based on an hourly or per diem rate, a flat fee, or some formula related to the number of hotels actually acquired by the client.

Buyers can also research the market and successfully locate potential products on their own, but usually only if the buyer is familiar with the local area and knows all the property owners and potential sellers or if the buyer is a major, well-known buyer of lodging facilities and is likely to receive solicitations directly from potential sellers. By dealing directly with the seller, the buyer can avoid paying a fee to a broker or a search firm, and thus eliminate a considerable expense, which is ultimately reflected in the purchase price of the property.

## [3] Preliminary Market Study and Appraisal

Before any money is committed to the purchase of the property, prudent investors perform or commission a thorough preliminary economic market study and appraisal. The information yielded by this analysis is used to determine the type of hotel and facilities best suited to the location and the type of management and franchise affiliation (if any) that would be the most effective. Another important product of a market study is a forecast of the revenues and expenses that the subject property can be expected to realize. This information is vital to the buyer during the negotiation of the sale of the property, because it can be used to determine the value of the facility.

The first step in evaluating a proposed investment is to analyze the site of the proposed or existing property. The suitability of the site for hotel operations is one of the most important determinants of the success of an investment. The site analysis involves such factors as the physical suitability of the land, access and visibility, the availability of utilities and other services, and the applicable zoning regulations. Chapter 6 examines all of these concerns and shows how they are to be weighed in the evaluation of a proposed site.

Once a particular site has been selected, the area in which it is located must be evaluated. Generally, this evaluation includes both the immediate neighborhood of the site and its market area. The extent of the relevant neighborhood can usually be determined by simple observation of the surrounding area, including roads and land-use patterns. The market area, on the other hand, is often harder to identify because it involves a larger area and depends on more abstract factors (e.g., competition and travel patterns). Chapter 7 explains how both the neighborhood and the market area can be determined and evaluated for suitability.

An important step in any hotel investment is an examination of the supply of lodging facilities in the subject area. Before the success of the proposed hotel investment can be determined, the appraiser must first determine the degree to which other hotels in the area would compete with the subject property. Chapter 8 discusses how this analysis should be performed. It explains how operating information for competitive hotels can be obtained or projected and shows how data obtained from competitors can be adjusted to eliminate any bias that they might contain.

After the supply of hotels has been evaluated, the existing demand must be quantified to determine its ability to support a new hotel or the acquisition of an existing facility. The demand analysis can be performed using one of two methods: the demand generator build-up approach or the lodging activity build-up approach. Chapter 9 explains these two methods and shows how the data necessary to use them can be obtained.

In conjunction with the analyses of local supply and demand, the appraiser must determine the competitive positions of all the local facilities and how the subject property would fit into this picture. Generally, this task involves determining the current market share, average room rate, and occupancy rate of the existing competition. Once this determination has been made, the appraiser can forecast these variables for the subject property. Chapter 10 shows how this analysis is accomplished.

One of the final steps in the preliminary appraisal is to forecast the income and expenses of the proposed hotel investment. The income projection focuses on a hotel's main categories of revenue, such as rooms, food and beverage, and telephone income. The expense projection examines a hotel's main items of expense, such as rooms, food and beverage, telephone, administrative, management, and marketing costs. Chapter 11 discusses the various categories of revenue and shows how a revenue forecast is made. Chapter 12 does the same for expenses.

A property valuation, along with the forecasts of revenue and expense, allows the appraiser to make a recommendation regarding the feasibility of a proposed hotel investment. The first step in a property valuation is to determine the overall worth of the subject property. This step entails appraising an existing hotel or forecasting the value of a proposed property. This value is contrasted against the cost of the property, which is either the cost of acquisition or of construction. Chapter 13 explains the three basic methods for performing a property valuation: the cost approach, the sales comparison approach, and the income capitalization approach.

## ¶ 1.03 DEVELOPMENT, ACQUISITION, AND FINANCING

Once the necessary planning for a hotel project has been completed, the actual process of development or acquisition, as outlined in Chapters 14 through 17, can begin. Chapter 14 discusses hotel investment, offering reasons to invest in hotels, a historical perspective for the investor, and finally key strategies for and insights into the investment process.

Chapter 15 discusses important considerations for those who wish to own a hotel property. The form of hotel ownership is a very important decision that is usually based on tax, legal, or business considerations. For example, an owner might choose to form a corporation instead of individual ownership in order to limit his personal liability.

In this chapter, the following business entities are discussed:

1. Individual ownership
2. Concurrent ownership (by two or more individuals)
3. Partnership (general and limited)
4. Regular corporation (C Corporation)
5. S Corporation
6. Limited liability company (LLC)

7. Trust
8. Real estate investment trust (REIT)

Chapter 16 explores the various financing techniques and sources of capital commonly used in the hotel industry, along with the mortgage loan process and what the hotel developer should consider when obtaining a mortgage.

Chapter 16 divides equity and debt sources into the following two categories:

1. Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:
   —Commercial banks;
   —Life insurance companies;
   —Private credit companies; and
   —Pension funds.
2. Investment conduits, which are primarily entities that invest in hotel real estate mortgages and pass through income and gain to investors (both private individuals and institutions), including:
   —Real estate limited partnerships (RELPs);
   —Real estate investment trusts (REITs); and
   —Commercial mortgage-backed securities (CMBS).
3. Mortgage financing, which is how most hotels are financed. Topics covered include:
   —Types of Mortgage loans; and
   —Obtaining a hotel mortgage.

Chapter 17 focuses on two issues related to the buying and selling of hotel properties. The first is the importance of hiring a professional broker when selling a hotel property. The second is the like-kind exchange. An exchange of hotels, or an exchange of business property for a desired hotel property, is a creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, because appreciated property can be exchanged without incurring any tax on the appreciated gain.

## ¶ 1.04 FRANCHISE AFFILIATIONS AND HOTEL MANAGEMENT

Two of the most important steps in the hotel investment process are obtaining a franchise affiliation and selecting a hotel management company, as described in Chapters 18 through 21. The choice of a franchise affiliation is an important decision in a hotel investment that should be made as early in the acquisition or development process as possible. Even more so than a management company, a franchise company will want the opportunity to participate in decisions regarding designs and specifications for a lodging facility, because most have companywide standards that must be met by each of their properties. An early decision also enables the property owner to accurately determine the cost of the franchise affiliation and use the information when analyzing the economics of the project.

Chapter 18 discusses the major concerns in choosing a franchise affiliation, including the advantages and disadvantages of franchises, the services offered by franchisors, and the fees charged by franchisors. The chapter also examines the process for selecting a franchise affiliation and the agreements between franchisors and franchisees.

## [1] Property Management

Whether the project in question is a development or an acquisition, a management company should be retained as early as possible in the process. In the case of a development, a management company should be brought in before any significant amount of time is spent on architectural drawings, so that the management company will have the opportunity to provide suggestions regarding the layout and general design of the facility. Securing a management company early on is even more important for a hotel acquisition, because the company will often be able to generate valuable information regarding the projected operating performance of the property, which can be a critical factor for the purchaser during the negotiation of the sale of the property. In addition, the management company will indicate what changes must be made to the property if improvements are required in order to meet the company's operating standards. This input will also have an effect on the negotiating position of the buyer.

Chapter 19 describes the two basic types of management companies: first-tier operators and second-tier operators. It examines all of the important considerations in choosing a management company and looks at the actual contract negotiation process. It also compares the hiring of individual managers to the hiring of a management company.

## [2] Management Contracts

The proper execution of the management contract is a vital step for the successful development of the hotel investment. This document spells out the basic relationship between the owner and the operator. Each party must be able to negotiate the contract with a full understanding of the consequences of including or disallowing a particular provision. If either party is permitted to include provisions that are disproportionately favorable to its position, the working relationship between the parties can be severely damaged.

Chapter 20 provides an in-depth analysis of operating agreements between hotel owners and management companies. It describes the basic provisions found in management contracts, ranging from fee structures, financial reporting, and budgeting to terminations, assignment of employees, and indemnification. Appendix 3 contains a wide assortment of clauses, taken from actual management agreements, that can be used to assemble a working contract. The clauses are labeled to show their orientation—owner, operator, or neutral.

Chapter 21 steps back a bit to discuss the essential steps in the coordination and execution of a hotel's development. The actual process of construction is not discussed, but the phases that a hotel development project typically goes through and the roles of the main contributors to a development project are explained in detail.

# ¶ 1.05 OTHER ISSUES

Chapters 22 through 24 discuss other timely issues of interest to hotel developers. The focus in Chapter 22 is on international markets. The chapter includes a discussion of the benefits of investing in developed countries versus developing ones. It also includes country-by-country descriptions of the hotel markets in Europe and the Middle East. For each country, the state of the current hotel market and its potential for growth is discussed.

Chapter 23 focuses on a particular market within the hotel industry—the casino gaming industry. Casino-style gaming is currently legal in twenty-two states, in a variety of forms such as on riverboats, at riverside docks, and in saloons, and on various sites including Indian reservations, public parcels and waterways, and privately owned land. A combination of consumer acceptance and the local municipalities' need to increase revenue has resulted in an array of new jurisdictions and gaming venues. This chapter provides a detailed analysis of the current state of the industry as well as its future.

Chapter 24 offers practical advice about the selection of a consulting and appraisal firm to perform an economic market study and appraisal of property. The chapter includes an analysis of the major changes that have taken place in the appraisal industry since the passage of the Financial Institutions Reform and Recovery Enforcement Act (FIRREA) in 1990.

## ¶ 1.06 INDUSTRY SOURCES AND CONTACTS

The directories at the back of *Hotel Investments Handbook* offer information about companies currently involved in the hotel industry, such as hotel developers, lenders, management companies, and franchise companies. Each entry includes the name, address, and telephone number of the firm along with the person to contact. Once an investment has reached the planning stages, these directories can provide investors with invaluable leads as to the people and firms to contact to make their project a reality.

CHAPTER 2

# History of the Lodging Industry

# ¶ 2.01 COLONIAL TIMES TO WORLD WAR II

## [1] Inns, Rooming Houses, and Grand Hotels

The first lodging facilities developed in the United States were coaching inns and taverns. Patterned after English inns, these facilities were situated primarily in seaport towns and along coaching routes. As the new colonies developed and the country expanded westward, lodging facilities with higher degrees of opulence were established. Influenced by their European counterparts, they closely resembled the hotel as we know it today and were located in resort and urban settings.

The growth of the U.S. railroad system led to an increased demand for overnight accommodations for rail travelers. Numerous small rooming houses were built near train stations to accommodate transient guests. Quite spartan, these facilities generally had much lower standards of service and cleanliness than the luxury hotel properties found in the cities and resort areas. Travelers in most situations had a choice between high-quality downtown hotels and inexpensive accommodations in railroad rooming houses. For many travelers, unable to afford first-class accommodations, the railroad rooming houses were the only viable option for overnight accommodations.

## [2] Birth of the Modern-Era Hotel

At the turn of the century, the United States experienced an economic expansion that, in conjunction with improvements in transportation and lower travel costs, opened up travel to the middle class, thereby creating a new and rapidly expanding market for hotel accommodations. The economic expansion also brought about increased commercial activity and ever-larger numbers of business travelers. However, neither the hotels at the upper end of the market nor those at the lower end satisfied the needs of business travelers.

### [a] The First Significant Commercial Hotel

In response to expanding commercial market demand, Ellsworth M. Statler in 1908 opened the Buffalo Statler in Buffalo, New York—the first modern era hotel meant to accommodate the needs of the commercial guest. Many of the conveniences taken for granted today were first instituted by Statler in this hotel, which became the model for reasonably priced, efficiently run commercial hotels throughout the country. Standard features in all of Statler's hotels included private baths, full length mirrors, morning newspapers, and overnight laundry. "A bed and a bath for a dollar and a half," Statler's tagline, came to mean a standardized hotel product to U.S. travelers.

### [b] Luxury Hotels in the Early 1900s

During the early 1900s, an aggressive expansion in hotel construction took place in the United States as large luxury hotels (e.g., the Plaza, built in New York City in 1907) were constructed in major cities, and the commercial hotel segment continued to emerge. This expansion slowed during World War I, but when the nation's involvement in that war concluded in 1918, there was a tremendous resurgence in hotel development, which lasted until the early 1920s.

## [3] Overdevelopment in the 1920s

After the war, the middle class continued to prosper, and investment capital for hotel development projects was generated. The fact that nationwide hotel occupancy rose from 72 percent in 1919 to 86 percent in 1920, coupled with the perception that real estate was a sound, safe investment vehicle, made many people eager to contribute development capital as they listened to hotel promoters. Many times the developer's arguments for investment were predicated not on economic feasibility but on civic pride, improving a neighborhood, or the personal prestige associated with investing in new hotel development projects. In some cases, local merchants were promised business from the hotel when it opened in exchange for an investment in the project. In these "community-financed" hotel projects, real estate bonds for first and second mortgages were sold to local residents to stimulate business for the hotels from the local community. In many situations, the financing structures that were created involved extremely high leverage accompanied by a commensurately high degree of risk.

Despite these conditions, however, investors were convinced of the viability of hotel development projects. Investment capital was readily available, and numerous hotel development projects were financed, resulting in a boom in hotel construction throughout the decade.

By the mid-1920s, *Hotel Management* (a trade publication that later became the current *Hotel and Motel Management*) began to print articles by industry spokespersons warning against "over-hoteling" and urging professional hoteliers to reveal to the public the "real facts" about their hotel's occupancy level and financial condition to offset the larger-than-life stories that had contributed to the overbuilding. To illustrate the extent of the overbuilding problems, a nationwide survey was conducted in 1928 and 1929 by an objective body, the Engineering-Economics Foundation. This postgraduate college in Boston quantified hotel room supply, guest demand, occupancy levels, rates, and hotel failures between 1919 and 1928. They found that nationwide hotel occupancy had drastically declined from a high of 85.5 percent in 1920 to 67.6 percent in 1928. A staggering decrease of 17.9 occupancy points equated to a 21 percent decline in hotel rooms sold.

Room rates remained generally constant from 1921 to 1928, but the Foundation determined that the additional services offered to guests during this period considerably reduced the profitability of hotel operations. Hotel failures averaged a stunning 15 percent annually between 1924 and 1928.

## [4] Depression Years

The true financial condition of the hotel industry became quickly apparent immediately following the stock market crash of 1929. Hotel rate wars became common, leading one industry spokesman to suggest mergers of hotels within cities to stabilize rapidly falling prices. However, even low rates could not stimulate demand.

By 1933, one third of the country was out of work, the gross national product had dropped by almost half, and the lodging industry suffered severely as a result. By 1935, more than 80 percent of the hotels in the nation were in foreclosure or in some form of liquidation. Many properties closed entirely, never to reopen.

### [a] Acquisition Opportunities for Ready Capital Sources

As is generally the case in real estate cycles, a major opportunity arose from the collapse of the hotel industry for investors who had available cash. These investors were able to acquire distressed hotels with minimal cash outlays and reasonable financing. It was during this period that some of the most well-known hotel chains were born.

### [b] The First Major Hotel Chains

Conrad Hilton entered the lodging industry in 1919 with the purchase of the 40-room Mobley Hotel in Cisco, Texas. During the 1920s, Hilton expanded his holdings throughout Texas, and had acquired a total of eight hotels by 1929, when the stock market crashed. Because his hotels were highly leveraged, Hilton suffered tremendously. Despite aggressively cutting costs (e.g., by removing guestroom telephones and shutting off entire floors), he was able to retain control of only five hotels in his chain. By 1935, however, profits from oil leases he had purchased provided Hilton with sufficient capital to satisfy his creditors and to fund additional hotel acquisitions. Hilton purchased managing control of the Sir Francis Drake in San Francisco, the Town House in Los Angeles, the Stevens in Chicago, and the Roosevelt and Plaza Hotels in New York.

Another substantial hotel chain was developed during the same period. Ernest Henderson founded what was to become the Sheraton hotel chain in 1937 with the initial purchase of the Stonehaven Hotel in Springfield, Massachusetts. By 1941, his developing hotel company had acquired four hotels and Henderson was well on his way toward building one of the nation's largest lodging chains.

Large, sophisticated hotel development companies, such as Hilton and Sheraton, were successful in persuading skeptical bankers and other investors to invest in their hotel organizations. By taking advantage of the extremely depressed hotel real estate market, the strong, well-capitalized hotel companies were able to continue to aggressively expand their hotel portfolios by acquiring hotel properties at depressed prices.

### [c] Early Valuation Theory

Financial analysts who monitored the hotel industry advised investors during the depression years not to value hotels on the basis of their present income streams, which were extremely depressed. They stressed rather that hotels should be valued on the expectation of future earnings, which were expected to rebound as the economy recovered.

Basing their conclusions on the pattern of the previous recession, hotel industry writers and analysts optimistically forecast three years of depressed sales and subsequent earnings before the industry would fully recover. This theory did not hold true because it did not take into account the tremendous overbuilding that preceded the depression; in addition, the economy did not fully recover until the early 1940s.

## [5] Economic Recovery in the Early 1940s; World War II

Hotel occupancy levels recovered shortly after 1940 as the general economy of the United States improved. Room supply had been diminished by the closing of many hotels during the depression. With the onset of World War II, the industry experienced a tremendous increase in lodging demand that surpassed even the booming 1920s. As a result of the war, the country was on the move: servicemen traveled home on leave, civilians relocated near defense plants, and the commercial market segment increased dramatically as all industrial activity related to the war effort was heightened. Despite the large increase in demand, supply remained constant because construction materials and labor were focused on the war effort. Additionally, financing was generally unavailable for new construction because lenders and investors still had a fresh memory of the devastation in the real estate industry caused by the last economic downturn.

In some markets throughout the country, hotel room supply was significantly affected when such hotels as the Stevens in Chicago and the Greenbrier in White Sulphur Springs, Virginia were converted to housing for troops. The combination of increased demand and constant room supply resulted in tremendous increases in hotel occupancy rates. Occupancy levels exceeded 90 percent throughout the country—translating into one of the most profitable economic cycles the industry has experienced.

During this period of extremely high demand and limited supply, labor and material shortages significantly compromised the service levels of most hotels, in many cases forcing guests to wait for hours in hotel lobbies for accommodations. The situation became so untenable during this period in the New York City market that hotels were forced to limit the length of stay to three days for all guests.

## ¶ 2.02 POST-WORLD WAR II ERA: CONTROLLED GROWTH AND CHAIN EXPANSION

In the years immediately following World War II, a construction boom equaling that of the period immediately after the first World War failed to occur, primarily because hotel lenders were concerned about a repeat of the financial disaster of the 1930s. Averse to providing development capital to new hotel developers and new construction projects, lenders did, however, provide acquisition capital and limited development capital to proven industry performers to allow them to continue the expansion of their hotel chains. Having developed successful track records during the 1930s and 1940s, the larger hotel chains (specifically Sheraton and Hilton) were looked on favorably by lenders and received assistance during the 1950s in expanding their chains, both by acquiring existing properties and, to some extent, by building new hotels in key cities. The Hilton hotel company purchased the Statler chain of 10 hotels in 1954 for $111 million from Statler's widow, and the Sheraton organization continued its expansion plans by acquiring 22 hotels from Eugene Eppley in 1956.

### [1] Motels

During the 1950s, continued growth of higher-end hotel chains was matched by the expansion at the lower end of the market of the family-operated tourist courts, developed initially in the 1930s. With their beginnings in these tourist courts, motels in the early years were usually 20- to 50-unit, family-run operations in which a small investment (such as a retirement nest egg) was made and family members contributed all of the labor. Although during World War II the occupancies of most of the larger hotel properties increased dramatically, the business of the smaller tourist courts declined because people had neither the time nor the money to vacation. Additionally, gasoline and food supplies were rationed, and leisure travel was not popular. It was not until after the war that the situation improved for this segment of the lodging industry.

After the war, travel in the United States became increasingly popular, stimulated by an improving economy that provided increased disposable income and by improvements in automobile travel. Traveling by automobile was simple and relatively inexpensive. The motel market expanded to include business travelers (especially salespeople, middle managers, and small business owners) in addition to vacationers, as well as employees traveling on government-related assignments.

The first motels were distinctly different from the larger hotels of the same period in terms of size, construction costs, land values, and management requirements. They provided lodging accommodations at convenient highway locations; they were much smaller and provided fewer amenities, but charged lower rates than the typical urban hotel facilities of the era.

## [2] The Late 1950s and Early 1960s

During the late 1950s and early 1960s, several new lodging chains had their beginnings. Holiday Inns, Ramada Inns, Howard Johnson Inns, Marriott, Hyatt, and Radisson all successfully won significant market share in their market segments through aggressive and inventive sales and marketing practices and techniques.

### [a] International Expansion Activities

International expansion activity by several U.S. hotel companies became prevalent during the 1960s. Pan American Airways' subsidiary, Inter-Continental Hotels Corp., which had initially been founded in the late 1940s with the opening of the Inter-Continental in Belem, Brazil, continued to develop hotels in Latin America. Hilton Hotels, which had been operating the Caribe Hilton in Puerto Rico since the late 1940s, established its Hilton International division and began expanding operations in Europe and South America.

### [b] Marketing Advantages Through Related Activities

A significant move toward vertical integration within the airline and lodging industries occurred during the 1960s as several large airlines acquired or merged with hotel companies. In 1967, Hilton International Corporation (by then a separate company from Hilton Hotels) was purchased by Trans World Airlines. UAL, Inc. purchased the Western International hotel chain, which is now known as Westin Hotels. Another example of the union of lodging and transportation companies was Holiday Inns' acquisition of the Continental-Trailways bus lines and the Delta Steamship Lines in the late 1960s.

### [c] Evolution of the Convention Hotel

The convention and meeting market became a focus of interest during the 1960s as hotel chains sought new opportunities for growth and increased revenues. A prime example of this type of expansion was the development of the The New York Hilton, which opened in 1963. Designed and built specifically to cater to the growing convention market, this type of facility was established in large cities that provided numerous tourist attractions to bolster attendance at conventions and meeting events. In addition, holding major events in large cities provided attendees with easy and relatively inexpensive travel options.

#### [d] Start of Franchise Development

Beginning in the 1950s, motel chains such as Holiday Inns used the concept of franchising as a technique for financing their growth. Rather than developing motel properties with their own funds, these lodging firms sold a standardized franchise product and package to investors who then developed and operated the properties as their own businesses.

#### [e] Product Diversification and Segmentation

Spurred by competition and the oversupply of rooms, companies diversified their product types and plunged into new market segments. The lines of price value and service demarcation become cloudy with the push into diversified business lines. More mature segments (e.g., full-service hotels) began experiencing competition from limited-service properties, suite properties, and extended-stay facilities. Companies learned that brand recognition can stretch across several price points, affording ready acceptance to new brands and products. This segmentation fueled much new development and provided a means of absorbing older properties whose location and age made them less competitive than the newer ones. This specialization attracted new capital, and the limited scope of services and lower variable costs reduced development costs and provided higher operating margins.

As franchise growth proliferated, however, drawbacks such as lack of control by the franchiser became apparent. To gain further control of the management of the brand, the hotel companies aggressively pursued management contracts in addition to franchise agreements.

## ¶ 2.03 EARLY 1970s: CONSTRUCTION BOOM, ENERGY CRISIS, AND DOWNWARD SPIRAL

In the early 1970s, as a result of a healthy global and domestic economy and an expanding U.S. interstate highway system, travel in the United States was flourishing. Hotel supply and demand were at an imbalance, with hotel rooms satisfying only two-thirds of the pace of demand growth. As a result, hotel occupancies climbed to 65 percent in 1974. Higher occupancies and increased room rates coupled with obtainable hotel financing accelerated hotel development activity. At the same time, many hotel franchise companies were aggressively expanding to increase their national exposure.

Also, during this era REITs (Real Estate Investment Trusts) were formed, allowing small investors to participate in real estate mortgages and equities.

### [1] The Bubble Burst

As a result of favorable demand and available development capital, numerous hotels entered the marketplace in 1974, just as the U.S. economy began to soften as a result of the OPEC oil embargo, which began in 1973. The embargo dramatically increased energy prices and decreased consumer confidence, leading to a decrease in business and leisure travel. Annual hotel occupancy declined to 62.3 percent from occupancy levels approaching 70 percent earlier in the decade. In 1975, room demand increased by only 0.7 percent, further exacerbating the oversupply situation.

Many lenders and developers believed, wrongly, that a national franchise would virtually guarantee a successful and profitable operation. The bubble burst on the lodging industry when inflation caused construction and interest rates to radically escalate. Additionally, the 1974 energy crisis drastically reduced travel, and the accompanying recession curtailed business trips, conferences, and conventions.

### [2] The Involuntary Owners

Operators of undercapitalized properties quickly became delinquent with their financial obligations, and in numerous situations, lenders were forced to foreclose to protect their financial interest in the projects. To address their problems as involuntary hotel owners, lenders developed and organized work-out departments generally headed by experienced hotel personnel, or they engaged professional hotel management companies to assume the operational responsibilities for the foreclosed-upon assets.

These involuntary owners, in most cases, were seeking to dispose of these assets quickly to remove nonperforming loans from their books and to reduce their prices substantially to attract all-cash buyers. Lenders who were willing to hold their hotel assets and employ professional management to reposition and improve the properties' operation were generally able to recoup their original investment in three to five years, once the industry began to recover. However, even lenders who held their assets until economic conditions improved were typically forced to provide favorable financing to dispose of these assets at acceptable prices.

### [3] Historical Perspective on Hotel Values

Interestingly, the history of real estate development and economic cycles indicates that during periods of economic decline, the values of hotel assets do not generally decline as radically as their income declines. Sellers of hotel assets and lenders of hotel assets during periods of economic problems were often unwilling to sell at substantially reduced prices. Their objective was to wait out the downward cycle and dispose of their assets when the market began to recover.

## ¶ 2.04 LATE 1970s: RECOVERY AND CALM

The late 1970s was a period of relative calm for the lodging industry. Because most lenders were recovering from the financial wounds inflicted by the 1975 recession, they had little interest in making hotel mortgages. New construction was restrained, and consisted primarily of additions to existing hotel properties and the development of some larger hotels oriented toward the commercial and convention markets. The rebirth of center-city hotels was a direct result of fuel shortages and the availability of government financing for inner-city redevelopment projects. Highway-oriented properties, on the other hand, were adversely affected by escalating gasoline prices and decreased automobile travel. These lodging facilities lost some of their appeal among investors and hotel companies.

Decreased building activity, the normal retirement of older hotels from the market, and an improving economy created a favorable supply-and-demand relationship and record-high occupancy levels from 1979 to 1980. Average room rates increased rapidly as operators took advantage of excess demand to recoup earlier losses and keep up with inflation.

### [1] Maturation of Systems and Procedures

Hotel companies that were formed in the 1950s and 1960s matured in the 1970s, becoming more professional and more sophisticated in their management systems and techniques. The disciplines of hotel operations, finance, accounting, and marketing improved during this era, and a great deal of emphasis was placed on making operations more efficient. This was accomplished by the consistent monitoring and measurement of sales and marketing activities and daily operational procedures. Additionally, the practice of comparing individual hotel performance with industry averages was expanded during this era. As the hospitality industry continued to expand and develop, many colleges and universities expanded their hotel and restaurant related curriculums, graduating an increasing supply of talented and well-educated hotel and restaurant personnel.

### [2] Chain Expansion Through Asset Sales

To maximize cash flow and minimize financial risk, in the late 1970s and early 1980s hotel chains began to sell ownership of their hotels to investment groups while retaining ongoing management of the facilities. This practice generated capital—used to foster further acquisition and development activities—through fee management agreements with the new owners of the assets. Because the chains were maintaining and managing the properties on a daily basis, they were able to maintain their established standards. (See Chapter 16 for further discussion of the role of management contracts in the industry.)

## ¶ 2.05 THE 1980s

After the decline in hotel development during the late 1970s, the environment seemed conducive to a period of renewed expansion. However, the Federal Reserve tightened the money supply in the early 1980s, sending the prime interest rate up to double-digit levels, and most of the projects that were in the preliminary stages but lacked suitable financing were put on hold. In 1983, the national inflation rate began to come under control, and inflationary pressures were reduced. These events resulted in a decline in interest rates, and tremendous amounts of capital became available for real estate development and investment. Hotel developers who had been out of the market since the mid-1970s rushed to initiate new projects. These developers were aided by the following major real estate development incentives:

- Improved demand resulting in higher occupancy rates;
- Escalating room rates;
- Readily available debt and equity financing; and
- Extremely favorable income tax benefits designed to stimulate the national economy out of the recession of the early 1980s.

A steady flow of new hotel properties entered the market during the 1980s, and as a result, the aggregate United States occupancy level declined every year between 1980 and 1987. Many hotels could not operate profitably under a scenario of declining occupancies, and stagnant room rates and another round of hotel foreclosures ensued.

## [1] Non-Economic Real Estate Transactions

As mentioned previously, during the 1980–1987 period many real estate syndications were structured using "tax-based" real estate transactions for investors able to take full advantage of taxation rules that permitted losses from one investment to offset other types of income. Additionally, a favorable capital gains tax rate enhanced the value of real estate investments. These "non-economic" real estate transactions (i.e., those not designed to generate cash flow) provided equity capital that would not have otherwise been available to develop these hotel projects. Also, in anticipation of pending changes in the tax codes governing such transactions, hotel construction projects that should have been postponed until market conditions improved were concluded prior to midnight, December 31, 1985.

Because of the extensive lead time needed to complete the entire development process, this led to a period of overbuilding and a glut of hotel rooms coming on the market at the same time. Additionally, since there was little incentive to justify a transaction's economics (i.e., cash flow and reversionary benefits), a number of syndicators overpaid for hotel properties, took out exorbitant transaction fees, and placed unreasonable amounts of debt on the assets.

## [2] The Savings and Loan Debacle

By the end of the 1980s, the depth of the savings and loan crisis was evident and the industry became fully aware of the serious problems it faced—too late to reverse the oversupply of rooms developed throughout the decade. Between 1985 and 1990, a staggering 556,000 new hotel rooms were added to the U.S. hotel supply.

## [3] Development of Product Segmentation

Although overall new construction slowed, hotel chains had still been active in development as "product segmentation" became the watchword of the 1980s. During the 1960s and 1970s, the concept of market segmentation and its emphasis on the demand side of the lodging equation affected every aspect of the industry. Marketers began to research and understand the buying public more clearly, to define specific segments by their varying characteristics, and to target the segments more effectively by offering the services, amenities, and prices that the public was seeking. In the 1980s, this concept was taken one step further, to product segmentation, when hotel products began to be designed specifically for targeted market segments. The trend in services and amenities during the past thirty years has been to deliver what is appropriate to each market segment and product type, on the basis of market demand and price. For luxury and first-class hotels, where high room rates are charged and guests expect high quality, services and amenities have been increased and expanded. Concierge levels have been added, guestrooms have been lavishly furnished, and guestroom amenities such as toiletries, robes, towels, and personal care equipment have been added and upgraded. Conversely, services and amenities in economy-level properties have tended to be reduced or eliminated in order to reduce or maintain low room rates, which are of prime importance in this market segment.

### [4] Extended-Stay and Suite Concepts

A new market segment was defined and addressed during the 1980s. Known as the extended-stay market, it comprised guests who needed accommodations for a period of time greater than the typical guest's one to three days, for such reasons as business training, temporary assignment, or relocation. Demand for these needs had previously been met chiefly by short-term lease apartments, but the rapidly growing extended-stay market represented one of the fastest growing segments the industry has witnessed since its beginning.

All-suite hotels also proliferated during this era and several major hotel chains began to aggressively expand in this arena. The unique feature of a hotel room's having separate sleeping and living areas was extremely popular in the commercial market segment as well as the leisure segment—allowing parents to be in the same general area as their children but providing two separate sleeping areas.

### [5] Supply and Demand Imbalance

On a national level, lodging demand gained strength during the second half of the 1980s, but the market was awash with excess rooms. Once pressed to meet soaring demand, the industry was now buffeted by listless occupancy, tight pricing, and margin pressure. Hotel chains, which had eagerly capitalized on booming demand, were now locked into an intense battle for market share.

### [6] Lodging Industry Stock Performance

The publicly traded stock of the major hotel companies performed as well as the broader markets in 1988 but traded at the lower range of historical trading ranges. Operating trends confirmed the industry's overheated expansion, and although occupancy levels remained at 65 percent in 1988, the industry continued to operate well below its historical peaks. The excess room supply impeded upward price movement (increases were held to around 3 percent—below the Consumer Price Index (CPI)).

## ¶ 2.06 THE 1990s: SIGNIFICANT EVENTS

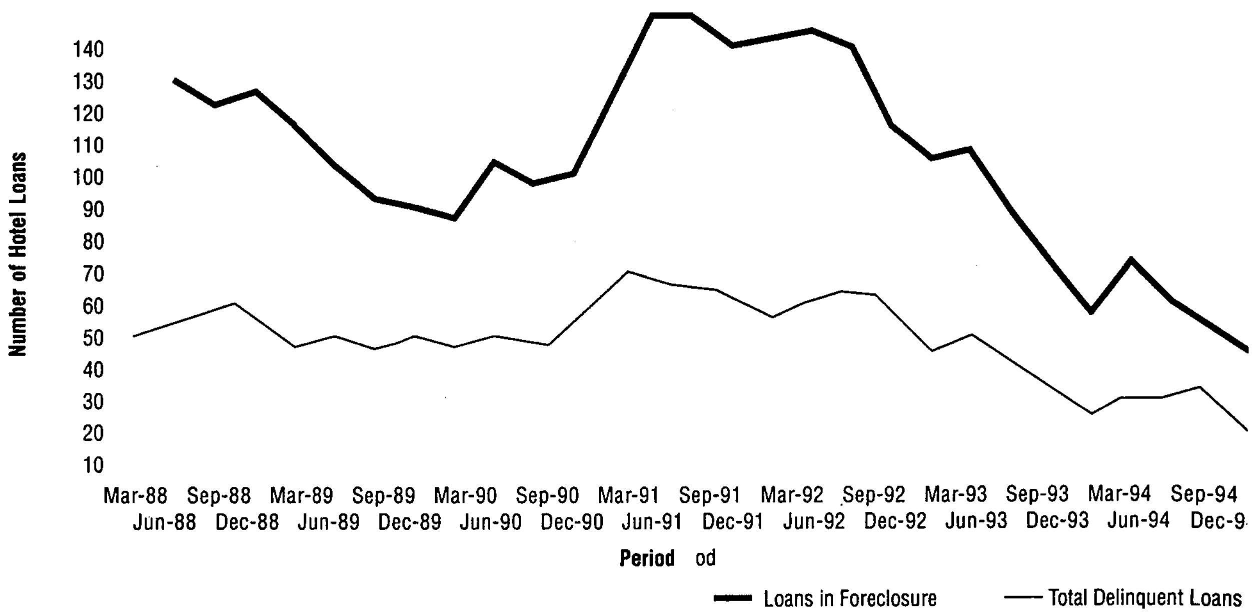
The national economy entered another recession in 1990, which along with overbuilding and the negative effects of the Persian Gulf War in 1991 caused the national hotel occupancy rate to bottom out at 60.8 percent in 1992. In some markets, hotel occupancies fell as low as 35 percent.

### [1] Nonperforming Loans

The number of nonperforming loans reached record levels, and the majority of lenders moved to a workout mode of operation in order to foreclose and restructure their hotel investments. Many of the savings and loans were taken over by the federal government, and their hotel assets were sold at auction. Exhibit 2-1 illustrates hotel loan performance as reported by the American Council of Life Insurance. The number of hotels in foreclosure peaked in 1991 as loan restructuring was an attractive alternative to foreclosure. During this period, the number of restructured loans almost doubled from previous levels.

**Exhibit 2-1 Hotel Loan Performance**

*Source: American Council of Life Insurance*




## [2] Gradual Improvement

The industry began to improve around 1992. The national average occupancy was 61.7 percent, a 2.6 percent increase over 1991 performance levels and the largest increase in more than ten years. This was the result of a 4 percent surge in demand coupled with a 1.3 percent rise in supply. All regions of the country except for the West Coast experienced this improvement, with hotels in the New England, South Atlantic, and East North Central regions showing above-average increases.

By 1993, new hotel construction had declined significantly. Lenders, trying to get out from under problematic hotel portfolios, curtailed all real estate lending and would not even consider funding a hotel development project. The tax benefits associated with hotels had been reduced significantly, and passive investors left the hospitality market entirely.

## [3] Rebirth of the REIT

In 1993, Real Estate Investment Trusts (REITs) again emerged as an alternative financing source for hotel acquisition and development. The first successful hotel REIT offering of the 1990s occurred in August, 1993, with the initial public offering of RFS Hotel Investors, Inc. Since the initial offering, numerous additional offerings have been completed. Hotel income does not qualify as income from real estate under REIT operating restrictions, which stipulate that a REIT must derive at least 75 percent of its gross income from rents and mortgage interest. Therefore, hotel operating income must be converted to lease income through a more complete REIT structure whereby the REIT owns the hotel properties and leases them to a third-party operating entity.

A great deal of activity continued in the REIT market until the fall of 1994, when the increase in interest rates and the perception of oversupply of offerings and pending structural problems brought the hotel REIT market to a virtual halt. Yields on existing REITs fell and numerous offerings in the planning stages were put on hold or canceled.

The Hotel Real Estate Investment Trust (REIT) was reinvented in late 1990's to serve the management-intensive hotel business. Especially popular were the few so called paired shared REIT's that were able to take advantage of a loophole in the tax law and raise capital very quickly and cheaply to acquire hotel companies. The two most famous Paired-Shared REIT's were Starwood and Patriot Hotels. The hotel market soon turned into a sellers market when the REITs exploded on the scene, buying up so much hotel property that they started a bidding war for hotel restate in late 1997 and early 1998. Then in the fall of 1998, a credit crunch hit the real estate market and REITs, which had paid a premium for hotel properties started to find their stock values declining rapidly. REIT stocks were left at one-half of their 52-week highs. In addition, Congress passed legislation that severely restricted future activity of paired-shared REITs and thus many of them have converted or are in the process of converting to Regular C corporations.

## [4] Alternative Financing Sources

Another source of capital was introduced in 1994-REMICs (Real Estate Mortgage Investment Conduits). Initially, mortgage conduits were offered through national home mortgage programs Fannie Mae and Freddie Mac. In these cases, the government is involved to provide an incentive fostering homeownership. The government is not involved in facilitating hotel lending but otherwise the process is in many ways similar. The process starts with the investment bank making a loan to a borrower. When the investment bank amasses a large enough portfolio of loans, it then packages the loans for sale to investors in the secondary market. The loan portfolio is split into distinct subgroups called tranches, with loans of various risks offering commensurate interest rates of return. It is this intention to sell the loans to subsequent investors that leads to the unique feature of REMIC loans. Ratings are provided by firms such as Standard and Poors or Fitch. These rating agencies have historically taken a very conservative approach to hotel transactions, and hotel loans earmarked for a conduit require conservative underwriting. The advantage of these financing vehicles is that loan terms are up to 23 years, which eliminates the rollover risk borrowers face with balloon loans. Additionally, the loans are nonrecourse and are assumable.

## [5] The Hot Market: Increased Occupancies, Profitability, and Values

As occupancy rates continued to improve, resulting in rapidly rising hotel values, acquisition activity continued to increase. There was a feeling in the investment community, however, that the market for acquisitions was becoming overheated, and investors were becoming cautious in order to avoid the first-loss position that the equity players take. New construction of full-service hotel projects continued to be rare, but several developers indicated they were preparing to develop several projects. The only significant addition to supply was in the limited-service market segment.

The pace of hotel sales transactions quickened throughout 1994 and increasingly involved full-service hotels. Many of these properties were owned by insurance companies that are penalized heavily under risk-based capital rules. Both, U.S. hotel operators and foreign buyers displayed healthy appetites. Marriott purchased several full-service hotels from a large insurance company, and Starwood Capital and Goldman Sachs Whitehall fund purchased the upscale Westin hotel chain.

Impressive value increases were a result of vastly improved occupancies and average rates, large amounts of capital in the marketplace, and no significant new supply in sight. The full-service sector offered the best buy for investors.

The impressive recovery of the lodging industry continued, and 1995 was a banner year, posting $7.6 billion in pretax profits spurred by increased occupancies, room-rate gains, and operating efficiencies. 1995 represented the third consecutive profitable year for the lodging industry since it bottomed out in the economic recession of the early 1990s. Financial performance improved substantially as demand for lodging accommodations rose over the past several years while only a limited number of new hotels entered the market.

## [6] Demand Outpaces Supply

In 1995, driven by the expanding economy, total U.S. lodging demand increased at a 3.1 percent compounded average growth rate. Between 1991 and 1995, total aggregate hotel supply increased by only 1.4 percent. Average U.S. occupancy increased to 66.3 percent in 1995—the highest level in twelve years. With improved occupancy levels, hotel owners were able to increase room rates and the average daily room rate in the United States increased by 4.8 percent in 1995-following a 3.8 percent increase in 1994—the first year in which room rates have grown faster than inflation since 1986.

## [7] The Markets, the Buyers, and the Sellers

The top five markets for new construction were the Dallas, 8174 rooms; Atlanta, 7435 rooms; Phoenix, 7335 rooms; Orlando, 6824 rooms; and Chicago, 5059 rooms. Additionally, the top five contenders for most rooms added to a hotel market segment in 1997 were Hampton Inn, 12826 rooms added; Holiday Inn Express, 8536 rooms added; Courtyard by Marriott, 7791 rooms added; Comfort Inns 6728 rooms added; and La Quinta, 6654 rooms added.

Significant sales activity and price increases resulted from this improved profitability and value. The life companies who in the past had been sellers became active buyers. Wall Street looked favorably on the industry and continued to supply debt and equity components for the acquisition of hotel products.

The products that were offered for sale in 1997 were supplied by portfolios of subperforming and nonperforming loans, foreign financial institutions, U.S. banks, and private sellers.

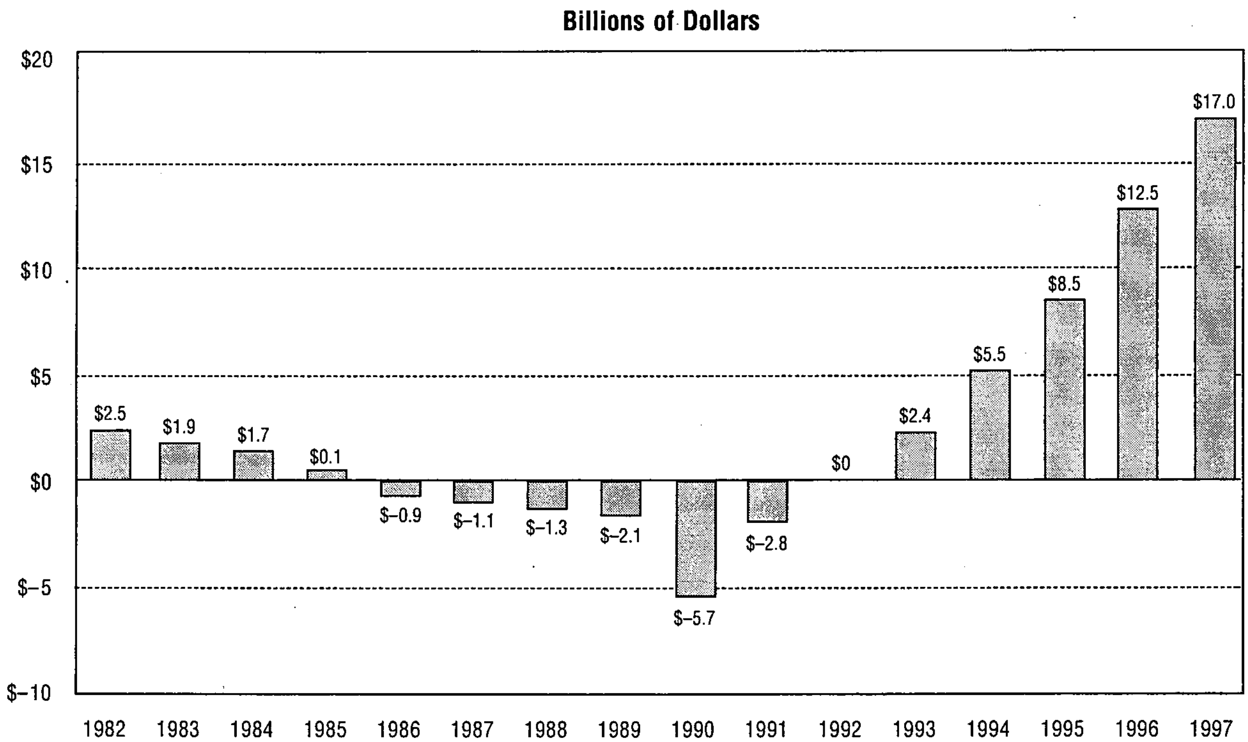
## [8] Future Trends

The supply of new hotel rooms is expected to increase slowly during the next several years. Lenders (not necessarily traditional banks and insurance companies, but credit companies and Wall Street securities firms) are beginning to make hotel loans based on very conservative lending criteria. This activity is commencing with the refinancing of existing properties, and the consensus is that hotel lenders will eventually become interested in financing new construction projects in selected markets. This change will occur when occupancies and room rates recover sufficiently to justify new projects that will substantiate the costs of development and construction. Additions to supply are expected to peak in 1998.

With the credit crunch in late 1998 along with the collapse of the CMBS market, the hotel industry is more difficult to predict how the industry will fare. Hotel valuation has retreated somewhat from their highs and financing is becoming more difficult to obtain. Cash has once again taken over as the preferred method of buying. The near term future of the hotel industry is tied to how well the economy performs. As is shown in Exhibit 2-2, the industry has had record earnings since bottoming out in the early 1990s.

**Exhibit 2-2 Lodging Industry Profitability 1982–1997**

*Sources: Smith Travel Research*




Hotel demand is expected to continue to increase if the U.S. economy improves. A peak in demand growth was projected to occur in 1996. Occupancies are projected to peak in 1997, returning to the highest level since 1979. Thereafter, occupancy is expected to decline slightly in the years ahead but occupancies are still healthy enough for hotels to boost hotel rates between 5 and 6 percent. This will increase overall RevPar, even in face of falling occupancies (see Exhibits 2-3 and 2-4).

**Exhibit 2-3 Lodging Outlook Survey for the Year Endling December, 1998**

*Sources: Smith Travel Research*

| Top 25 Markets | Occupancy Percent 1998 | 1997 | % Chg | Average Room Rate 1998 | 1997 | % Chg | Room Revenue % Chg | Rooms Available % Chg | Rooms Sold % Chg |
|---|---|---|---|---|---|---|---|---|---|
| Anaheim–Santa Ana, CA | 65.1 | 67.5 | –3.6% | 79.48 | 75.37 | 5.5% | 2.3 | 0.6 | (3.0) |
| Atlanta, GA | 64.9 | 63.3 | 2.5% | 78.02 | 76.48 | 2.0% | 10.5 | 5.7 | 8.3 |
| Boston, MA | 72.9 | 74.2 | –1.8% | 127.05 | 117.1 | 8.5% | 10.0 | 3.3 | 1.4 |
| Chicago, IL | 71.1 | 71.6 | –0.7% | 109.57 | 101.55 | 7.9% | 11.5 | 4.2 | 3.4 |
| Dallas, TX | 66 | 66.3 | –0.5% | 82.56 | 78.99 | 4.5% | 11.9 | 7.6 | 7.1 |
| Denver, CO | 69.3 | 70.8 | –2.1% | 78.15 | 76.06 | 2.7% | 11.8 | 11.1 | 8.8 |
| Detroit, MI | 66.1 | 66.2 | –0.2% | 74.33 | 70.34 | 5.7% | 10.0 | 4.3 | 4.1 |
| Houston, TX | 63.5 | 63.8 | –0.5% | 74.38 | 70.92 | 4.9% | 14.3 | 9.5 | 8.9 |
| Los Angeles – Long Beach, CA | 69.3 | 68.7 | 0.9% | 88.59 | 82 | 8.0% | 10.3 | 1.3 | 2.1 |
| Miami – Hialeah, FL | 70.3 | 71.6 | –1.8% | 101.77 | 94.77 | 7.4% | 7.5 | 1.8 | 0.1 |
| Minneapolis – St. Paul, MN | 68.9 | 68.5 | 0.6% | 79.06 | 76.36 | 3.5% | 12.8 | 8.3 | 8.9 |
| Nashville, TN | 62.7 | 66.8 | –6.1% | 74.72 | 73.06 | 2.3% | 0.1 | 4.2 | (2.1) |
| New Orleans, LA | 68.3 | 69.3 | –1.4% | 108.78 | 104.64 | 4.0% | 8.3 | 5.7 | 4.2 |
| New York, NY | 81.3 | 80.3 | 1.2% | 180.01 | 165.01 | 9.1% | 10.9 | 0.5 | 1.6 |
| Norfolk – Virginia Beach, VA | 59.3 | 57.3 | 3.5% | 66.7 | 64.67 | 3.1% | 7.7 | 0.8 | 4.4 |
| Oahu Island, HI | 72.3 | 77.2 | –6.3% | 112.88 | 113.28 | –0.4% | (6.7) | – | (6.4) |
| Orlando, FL | 74.7 | 79 | –5.4% | 84.64 | 79.81 | 6.1% | 3.8 | 3.4 | (2.1) |
| Philadelphia, PA–NJ | 68.8 | 70.4 | –2.3% | 96.46 | 90.26 | 6.9% | 9.2 | 4.5 | 2.1 |
| Phoenix, AZ | 64.7 | 69.1 | –6.4% | 99.14 | 98.63 | 0.5% | 4.7 | 11.2 | 4.2 |
| San Diego, CA | 72.7 | 71.4 | 1.8% | 97.72 | 86.26 | 13.3% | 16.2 | 0.6 | 2.5 |
| San Francisco, CA | 78.7 | 79.8 | –1.4% | 128.82 | 117.74 | 9.4% | 7.9 | (0.1) | (1.4) |
| Seattle, WA | 71.5 | 72.2 | –1.0% | 94.57 | 89.59 | 5.6% | 11.1 | 6.3 | 5.3 |
| St. Louis, MO–IL | 62.2 | 62.9 | –1.1% | 69.37 | 68.81 | 0.8% | 4.6 | 5.0 | 3.7 |
| Tampa – St. Petersburg, FL | 64 | 65.3 | –2.0% | 77.68 | 73.35 | 5.9% | 9.5 | 5.5 | 3.4 |
| Washington DC, MD–VA | 70.4 | 70.6 | –0.3% | 105.05 | 100.11 | 4.9% | 7.0 | 2.3 | 2.0 |

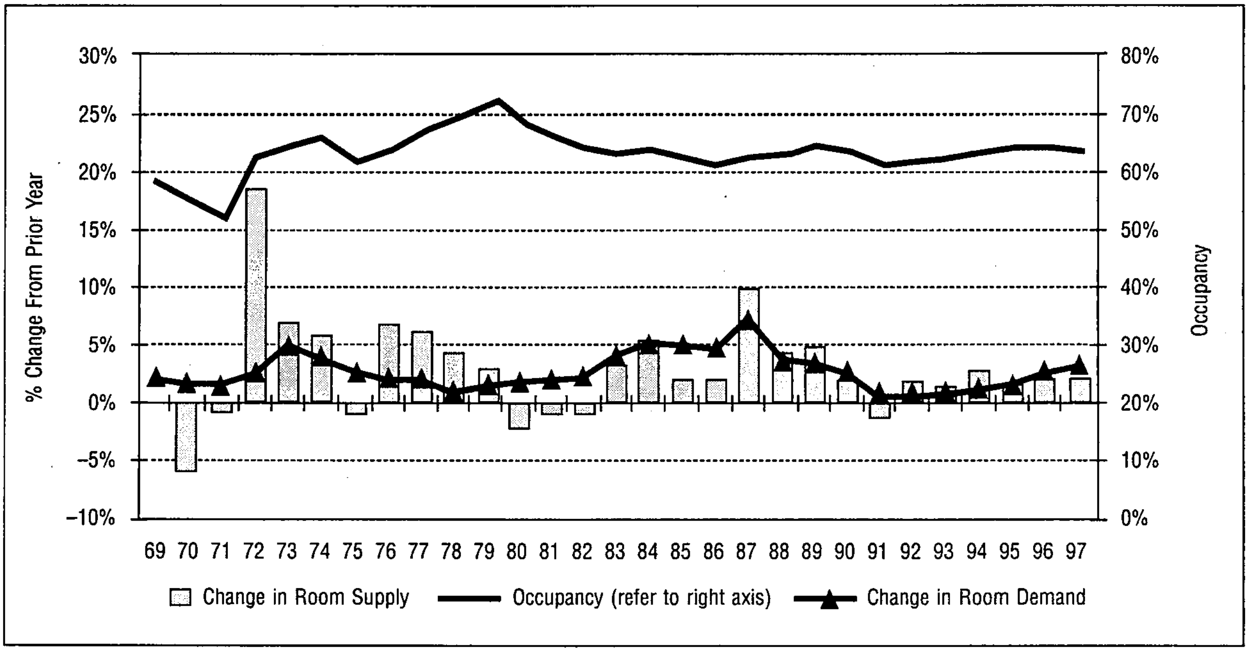
Occupancy is calculated by dividing the room night demand by the supply. During the historical period, supply increased at rates ranging from 0.7% in 1982 to 6.0% in 1974. Demand declined each year from 1980 until 1983 and also in 1974, but increased in all other years. In 1979, demand growth peaked at 5.3%. Changes in supply and demand had a varied impact on occupancy. In addition to declining when demand fell, occupancy also dropped when the increase in demand was smaller than the increase in supply.

Also, the data presented in Exhibit 2-4 can be related to historical economic trends. The early 1970s marked the beginning of a hotel building boom reminiscent of the 1920s. Many factors contributed to this expansion, but the two main elements were readily available financing and aggressive chains that were eager to sell franchises.

There will be fewer unencumbered turnaround assets offering high returns because many assets have already been repositioned and are stabilized. There will be limited additions to supply in the foreseeable future.

**Exhibit 2-4 Occupancy, Demand, and Supply Growth From Prior Year**

*Sources: Bear, Stearns & Co. Inc.; Coopers & Lybrand L.L.P.; Smith Travel Research.*



# CHAPTER 3

# National Supply



## ¶ 3.01 QUANTIFICATION OF SUPPLY

Over the years, various attempts to quantify the national supply of transient lodging facilities have produced a wide range of estimates of both the number of facilities and the number of available rooms. "Transient" and "lodging facility" are subjective terms. Some of the issues that must be considered when trying to define them include:

- Is a property that rents rooms on a weekly, monthly, or annual basis considered a transient lodging facility?
- How is a property categorized if it rents rooms for various periods of time?
- How is a mixed-use property categorized?
- Should a property be counted if it is open only part of the year?
- How many rooms must a lodging facility contain to be included in the count?

One of the best sources of data on the supply of lodging facilities in the United States is Smith Travel Research. Many active hotel industry participants subscribe to *Lodging Outlook,* published monthly by Smith Travel Research, which provides data related to the supply, demand, and room sales for lodging markets, along with estimated occupancies and average rates. Smith Travel Research also publishes the *Host Study,* which presents composite hotel and motel operating statistics broken down by type, location, region, price tier, and market orientation, along with other valuable hotel investment information.

Exhibit 3-1 shows the approximate size of the US hotel market by property size. Another useful measure of the US market is to breakdown the number of hotel rooms by region (see Exhibit 3-2).

**Exhibit 3-1 1998 Industry by Property Size**

*Sources: Smith Travel Resource*

| | # Hotels | # Rooms |
|---|---|---|
| Over 500 Rooms | 464 | 424,587 |
| 300-500 Rooms | 1,022 | 379,826 |
| 150-299 Rooms | 4,168 | 829,897 |
| 75-149 Rooms | 11,959 | 1,292,301 |
| Under 75 Rooms | 18,124 | 810,508 |
| | 35,737 | 3,737,119 |

**Exhibit 3-2 1998 Industry by Region**

*Sources: Smith Travel Resource*

| | # Hotels | # Rooms |
|---|---|---|
| New England | 1,651 | 147,104 |
| Middle Atlantic | 2,646 | 315,588 |
| South Atlantic | 8,054 | 897,967 |
| E.S. Central | 2,540 | 238,015 |
| W.S. Central | 3,583 | 390,502 |
| E.N. Central | 4,482 | 446,300 |
| W.N. Central | 3,156 | 258,947 |
| Mountain | 3,902 | 456,255 |
| Pacific | 5,723 | 586,441 |
| | 35,737 | 3,737,119 |

According to the census and Smith Travel Research data, the number of properties declined from 51,860 in 1972 to 35,737 in1998, an attrition of roughly 30 percent. At the same time, however, the number of rooms increased from 2.3 million to 3.7 million, an increase of 40 percent. These figures indicate that older, smaller lodging properties are closing and being replaced by new facilities with larger room inventories. Moreover, the trend in the lodging industry has been characterized by the disappearance of small, independent properties and the arrival of larger, brand name properties.

## ¶ 3.02 CLASSIFICATION OF LODGING FACILITIES

Meinrad LP and Smith Travel Research monitors the lodging supply in the United States and determines the market share of lodging facilities based on both locational characteristics (Exhibit 3-2) and class, as determined by pricing tiers (Exhibit 3-3).

**Exhibit 3-3 Market Share by Class**

*Sources: Smith Travel Resource*

| | # Hotels | | # Rooms | Percent |
|---|---|---|---|---|
| Upper Upscale | 1,187 | | 459,425 | 12.3% |
| Upscale | 1,676 | | 314,759 | 8.5% |
| Midscale with Food/Beverage | 5,078 | | 671,969 | 18.0% |
| Midscale without Food/Beverage | 4,552 | | 414,976 | 11.2% |
| Economy | 9,041 | | 2,592,688 | 19.6% |
| Chains | 21,534 | 60.4% | 2,592,688 | 69.9% |
| Independents | 14,099 | 39.6% | 1,133,590 | 30.4% |
| | 35,633 | 100.0% | 3,726,278 | 100.0% |

As Exhibits 3-2 and 3-3 indicate, highway and suburban markets are the sites of the majority of the lodging supply. In terms of class, the largest number of lodging facilities are considered mid-price, which according to Smith Travel Research, have average rates of roughly $60, followed by upscale facilities, which have average rates of roughly $75. Another way of looking at market segmentation is by brand name, Exhibit 3-4 shows the 10 largest hotel chains by number of rooms.

**Exhibit 3-4 Meinrad Hotel Segmentation***

*Sources: Meinrad LP, January 1997*

| Top 10 Hotel Brands/Flags | Brand Portfolio Totals | | | Share of Total U.S.A./Canadian Rooms | |
|---|---|---|---|---|---|
| by # of Hotel Rooms | # Rooms | # Hotels | AVG | % Individual | % Cumulative |
| 1 Holiday Inn | 240,951 | 1,286 | 187 | 6.84% | 6.84% |
| 2 Best Western International, Inc. | 195,002 | 2,106 | 93 | 5.54% | 12.38% |
| 3 Days Inn | 145,343 | 1,505 | 97 | 4.13% | 16.51% |
| 4 Comfort Inn | 99,382 | 1,161 | 86 | 2.82% | 19.33% |
| 5 Ramada Inn | 99,335 | 630 | 158 | 2.82% | 22.15% |
| 6 Marriott Hotels and Resorts | 97,505 | 226 | 431 | 2.77% | 24.92% |
| 7 Hilton Hotels and Resorts | 95,949 | 231 | 415 | 2.72% | 27.64% |
| 8 Motel 6, L.P. | 83,987 | 740 | 113 | 2.39% | 30.03% |
| 9 Super 8 Motels | 82.,518 | 1,337 | 62 | 2.34% | 32.37% |
| 10 Sheraton Hotels Worldwide | 64,055 | 160 | 400 | 1.82% | 34.19% |
| 250 OTHER BRANDS | 1,328,424 | 11,278 | 118 | 37.72% | 71.92% |
| INDEPENDENT | 988,991 | 12,828 | 77 | 28.08% | 100.00% |
| TOTAL POPULATION | 3,521,442 | 33,488 | 105 | 100.00% | |

## [1] Facility Types

The type of facility refers to the actual physical property and the primary amenities offered to guests. Among the different facility types are the following: commercial, convention, resort, motel, casino, and extended-stay properties.

### [a] Commercial Hotels

Commercial facilities cater primarily to the individual business traveler and are generally situated in downtown or commercial districts. Amenities typically include a restaurant, a lounge, meeting facilities, a fitness room, and a gift shop. The services offered by many commercial hotels include room service, a business center, concierge and valet services, shoe shine service, daily newspapers, airport shuttle, and local transportation. Modern commercial facilities also provide work desks, multiple telephones with dual lines and data ports, in-room coffee makers, irons and ironing boards, and copy and facsimile services.

### [b] Convention Hotels

Convention hotels are large facilities that characteristically have meeting spaces with the capacity to handle large groups of people. Generally, hotels with more than 30 square feet of meeting space per guestroom located near convention centers are considered convention hotels. Convention hotels generally contain a large inventory of guestrooms with a high percentage of double/double bedding configurations. Most convention hotels provide large ballrooms and small breakout rooms for meetings and conferences. In addition, some hotels feature exhibit space and auditoriums. Convention properties also typically offer extensive food and beverage facilities and other services and facilities found in comerical hotels, although the level of service tends to be less personal.

### [c] Resort Hotels

Resort hotels are oriented toward leisure travelers seeking a scenic or recreational environment, such as the seashore or the mountains. Typically, the improvements are sprawled over a large parcel of highly landscaped land. Recreational facilities are provided, allowing guests to enjoy such activities as swimming, golf, tennis, boating, skiing, skating, sailing, riding, and hiking. Extensive food and beverage facilities as well as 24hour room service are necessary, because the resort's location is often secluded. Other typical amenities include retail facilities, activities desks, children's programs, and massages.

### [d] Suite Hotels

Suite hotels feature guest quarters that contain both a sleeping area and a separate living area. In some suite hotels, one suite is composed of two normal-sized guestroom modules. Most suite hotels, however, use a single room (13 feet by 36 feet) with the sleeping area to the rear and the living area in the front, separated by a physical wall. Suites generally offer rudimentary kitchen facilities (e.g., a wet bar, microwave oven, and mini refrigerator) but are not designed for involved food preparation. Guests are generally provided with a complimentary breakfast and evening cocktails. Suites typically contain a sofa bed in the living area that can be used for families with children.

The appeal of suites to the commercial traveler is that business can be conducted in the guestroom without the inappropriate presence of a bed. The public space in suite hotels is generally limited, with a minimal amount of meeting space and usually one food and beverage facility. However, many suite hotels feature partial or full atriums. By increasing the size of guestrooms and decreasing the size of meeting and public spaces, suite hotel companies are able to maintain total cost per room to approximately that of a commercial or convention hotel. Business travelers who do not require large meeting rooms or extensive food and beverage facilities are attracted by the price-value relationship of the larger accommodations and inclusive food and beverage. Leisure travelers, particularly families, benefit from using the expandable sleeping capacity and the money-saving food and beverage component.

## [e] Extended-Stay Hotels

Extended-stay hotels provide a residential atmosphere by offering larger, apartment-type guestrooms with separate living and sleeping areas, full kitchens, exterior entrances, and recreational facilities. Extended-stay hotels generally resemble garden apartment complexes and usually have a small administrative building that houses the front office and lounging/dining area. Guest suites are furnished with more residential-style casegoods and softgoods and often feature a fireplace. Extended-stay hotels attract travelers who must stay in an area for an extended period of time. The average length of stay at Marriott's Residence Inns, for example, is ten days. Typical guests at residence hotels include: relocated employees, auditors working on long-term projects, attorneys involved in a lengthy trial, and engineers assigned to a building project.

Until recently, such extended-stay customers generally had to use either hotels that did not provide necessary domestic facilities, or furnished apartments rented on a weekly or monthly basis. From an operational point of view, the extended-stay product is unique and profitable for several reasons: the lower guest turnover requires less front office staffing, the longer stay enables the property to achieve high levels of occupancies (greater than 80 percent) because the normal weekly fluctuations do not occur; the facilities are oriented towards commercial demand, which contributes to higher average rates; and the extended-stay property generally achieves low expense ratios and high profitability ratios.

The extended-stay concept has proven to be highly successful. However, as these products cater primarily to white-collar business travelers, hotel companies have recognized a niche for secondary commercial markets that are more blue-collar in nature. New mid-priced extended-stay products such as Candlewood Suites (Doubletree) and Homestead Village, MainStay (Choice Hotels) are being developed. In addition, Marriott is currently planning an as-yet-unnamed mid-rate, extended-stay product.

## [f] Conference Centers

Conference centers combine lodging and extensive meeting and conference facilities within an environment conducive to educating and training. This environment provides the distinction between a true conference center and what might be termed a convention hotel. Convention hotels attract some educational meetings and seminars but also cater to various meetings of socially-oriented groups. Social gatherings can at times become noisy and distracting and can have a disturbing effect on a business conference taking place at the same time. In contrast, conference centers provide a quieter, more tranquil, and more serious atmosphere for conference attendees. Typically, conference centers provide meals, conference planning, audio/visual equipment, support services, flexible meeting facilities, and recreational amenities in an all-inclusive package.

### [g] Micro-Budget Motels

The micro-budget motel, or hard-budget motel, includes a very small and compact guest room that consists of 180 to 200 square feet of space, compared with 220 to 250 square feet for the traditional budget product. This type of facility keeps its costs low by eliminating such amenities as restaurants, lounges, meeting rooms, swimming pools, complimentary breakfasts, morning newspapers, and special soaps and shampoos. Minimization of the improvements allow for aggressive rate policies. Chains such as Microtel, Daystop (Days Inns), and Sleep Inns (Choice Hotels) offer this type of product, which attracts the highly rate-sensitive traveler. Key elements in the success of a micro-budget motel include: room rates at 10 percent to 25 percent below those of other economy products in the market, minimum marketing expenses and franchise fees, elimination of superfluous development costs, and tight operational cost controls.

### [h] Casino Hotels

Casino hotels provide guests and visitors with on-site gaming facilities. A well managed casino can be a major profit center, with the hotel facilities acting as an amenity to attract casino patrons. Casino hotels usually offer buffet-style restaurants, cocktail lounges, retail outlets, and entertainment facilities. Depending on the extent and orientation of the gaming facilities, the guestroom furnishings range from moderate to luxury. Suites are provided for "high rollers" and other high-profile guests. Recent mega-casino hotels feature prominent entertainment amenities such as amusement parks, theaters, and architectural monuments as part of an effort to appeal to a wider range of guests.

### [i] Bed and Breakfast Inns

These inns generally offer quaint, residential-style accommodations along with breakfast. Historic areas in the United States (i.e., Annapolis, Maryland; Charleston, South Carolina; Carmel, California; and Savannah, Georgia) have numerous bed and breakfast inns that cater primarily to leisure travelers.

### [j] Mom-and-Pop Motels

Small, independent, family-operated motels are commonly referred to as "mom-and-pop" motels. These older-style lodging facilities usually have fewer than 50 units and offer limited amenities. Tourist cabins and camps are usually included in this category.

### [k] Boutique Hotels

A boutique hotel is a small lodging facility that caters to upscale patrons looking for intimate, quiet surroundings. Often converted from historic structures, these properties usually offer high-quality amenities and furnishings, signature upscale restaurants, and extensive, personalized guest services. Public areas and meeting facilities are generally minimal in boutique hotels.

### [l] **Health Spas**

A health spa is a hotel that provides various health-oriented services and activities, such as special diets and dining plans, exercise programs, medical supervision, massage and therapy, and health education and training. Many resort hotels offer spa programs, but true health spas are solely dedicated to such activities and enforce strict regulations for spa guests.

### [m] **Boatels**

A "boatel" is a lodging facility that is specifically associated with a marina development. This type of facility generally accommodates leisure travelers who wish to enjoy nearby bodies of water, along with boat owners seeking accommodations and other amenities on shore. The amenities typically offered by a boatel include a restaurant, a lounge, a ship's store, laundry facilities, docks, and marine equipment repair and service.

## [2] **Class**

Product segmentation was the key phrase in the hotel industry during the 1980s. Many lodging chains saw the opportunity to segment their markets and create products specifically aimed at a particular type of traveler. In most instances, the segmentation was based on the class of hotel rather than the type of facility. For example, Marriott created Courtyards and Fairfield Inns, which are commercial and leisure oriented properties, respectively, catering to two classes of customers: mid-rate and budget travelers, respectively. Residence Inns, another Marriott product, feature large guestrooms, full kitchens, and comfortable living areas for extended stays and represent product segmentation by type of facility.

The class of a lodging facility is a way of describing the quality of the property and the level of service provided. Generally, a lodging facility's class is reflected in its ability to achieve a certain room-rate level. The class of a hotel is also relative to its particular market area. The facilities and level of service that might be considered first-class in Amarillo, Texas might not receive such a rating in San Francisco. Generally, the best hotel within a particular market is classified as an area's first-class property; other facilities within the same market that offer a lower level of quality or service have a lower ranking.

The lodging industry does not seem to have a uniform definition of the various hotel classes. Terms such as "economy," "first-class" (or "upscale"), and "luxury" have different meanings for different people. However, Smith Travel Research publishes average rate and occupancy information for each class category defined previously. Exhibits 3-5 and 3-6 illustrate the various class categories and the corresponding average occupancy and average room rates for lodging facilities in the United States.

**Exhibit 3-5 ADR Performance by Location Type (1996–1997)**

*Sources: Bear, Stearns & Co. Inc.; Smith Travel Research.*

| Location | 1997 | 1996 | % Chg. |
|---|---|---|---|
| Resort | $114.85 | $108.69 | 5.7% |
| Urban | 114.80 | 106.56 | 7.7 |
| Airport | 77.98 | 72.11 | 8.1 |
| Suburban | 72.23 | 68.31 | 5.7 |
| Highway | 55.16 | 52.46 | 5.1 |
| Total U.S. | $75.16 | $70.81 | 6.1% |

Note: U.S. results may differ slightly from those elsewhere in report due to processing methodology.

**Exhibit 3-6 Occupancy Performance by Location Type (1996–1997)**

*Sources: Bear, Stearns & Co. Inc.; Smith Travel Research.*

| Location | 1997 | 1996 | bps Chg. |
|---|---|---|---|
| Airport | 70.5% | 71.0% | −0.7% |
| Urban | 69.8 | 69.7 | 0.1 |
| Resort | 69.7 | 69.1 | 0.9 |
| Suburban | 65.9 | 66.3 | −0.6 |
| Highway | 60.8 | 61.7 | −1.5 |
| Total U.S. | 64.5% | 65.% | −0.8% |

Note: U.S. results may differ slightly from those elsewhere in report due to processing methodology.

Most hotel chains attempt to market to a particular class of traveler. For example, Microtel caters to the very rate-sensitive budget traveler, while Ritz-Carlton Hotels attract an upper-end, luxury-oriented, clientele. Most chains attempt to create and maintain a specific image with respect to their class of facilities and service. Holiday Inns, for example, have enforced stringent product improvement requirements on franchisees in order to combat a declining general product-quality perception. Properties not conforming with Holiday Inns' requirements and standards have been disconnected from the chain

## [3] Location

Hotels and motels can be classified by the characteristics of their locations, which often influence the market segments they will attract. Resort hotels, for example, draw entirely different customers from those who stay at downtown hotels.

### [a] Airports

Situated either at or near an airport facility, this type of hotel usually attracts commercial travelers, small meetings and groups, and airline-related visitation such as crews and distressed passengers. Contracts with airlines typically provide a substantial base of business. However, as this demand segment of the lodging market is highly discounted (for the steady block of rooms), average room rate for an airport hotel may be skewed downward relative to its proportion of airline business.

Airport hotels generally offer shuttle service to and from the airport. As part of this service, airport hotels often provide telephones at the airport that allow arriving guests to dial the hotel directly at no charge. Meeting facilities are also generally provided in order for airport hotels to attract the meeting business of out-of-town travelers who wish to use the airport as a convenient and accessible gathering place for meetings.

### [b] Highways

Highway hotels are designed for guests traveling by automobile. Properties with highway locations typically attract both commercial and leisure travelers. Proximity to a major roadway (usually an interstate), accessibility, and visibility are the major attributes required for this type of property. Highway hotels typically feature limited meeting facilities; a restaurant on property or nearby; and amenities to attract leisure travelers, such as a swimming pool and a playground. Other typical amenities include complimentary hot beverage service, sundries, and road maps.

Highway hotels are exposed to certain risks. In the past, they have suffered when travel has declined because of gasoline shortages and economic recessions. In addition, changes in traffic patterns created by new routes can devastate (or improve) a highway hotel's business. Currency exchange rates and the affordability of airline travel are other factors that affect the profitability of a highway hotel.

### [c] Downtowns

Hotels situated in the downtown area of a city cater mostly to the commercial and meeting and convention market segments. Depending on the nearby dining alternatives, a downtown hotel may need to have only minimal food and beverage facilities. The facilities, amenities, and level of service offered by a downtown hotel are dictated by its proximity to such demand generators as office complexes and convention centers. Adequate parking is almost always a primary consideration for a downtown lodging facility. Depending on the age of the improvements, off-street parking may be available on-site or in a nearby parking garage. Valet parking is an important amenity for upscale hotels.

### [d] Suburbs

Suburban hotels are generally located near office, retail, and light industrial areas. Proximity to demand generators, dining options, and leisure activities are important aspects of suburban hotels. Suburban locations typically allow for low- to medium-density rather than high-density construction, extensive recreational facilities, and ample surface parking, Development costs are typically lower for suburban hotels than for downtown properties.

### [e] Convention Centers

A hotel located near a convention center will draw patronage from the events held at the center. Convention center hotels typically provide food and beverage facilities, additional meeting facilities, and recreational facilities. It must be noted, however, that most convention centers generate roughly 100 to 130 days of transient visitation per year, which alone is insufficient to justify a lodging facility. Therefore, a convention center hotel should be designed to attract other demand segments, such as commercial and leisure travelers. In addition, meeting facilities should be adequate to accommodate self-contained, smaller meetings and functions.

### [f] Resorts

Resort hotels are located in areas with considerable scenic beauty or recreational opportunities. Resort properties attract primarily the leisure demand segment of the lodging market and sometimes leisure-oriented meetings and conventions such as corporate-incentive groups. Resorts typically feature extensive food and beverage facilities, recreational amenities, and retail facilities. Activity desks are also usually provided for off-property activities and tours. Resorts also provide 24-hour room service, currency exchange, in-room movies, ample parking space, and manicured landscaping. Artwork and design motifs reflect the property's location.

### [g] Mixed-Use Facilities

Lodging facilities that are situated in multiple-use developments that contain both hotel and non-hotel elements (e.g., office space, retail property, and residential property) are referred to as mixed-use properties. The synergy between the various components of the development is often beneficial for the whole project. Additional facilities and amenities for the hotel component are highly dependent on the nature of the other uses in the development.

## ¶ 3.03 GUESTROOM DESIGN

Hotel guestroom design is more influenced by facility orientation and class than by locational attributes. The floor plans in Exhibit 3-7 illustrate typical sizes and guestroom layouts for various types and classes of hotels.

Exhibit 3-7(a) shows the floor plan of a microbudget motel guestroom. The total area is 190 square feet and provides enough space for one bed. Although the guestroom is relatively small, it has all of the normal amenities found in conventional budget motel guestrooms.

Exhibit 3-7(b) shows the floor plan for a typical budget motel. The total area of the room is 236 square feet and provides sufficient space for two double beds. In this example, the window is situated adjacent to the entry door, which means that the property probably has exterior corridors.

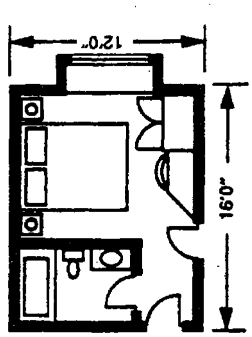
Exhibit 3-7(c) shows a floor plan typical of a mid-rate facility. The 300-square-foot room includes a larger bathroom, a separate closet, and a sleeping area containing a king-sized bed and two chairs. The guestroom also contains a combination desk/dresser with a television. The corridor to which the room has access is interior.

Exhibit 3-7(d) provides an example of a luxury hotel room that totals 450 square feet. Although the length of the room is 25 feet, which is comparable to properties of lower class, its width is 18 feet, creating a feeling of greater open space. The bathroom is above average in size and the sleeping area has capacity for a desk, two small couches, and a coffee table.

The accommodations offered by suite hotels come in many sizes and shapes, but by definition a suite contains separate sleeping and living areas. Exhibits 3-7(e) and 3-7(f) illustrate the layout of two typical suite configurations. Exhibit 3-7(e) shows a rectangular guestroom module in which the living area is in the front -and the sleeping area is to the rear. The suite in Exhibit 3-7(f) is square, which results in a side-by-side placement of the living and sleeping areas. Both of these suite layouts contain

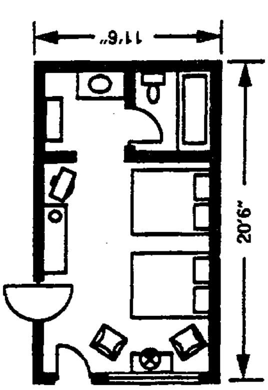
## Exhibit 3-7 Typical Guestroom Sizes and Layouts for Various Hotel Types

**(a) MICROTEL**



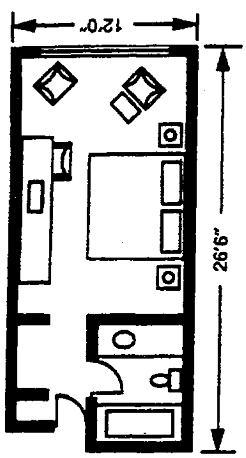

| Square Feet: | |
|---|---|
| Living | 132 |
| Entry | 15 |
| Bath | 45 |
| Total | 192 |

**(b) BUDGET MOTEL**



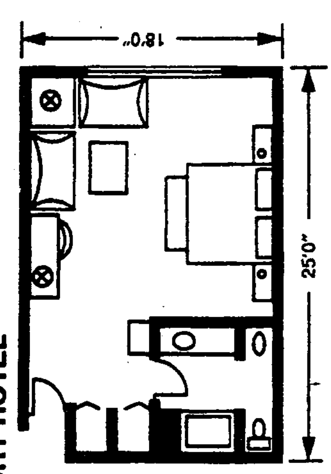

| Square Feet: | |
|---|---|
| Living | 204 |
| Entry | 0 |
| Bath | 32 |
| Total | 236 |

**(c) MIDRATE HOTEL**



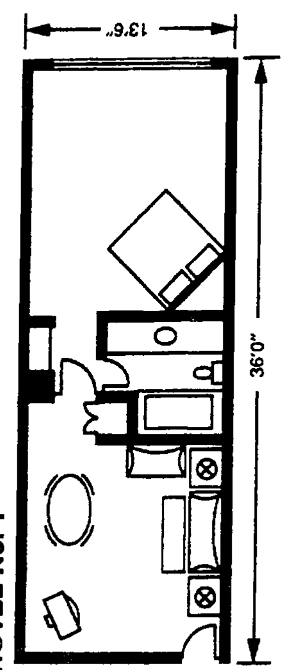

| Square Feet: | |
|---|---|
| Living | 221 |
| Entry | 35 |
| Bath | 48 |
| Total | 304 |

**(d) LUXURY HOTEL**



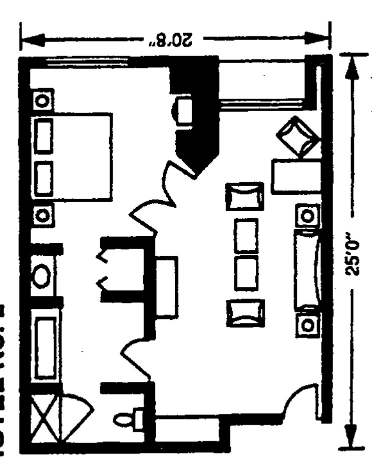

| Square Feet: | |
|---|---|
| Living | 379 |
| Entry | 0 |
| Bath | 71 |
| Total | 450 |

**(e) SUITE HOTEL No. 1**



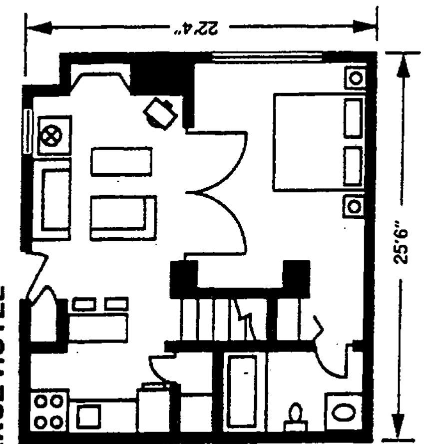

| Square Feet: | |
|---|---|
| Living | 235 |
| Entry | 0 |
| Bath | 62 |
| Bedroom | 189 |
| Total | 486 |

**(f) SUITE HOTEL No. 2**

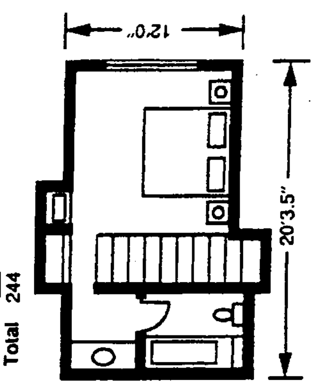



| Square Feet: | |
|---|---|
| Living | 239 |
| Entry | 0 |
| Bath | 81 |
| Bedroom | 180 |
| Total | 500 |

**(g) RESIDENCE HOTEL**




| Square Feet: | |
|---|---|
| Living | 320 |
| Entry | 0 |
| Bath | 50 |
| Bedroom | 210 |
| Total | 580 |




| Square Feet: | |
|---|---|
| Living | 181 |
| Entry | 27 |
| Bath | 36 |
| Total | 244 |

**Exhibit 3-7 (cont'd)**

| (a) Microtel | (b) Budget Motel | (c) Mid-Rate Hotel |
|---|---|---|
| *Square Feet:* | *Square Feet:* | *Square Feet:* |
| Living 132 | Living 204 | Living 221 |
| Entry 15 | Entry 0 | Entry 35 |
| Bath 45 | Bath 32 | Bath 48 |
| Total 192 | Total 236 | Total 304 |

| (d) Luxury | (e) Suite Hotel No. 1 |
|---|---|
| *Square Feet:* | *Square Feet:* |
| Living 379 | Living 235 |
| Entry 0 | Entry 0 |
| Bath 71 | Bath 62 |
| | Bedroom 189 |
| Total 450 | Total 486 |

| (f) Suite Hotel No. 2 | (g) Residence Hotel | |
|---|---|---|
| *Square Feet:* | *Square Feet:* | *Square Feet:* |
| Living 239 | Living 320 | Living 181 |
| Entry 0 | Entry 0 | Entry 27 |
| Bath 81 | Bath 50 | Bath 36 |
| Bedroom 180 | Bedroom 210 | |
| Total 500 | Total 580 | Total 244 |

approximately 400 to 500 square feet of space, which is only slightly larger than a typical luxury guestroom module.

Exhibit 3-7(g) shows a residence hotel room layout. A residence-type hotel, or extended-stay hotel, typically provides the greatest amount of space of any type of lodging facility. Guestroom modules typically consist of full-size living rooms, kitchens, and bedrooms. The layout in Exhibit 3-7(g) is of a duplex-loft arrangement. On the first floor there is a living room and full kitchen toward the front, and a bedroom area and full bath to the rear. On the second floor there is a second bedroom and second full bath. The first floor is 580 square feet in area and the loft second floor 244 square feet, for a total of 824 square feet.

## ¶ 3.04 AMENITIES

Amenities such as swimming pools, room service, and personal care items play a large role in the marketing of hotel rooms. Exhibit 3-8 shows the results of a survey conducted for the Dial Corporation by Michigan State University's School of Hospitality Business to determine frequent travelers' expectations of amenities and services. The American Hotel and Motel Association conducted a survey to quantify the usage of the amenities and services provided. The results of that survey are presented in Exhibit 3-9.

Although a swimming pool is frequently an expected feature of a lodging facility, especially for mid-price and luxury hotels, it is used by less than one-third of the guests. This creates a concern for hotel developers: should a costly swimming pool, which guests expect but rarely use, be included in the design of the property? The answer is generally yes, because of the need to conform with the local competitive environment, despite the low usage.

**Exhibit 3-8 Amenities and Services Expected by Frequent Travelers**

*Sources: Dial Corporation, Michigan State University*

| Amenity or Service | Economy | Mid-Priced | Luxury |
|---|---|---|---|
| Personal care items | 13% | 61% | 95% |
| Room service | 11 | 73 | 93 |
| Complimentary newspaper | 8 | 39 | 90 |
| Swimming pool | 39 | 83 | 92 |
| Cocktail lounge | 8 | 73 | 88 |
| Check cashing | 24 | 64 | 87 |
| In-room refrigerator | 5 | 27 | 74 |
| Complimentary breakfast | 11 | 42 | 71 |
| Iron/ironing board | 6 | 20 | 42 |
| In-room coffee maker | 24 | 46 | 54 |

**Exhibit 3-9 Usage of Amenities and Services**

*Source: American Hotel and Motel Association*

| Amenity or Service | Guest Usage |
|---|---|
| Television | 91% |
| Personal care items | 76 |
| Restaurant | 70 |
| More than two towels | 69 |
| Wake-up call | 59 |
| In-room coffee maker | 54 |
| Cocktail lounge | 29 |
| Swimming pool | 29 |
| Pay television | 20 |
| Exercise equipment | 15 |
| Check cashing | 10 |
| Room service | 10 |
| Laundry valet | 4 |
| Game room | 3 |
| Coin laundry | 2 |

## ¶ 3.05 FINANCIAL OPERATING CHARACTERISTICS

Income and expense statements for several types of hotels are contained in Exhibit 3-10, illustrating the common differences between the classes of hotels.

The income and expense statement for a commercial hotel shows that the property generates food and beverage revenue, telephone revenue, and other income. Its rooms department expense is 28.8 percent of rooms revenues, and its food and beverage expense ratio is 72.5 percent of food and beverage revenue. The commercial hotel's departmental expense is 43.3 percent of total revenues, and its house profit equates to 22.1 percent of total revenues. After fixed expenses, net operating income equates to 16.4 percent of total revenues.

The operating statement for a large convention hotel shows a similar departmental expense ratio at 45.0 percent of total revenues. However, because of the economies of scale, undistributed operating expenses equate to 21.9 percent of total revenues, as opposed to 34.6 percent of total revenues for the commercial hotel, resulting in house profit and net operating income levels of 33.1 percent and 26.9 percent, respectively, of total revenues.

In the income and expense statement for a resort hotel, particular differences are noted between the higher revenues generated from minor operating departments and those from rentals and other income. In addition, the resort's marketing and property operations and maintenance expenses are higher. Overall, the net operating income for the resort is 23.9 percent of total revenues.

The statement for the suite hotel shows that because food service is not a significant profit generator in a suite hotel, the restaurant has been leased. The property enjoys excellent operating ratios, which result in a net operating income of 40.7 percent of total revenues.

The extended-stay hotel's statement shows that this type of property generally achieves a high occupancy at a solid average room rate. As a result of the higher occupancy, the extended-stay hotel is able to realize a departmental income of 73.0 percent of total revenues, a house profit of 40.4 percent of total revenues, and a net operating income of 36.1 percent of total revenues.

While the operating data shown in Exhibit 3-10 is broadly typical for the various hotel classifications, it should be remembered that there are many factors, including local market conditions, chain affiliation, and management ability, that can dramatically affect the results of any lodging facility.

Exhibit 3-10 Hotel Operating Statistics by Type

## Exhibit 3-10 Hotel Operating Statistics by Type

| Type:<br>Number of Rooms:<br>Occupancy:<br>Average Rate: | Commercial<br>~300–500<br>~60%<br>~$75<br>% of Gross | PAR[1] | POR[2] | Convention<br>~1,000–2,000<br>~75%<br>~$150<br>% of Gross | PAR[1] | POR[2] | Resort<br>~300–500<br>~70%<br>~$150<br>% of Gross | PAR[1] | POR[2] | Suite<br>~200–300<br>~75%<br>~$100<br>% of Gross | PAR[1] | POR[2] | Extended-Stay<br>~100–150<br>~80%<br>~$100<br>% of Gross | PAR[1] | POR[2] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Departmental Revenue** | | | | | | | | | | | | | | | |
| Rooms | 66% | $16496 | $74.82 | 60.9% | $37,702 | $135.91 | 49.9% | $39,878 | $152.61 | 89.9% | $28,644 | $102.63 | 92.9% | $25,909 | $94.15 |
| Food | 25.9 | 6,467 | 29.34 | 25.1 | 15,553 | 56.07 | 28.4 | 22,721 | 86.95 | 0.0 | 0 | 0.00 | 0.0 | 0 | 0.00 |
| Beverage | 4.2 | 1,044 | 4.74 | 6.5 | 4,003 | 14.43 | 10.9 | 8,755 | 33.50 | 0.0 | 0 | 0.00 | 0.0 | 0 | 0.00 |
| Telephone | 3.0 | 759 | 3.44 | 3.0 | 1,836 | 6.62 | 2.2 | 1,722 | 6.59 | 5.2 | 1,645 | 5.90 | 2.3 | 629 | 2.28 |
| Minor Oper. Depts. | 0.0 | 0 | 0.00 | 3.2 | 1,992 | 7.18 | 7.0 | 5,568 | 21.31 | 4.1 | 1,408 | 5.04 | 0.6 | 157 | 0.57 |
| Rental and Other Income | 0.9 | 235 | 1.07 | 1.3 | 818 | 2.95 | 1.7 | 1,335 | 5.11 | 0.3 | 162 0.58 | 4.2 | 1,180 | 4.29 | |
| Total | 100.00 | 25,001 | 113.41 | 100.0 | 61,904 | 223.16 | 100.00 | 79,979 | 306.07 | 100.0 | 31,861 | 114.15 | 100.0 | 27,874 | 101.29 |
| **Departmental Expenses*** | | | | | | | | | | | | | | | |
| Rooms | 28.8 | 4,759 | 21.59 | 26.9 | 10,125 | 36.50 | 21.7 | 8,665 | 33.16 | 23.4 | 6,695 | 23.99 | 23.4 | 6,058 | 22.01 |
| Food & Beverage | 72.5 | 5,449 | 24.72 | 79.7 | 15,583 | 56.18 | 69.4 | 21,831 | 83.55 | 0.0 | 0 | 0.00 | 0.0 | 0 | 0.00 |
| Telephone | 82.5 | 627 | 2.84 | 31.1 | 570 | 2.06 | 54.6 | 940 | 3.60 | 29.9 | 491 | 1.76 | 44.3 | 279 | 1.01 |
| Minor Oper. Depts. | 0.0 | 0 | 0.00 | 57.3 | 1,609 | 5.79 | 86.4 | 4,811 | 18.41 | 45.3 | 595 | 2.13 | 87.7 | 1,176 | 4.28 |
| Total | 43.3 | 10,835 | 49.15 | 45.0 | 27,887 | 100.53 | 45.3 | 36,247 | 138.72 | 24.4 | 7,782 | 27.88 | 27.0 | 7,513 | 27.30 |
| **Departmental Income** | 56.7 | 14,166 | 64.26 | 55.0 | 34,017 | 122.63 | 54.7 | 43,732 | 167.35 | 75.6 | 24,079 | 86.27 | 73.0 | 20,361 | 73.99 |
| **Undistributed Operating Expenses** | | | | | | | | | | | | | | | |
| Administrative and General | 11.5 | 2,886 | 13.09 | 8.1 | 4,987 | 17.98 | 5.1 | 4,100 | 15.69 | 7.3 | 2,327 | 8.34 | 10.5 | 2,920 | 10.61 |
| Management Fees | 3.0 | 750 | 3.40 | 0.0 | 0 | 0.00 | 4.3 | 3,425 | 13.11 | 1.4 | 439 | 1.57 | 6.9 | 1,937 | 7.04 |
| Franchise Fees | 3.6 | 911 | 2.99 | 0.0 | 0 | 0.00 | 0.0 | 0 | 0.00 | 3.6 | 1,146 | 4.11 | 0.0 | 0 | 0.00 |
| Marketing | 7.3 | 1,814 | 9.37 | 6.5 | 4,014 | 14.47 | 6.5 | 5,238 | 20.05 | 8.2 | 2,603 | 9.33 | 6.4 | 1,783 | 6.48 |
| Property Oper. & Maint. | 5.4 | 1,342 | 6.09 | 4.9 | 3,051 | 11.00 | 4.9 | 3,905 | 14.94 | 3.4 | 1,077 | 3.86 | 4.6 | 1,293 | 4.70 |
| Energy | 3.8 | 951 | 4.31 | 2.4 | 1,468 | 5.29 | 3.4 | 2,752 | 10.53 | 2.9 | 928 | 3.33 | 4.2 | 1,182 | 4.30 |
| Total | 34.6 | 8,654 | 39.25 | 21.9 | 13,520 | 48.74 | 24.2 | 19,420 | 74.32 | 26.8 | 8,520 | 30.54 | 32.6 | 9,115 | 33.13 |
| **House Profit** | 22.1 | 5,512 | 25.01 | 33.1 | 20,497 | 73.89 | 30.5 | 24,312 | 93.03 | 48.8 | 15,559 | 55.73 | 40.4 | 11,246 | 40.86 |
| **Fixed Expenses** | | | | | | | | | | | | | | | |
| Property Taxes | 3.0 | 750 | 3.40 | 2.5 | 1,574 | 5.68 | 2.9 | 2,318 | 8.87 | 2.4 | 768 | 2.75 | 3.3 | 917 | 3.33 |
| Insurance | 0.7 | 164 | 0.74 | 0.4 | 219 | 0.79 | 0.6 | 487 | 1.86 | 1.7 | 537 | 1.92 | 1.0 | 292 | 1.06 |
| Reserve for Replacement | 2.0 | 514 | 2.32 | 3.3 | 2,083 | 7.51 | 3.1 | 2,475 | 9.48 | 4.0 | 1,259 | 4.50 | 0.0 | 0 | 0.00 |
| Total | 5.7 | 1,428 | 6.46 | 6.2 | 3,876 | 13.98 | 6.6 | 5,280 | 20.21 | 8.1 | 2,564 | 9.17 | 4.3 | 1,209 | 4.39 |
| **Net Income** | 16.4% | $4,084 | $18.55 | 26.9% | $16,621 | $59.91 | 23.9% | $19,032 | $72.82 | 40.7% | $12,995 | $46.56 | 36.1% | $10,037 | $36.47 |

*Departmental Expenses are expressed as a percentage of departmental revenues
[1]Per Available Room
[2]Per Occupied Room

# CHAPTER 4

# National Demand



## ¶ 4.01 INTRODUCTION

The demand for lodging in the United States is difficult to gauge, because it requires the evaluation of a number of economic and societal trends. Some of the most significant factors affecting lodging demand include:

- *Value of the dollar.* Declines in the value of the dollar enable more foreign tourists to travel to the United States while restricting the travel of Americans abroad; increases in dollar value reverse this situation.
- *Automotive fuel prices.* An increase in fuel prices discourages people from traveling, while a decrease permits less expensive transportation, resulting in an increase in travel and lodging demand.

- *Number of dual-income households.* Over the past twenty years, the increasing prominence of dual-income households has meant, for these families, greater disposable income that can be devoted to leisure travel.
- *Advances in telecommunications.* Increasingly sophisticated technology has enabled meetings and conferences to take place between participants situated around the globe, thereby reducing the need for business travel.
- *Implementation of frequent flyer/frequent guest programs.* In a number of travel-related industries, including the airline, car rental, and hotel industries, numerous incentive programs now exist that encourage travel by awarding free or reduced-cost transportation, lodging, and other financial rewards.

## ¶ 4.02 NATIONAL DEMAND DATA

The analysis of national trends affecting lodging demand depends in large part on pertinent data compiled by government and industry organizations. Data relating to lodging demand can be divided into four general categories:

1. Information regarding the actual use of transient accommodations.
2. Information regarding travel that may entail the use of transient accommodations.
3. Indicators of the general condition of the national economy and broad-based demographic trends that can have an indirect impact on the use of transient accommodations.
4. Information detailing specific characteristics of transient travel demand (e.g., primary reasons for leisure travel or selection of hotels).

Category 1 data provides the clearest indications of the current status of lodging demand, because the data requires little extrapolation or hypothesization. Categories 2 and 3 include information that does not directly reflect demand for transient accommodations, but from which useful inferences can nonetheless be drawn. Category 4 concerns such elements of demand as the most popular destinations for leisure travelers and preferences among the different market segments (i.e., commercial, meeting and convention, and leisure) regarding the amenities offered by lodging facilities. This sort of information indicates not overall levels of demand but rather characteristics of demand segments; it is useful for the proper planning, design, operation, and marketing of individual lodging facilities. Each of these categories of data is discussed in the following sections.

## ¶ 4.03 USE OF TRANSIENT ACCOMMODATIONS

Historically, the U.S. Travel Data Center has been the primary source of data regarding the use of transient accommodations and the actual dollar receipts of lodging facilities. This organization conducts monthly surveys of travelers to determine their travel patterns. In more recent years, Smith Travel Research (STR) has emerged as the definitive source of hotel industry data, providing occupancy and average rate statistics as well as supply, demand, and room sales trends on an aggregate national level and for most U.S. hotel submarkets. Several government agencies, including the Bureau of the Census and the Bureau of Labor Statistics, also compile information regarding the use of transient accommodations in the course of preparing nationwide industrial statistics.

## [1] Trends in Hotel Travel Volume

The U.S. Travel Data Center conducts monthly travelers' surveys from which a wide range of statistics are developed and hotel volume trends are tracked. Exhibit 4-1 shows the volume of travel that involved a hotel stay. This exhibit demonstrates a virtually continuous increase between 1986 and 1996.

**Exhibit 4-1 U.S. Resident Travel Volumes, 1986–1999—Hotel/Motel Travel**

*Sources: Travel Industry Association's National Survey*

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 86–96 Change |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Trips | | | | | | | | | | | | |
| Volume (millions) | 247.9 | 282.1 | 273.3 | 290.5 | 291.1 | 291.1 | 325.8 | 329.5 | 318.5 | 316.4 | 334.0 | 35% |
| Share of total | 47% | 50% | 47% | 49% | 49% | 49% | 50% | 51% | 48% | 47% | 49% | |

Exhibit 4-2 shows the compounded annual growth rates for several different travel categories, including travel volume by purpose of trip and by mode of transportation.

**Exhibit 4-2 Travel Growth Rates**

| Category | Compounded Annual Percent Change (1982–1993) |
|---|---|
| Total Travel | 2.8% |
| Hotel | 4.7 |
| Pleasure | 3.2 |
| Vacation | 3.4 |
| Weekend | 5.0 |
| Business | 5.2 |
| Auto | 2.0 |
| Air | 5.8 |

All categories showed an increase in travel volume between 1982 and 1993. As a result of the 1992 airline rate wars, the highest growth rate was recorded in air travel. Travel that involved hotel accommodations showed an impressive 4.7 percent average annual compounded growth rate during this period. The continuous increase in travel volume supports the observation that the cyclical declines in hotel occupancies in past years were a result of overbuilding rather than a reduction in the amount of travel.

## [2] Trends in Total Room Sales

Another direct indicator of transient demand is the annual percentage change in room sales, which is tallied by Smith Travel Research. Exhibit 4-3 tracks room sales trends since 1987 for the United States as a whole.

**Exhibit 4-3 Room Sales—U.S. Total**

*Source: Smith Travel Research*

| Year | Percent Change |
|---|---|
| 1987 | 8.3% |
| 1988 | 8.9 |
| 1989 | 9.1 |
| 1990 | 6.7 |
| 1991 | 1.2 |
| 1992 | 5.3 |
| 1993 | 6.3 |
| 1994 | 8.6 |

Consistent with trends in new hotel development, national room sales growth gained momentum during the late 1980s, peaking at 9.1 percent annual growth in 1989. Growth began to decline in 1990, and reached a relative low in 1991, when hotel room sales increased by only 1.2 percent, well below the pace of inflation. As the national economy began to recover, so did the relative health of the national hotel market. From 1992 to 1994, room revenues gradually increased to a rate of 8.6 percent, roughly on par with the sales growth levels experienced during the late 1980s.

# ¶ 4.04 TRAVEL INDUSTRY STATISTICS

Travel industry statistics are generally easier to obtain than information concerning the actual utilization of hotels and motels.

## [1] Food and Beverage Sales

Food and beverage sales are quantified each year by the National Restaurant Association for several categories, including lodging places and hotel and motel restaurants. According to data found in the *Statistical Abstract of the United States* 115th Edition, food and drink sales at lodging facilities had a compounded annual growth of 2.3 percent between 1980 and 1992, slowing to a rate of 1.3 percent annually from 1985 to 1992. Reflecting the economic recession, food and drink sales at lodging facilities declined by 0.9 percent from 1990 to 1992. Hotel restaurants showed growth rates of 4.1 percent, 2.3 percent, and negative 0.4 percent in 1990, 1991, and 1992, respectively. Motel restaurants experienced significantly lower volumes each year, with a 7.3 percent decline from 1980 to 1992, a 6.6 percent decline from 1985 to 1992, and a 5.4 percent decline from 1990 to 1992.

## [2] Domestic Passenger Traffic

Domestic passenger traffic figures for private cars and domestic airlines, buses, and railroads also provide indirect indicators of transient lodging demand.

According to the *Statistical Abstract of the United States* 115th Edition (Table 1009, p. 62), from 1970 to 1993 total passenger traffic increased at varying rates between 2.0 percent and 3.0 percent annually, with the greatest period of growth occurring during the 1980s. Growth slowed from an annual rate of 2.9 percent in the period from 1980 to 1993 to a rate of 2.2 percent annually from 1990 to 1993. In general, the greatest growth rate took place in domestic air travel, which had a 5.1 percent annual increase between 1970 and 1993—even though, between 1990 and 1993, the growth rate dropped to 1.0 percent. Because air travel tends to generate a high level of lodging demand, these trends are very favorable for hotels and motels, and particularly those located at major airport destinations. Surprisingly, railroad travel increased by 2.5 percent annually between 1990 and 1993, although that mode of transportation still remained only a minor contributor to overall passenger traffic.

## [3] International Travel Demand

International travel to the United States represents a growing source of hotel demand. Since 1983, international travel has been increasing at an estimated annual compounded rate of 8 percent. The low value of the dollar in relation to other currencies makes the United States an inexpensive destination for overseas travelers. Approximately 10 percent of the total U.S. hotel demand is currently generated by international travelers, and this percentage is projected to increase to 14 percent during the next three years. Surveys show that foreign visitors stay in hotels nearly twice as long as domestic travelers (7 nights as opposed to 3.6) and use hotels with nearly twice the frequency of U.S. travelers. International vacationers constitute an extremely attractive market, with an average stay of just under three weeks and per-capita spending that is six times higher than that of their U.S. counterparts.

The two primary sources of international travel to the United States are Canada and Mexico. Together, these countries represented more than 55 percent of the total international arrivals in 1994. Because of economic problems, travel from Canada to the United States has remained fairly level during the past several years. Travel from Mexico, however, has increased sharply. The passage of the NAFTA agreement is likely to engender a further influx of visitors from these two countries, which should have a favorable effect on the U.S. lodging industry.

According to data from the U.S. Travel and Tourism Administration, there was little change in the volume of international travel to the United States during the first part of the 1980s. As the dollar weakened in value against foreign currencies during the mid- to late 1980s, international travel increased significantly.

Offsetting the benefits of international travel to the United States is the outbound travel to international destinations by U.S. citizens. Between 1989 and 1994, foreign travel to the United States rose by 28 percent, while U.S. travel to international destinations increased by only 13 percent. Between 1989 and 1994, U.S. travel to Canada declined by 3 percent, while U.S. travel to Mexico rose by 5 percent. Total international travel by U.S. citizens has been increasing slowly.

## ¶ 4.05 ECONOMIC AND DEMOGRAPHIC TRENDS

Category 3 data, which indicates general economic health and broad-based demographic trends that can indirectly affect lodging demand, is readily available to analysts and investors. The most useful data of this type pertains to the gross domestic product and the contributions made to it by the wholesale and retail trade and the service industries. Gross domestic product, which is the broadest measure of economic activity, is a relevant indicator for both business and leisure travel.

Wholesale and retail trade generates about 15 percent of the nation's lodging demand, so the economic health of this segment of the economy has particular importance for the lodging industry. In constant 1987 dollars, the gross domestic product (GDP) had a compounded annual growth rate of 1.6 percent between 1987 and 1992. During this same period, the combined wholesale and retail trade grew at 2.1 percent, and services increased by 2.6 percent annually. Slower GDP growth occured from 1990 to 1992 than in the period from 1987 to 1992, largely reflective of the national economic recession.

## ¶ 4.06 CHARACTERISTICS OF TRAVEL DEMAND

Category 4 data is quite different from the first three categories of data in that it does not assist in quantifying lodging demand, but rather provides information about the characteristics of the demand—for example:

- The reasons commercial travelers select a particular hotel
- The usual lead time for booking an association training seminar
- The most popular destinations for pleasure travelers
- Why people travel
- The hotel amenities that travelers request most and the amenities that travelers actually use most

Although Category 4 data does not directly reflect overall hotel demand, an understanding of this information is essential for planning a lodging facility and operating it in a manner that attracts a sufficient level of demand. Exhibit 4-4 contains data regarding the characteristics of an average trip along with the number of nights per trip for the period from 1984 to 1993.

**Exhibit 4-4 Characteristics of an Average Trip**

*Source: U.S. Travel Data Center*

| | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 |
|---|---|---|---|---|---|---|---|---|---|---|
| Persons per trip | 1.62 | 1.62 | 1.59 | 1.57 | 1.58 | 1.60 | 1.62 | 1.65 | 1.63 | 1.64 |
| Nights per trip | 5.20 | 5.40 | 5.20 | 5.00 | 4.90 | 4.60 | 4.40 | 4.10 | 4.00 | 4.20 |

As the exhibit shows, the number of persons per trip has remained relatively flat during the past ten years—approximating 1.6 persons per trip—although during the late 1980s, the figure dipped slightly. As the late 1980s was a period of rapid economic expansion, the slightly lower statistics during that time might indicate an increase in individual business travel. The number of nights per trip has generally decreased from a 1985 peak of 5.4 nights per trip to 4.2 in 1993. Business travel budgets have been reduced, particularly during the recessive early 1990s, having a direct impact on the length of business trips, and increasing number of flight options and lower airfares have led to more short "commuter" flights.

With the increase in dual-income households, vacations have changed over the past decade. Mostly gone is the single, multi-week family vacation each summer; today, an increasing number of couples and families prefer shorter but more frequent vacations.

Category 4 data can be made more useful by being broken down into individual segments based on the unique characteristics of the travelers making up a particular segment. The most logical method for performing this operation is to use the purpose of the trip as a distinguishing characteristic. Three primary segments are (1) commercial demand, which consists of individual business people traveling for a business purpose; (2) meeting and convention demand, which consists of groups of people (more than three) traveling for the purpose of having a meeting of some type; and (3) leisure demand, which consists of individuals traveling for pleasure.

One important reason for looking at Category 4 data on the basis of individual demand segments is that different types of demand usually exhibit different characteristics that are useful for lodging facility planners and managers to know. For example, commercial demand exhibits a low double-occupancy rate, while leisure travel generates a much larger number of people per room; leisure travelers typically have a longer average stay than commercial patrons; and growth rates in commercial travel are often dependent on the local economy, whereas growth rates in meeting and convention patronage are most often affected by national economic trends. These characteristics can have a significant effect on the operating results of a lodging facility, so any analysis of lodging demand data should begin by dividing the data into individual segments.

## [1] Commercial Demand Segment

As shown in Exhibit 4-5, Business Trips increased from 1986 - 1996 by 17%. The total volume of business travel by person-trips increased even more by 26%. This indicates that the travel party size increased over the time period.

**Exhibit 4-5 U.S. Resident Travel Volumes, 1986–1999—Business Travel**

*Source: Travel Industry Association's National Survey*

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 86–96 Change |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Trips | | | | | | | | | | | | |
| Volume (millions) | 164.4 | 185.0 | 182.8 | 199.3 | 182.8 | 176.9 | 210.8 | 210.4 | 193.2 | 207.8 | 192.8 | 17% |
| Share of total | 31% | 33% | 31% | 34% | 31% | 30% | 32% | 32% | 29% | 31% | 29% | |
| PERSON-TRIPS | | | | | | | | | | | | |
| Volume (millions) | 200.1 | 218.3 | 224.1 | 245.6 | 221.8 | 224.0 | 278.0 | 275.4 | 246.7 | 275.2 | 251.2 | 26% |
| Share of total | 24% | 24% | 24% | 26% | 23% | 23% | 26% | 26% | 22% | 23% | 22% | |
| Travel Party Size (People) | 1.22 | 1.18 | 1.23 | 1.23 | 1.21 | 1.27 | 1.32 | 1.31 | 1.28 | 1.32 | 1.31 | |

Although business travelers who take 10 or more trips per year make up the smallest segment, this group of travelers has grown in size during the past decade. Hotel chains develop marketing plans aimed at these frequent travelers in an effort to develop brand loyalty. Today, most major commercial hotel chains offer a traveler incentive program, and according to U.S. Travel Data Center, approximately 16 percent of business travelers actively participate in a frequent lodger program. Exhibit 4-6 shows the average number of nights spent per business trip. Most businesspeople spend between two and three nights away from home, while only 13.6 percent of corporate travelers spend more than ten nights on the road.

**Exhibit 4-6 Nights Spent per Business Trip**

*Source: U.S. Travel Data Center*

| Number of Nights | Percentage of Commercial Travelers |
|---|---|
| 0 | 13% |
| 1 | 21% |
| 2-3 | 38% |
| 4-9 | 22% |
| 10+ | .6% |

The typical business traveler is always of interest to hotel investors and operators. Exhibit 4-7 shows some of the most important characteristics of the commercial segment.

**Exhibit 4-7 Demographics of Business Travelers**

*Source: U.S. Travel Data Center*

| | |
|---|---|
| Men | 69% |
| Age 25-55 | 45% |
| College graduate | 43% |
| Professional or managerial | 57% |
| Income $40,000+ | 68% |
| Two or more wage earners | 53% |
| Average miles per trip | 834 |
| Average nights per trip | 8.2 |
| Uses airline for trip | 35% |
| Stays in hotel or motel | 67% |

Exhibit 4-8 shows the types of transportation used by commercial travelers.

**Exhibit 4-8 Types of Transportation Used on Business Trips**

*Source: U.S. Travel Data Center*

| Primary Type Used | |
|---|---|
| Car travel | 62% |
| Airline | 35% |
| Bus/motorcoach | 1% |
| Company plane | 0.5% |
| Train | 0.5% |
| Other | 1% |

According to the U.S. Travel Data Center, the ten most important factors in hotel selection for commercial travelers are the following:

1. Convenient location
2. Clean, comfortable rooms
3. Room rates
4. Recommendations
5. Previous experience
6. Meeting facilities
7. Restaurant—food service
8. Company policy
9. Travel agent
10. Frequent guest program

Predictably, a convenient location is the key factor in the selection process. Clean, comfortable rooms are next on the list, followed by cost.

Commercial travel is distributed fairly evenly throughout the year for both frequent and infrequent travelers, although there is less activity during the months of December, January, and February. Business travel peaks during the spring and fall months, with a slight dropoff noted during the summer months. Exhibit 4-9 lists the distribution of business travel by month throughout the year.

In general, business travelers tend to be less price sensitive than other travelers; furthermore, they travel on a more regular basis, and their demand is fairly predictable. For these reasons, owners and operators of lodging facilities consider the commercial demand segment an extremely important component of the overall demand for lodging.

## [2] Meeting and Convention Demand Segment

One of the best sources of national demand data concerning the meetings and convention market segment is *Meetings and Conventions* magazine, a nationally recognized authority on all types of meetings and conventions. Every two years, the publishers of this periodical conduct a detailed survey of their readership to develop data related to the meetings and convention market in the United States, and then publish the information in a book titled *Meetings Market.*

**Exhibit 4-9 Distribution of Business Trips by Month**

*Source: U.S. Travel Data Center*

| | Percentage of Total | |
|---|---|---|
| | Frequent Travelers | Less Frequent Travelers |
| January | 6.4% | 5.6% |
| February | 3.6 | 5.3 |
| March | 8.4 | 9.1 |
| April | 10.8 | 11.1 |
| May | 8.0 | 9.1 |
| June | 11.5 | 9.9 |
| July | 8.4 | 9.7 |
| August | 7.5 | 9.0 |
| September | 9.6 | 7.9 |
| October | 9.4 | 8.7 |
| November | 9.5 | 8.6 |
| December | 6.9 | 5.9 |
| Total | 100.0% | 100.0% |

*Meetings Market* divides the meetings and convention market into three segments: corporate meetings, conventions, and association meetings. Exhibit 4-10 shows the important characteristics of corporate meetings.

**Exhibit 4-10 Characteristics of Corporate Meetings**

| Type of meeting | Average attendance | Average number of days' duration | Number in past year | Percentage of total | Average number of months' planning lead time |
|---|---|---|---|---|---|
| Management Meetings | 43 | 2.7 | 159,900 | 20% | 4.9 |
| Sales Meetings | 64 | 2.98 | 133,900 | 17 | 8.2 |
| Training Seminars | 67 | 2.6 | 261,000 | 33 | 2 |
| Incentive Trips | 81 | 6.5 | 60,200 | 8 | 4.6 |
| Stockholder Meetings | 82 | 1.6 | 10,300 | 1 | 4.7 |
| Professional/Technical Meetings | 86 | 4.6 | 101,000 | 13 | 3.3 |
| New Product Introductions | 98 | 2.3 | 30,500 | 4 | 1.5 |
| Other Meetings | 107 | 2.1 | 44,500 | 6 | 9.4 |
| Average/Total | 69 | 3.2 | 801.300 | 100% | 5.1 |

Corporate meetings typically have a fairly small attendance (the average is approximately 69 people) and range in duration from 1.6 days for stockholder meetings to 6.5 days for incentive trips. The average length of a corporate meeting is 3.2 days. Training seminars make up the largest number of corporate meetings, roughly one-third of all, followed by management meetings and regional sales meetings. The planning lead time for corporate meetings ranges from a low of 2 months to a high of 9.4 months. The length of lead time is an important consideration for new hotels that must pre-sell meeting space early enough to capture this element of the lodging market.

Major conventions typically consist of groups of 1,000 or more. A unique characteristic of conventions is the amount of time for which they are booked in advance. Exhibit 4-11 shows that as the size of a meeting increases, the number of months lead time required for booking arrangements also increases, to the point at which the average convention of more than 500 people is booked more than four years in advance. This finding demonstrates the need for a long pre-selling program for new hotels that plan to capture large meetings.

**Exhibit 4-11 Advance Time Required to Book Meetings**

*Source: Meeting Planners Survey*

| Number of Attendees | Months |
|---|---|
| 10–50 | 10 |
| 51–150 | 13 |
| 151–300 | 25 |
| 301–500 | 33 |
| 500+ | 55 |

Association meetings are generally composed of smaller groups that meet periodically to conduct the business of the association. These events consist of work sessions similar to corporate meetings but also generally involve some leisure-oriented and socially oriented activities. Exhibit 4-12 provides basic information about such meetings.

**Exhibit 4-12 Characteristics of Association Meetings**

*Source: 1994 Meetings Market Report*

| Type of Meeting | Average Attendance | Average Duration (Days) | Number in Past Year | Number of Month's Lead Time |
|---|---|---|---|---|
| Board Meeting | 35 | 1.8 | 62,500 | 6.3 |
| Educational Seminars | 102 | 2.1 | 57,000 | 9.2 |
| Professional/Technician | 111 | 2.3 | 35,700 | 7.2 |
| Regional/Local Chapter | 98 | 1.9 | 33,500 | 11.7 |
| Other | 178 | 2.4 | 17,800 | 9.2 |
| Average/Total | 91 | 2.1 | 206,500 | 10 |

Association meetings include such functions as board meetings, seminars, and local chapter meetings. They typically attract an average of 91 people, which is larger than the average corporate meeting, but the duration is somewhat shorter—on average, 2.1 days. Planning lead time for association meetings is generally somewhat longer than for corporate meetings, ranging from 6.3 months to 11.7 months.

The time of year of meeting and convention demand is an important consideration when planning a hotel oriented to this market segment. The meetings and convention market has strong seasonal swings in demand, with the high point coming in the late spring and the low point in the middle of winter. Exhibit 4-13 shows the percentage of major conventions held by month.

**Exhibit 4-13 Distribution of Conventions by Month**

*Source: 1994 Meetings Market Report*

| Month | Percentage of Meetings |
|---|---|
| January | 5% |
| February | 6 |
| March | 6 |
| April | 8 |
| May | 10 |
| June | 9 |
| July | 6 |
| August | 6 |
| September | 10 |
| October | 20 |
| November | 10 |
| December | 4 |
| Total | 100% |

The process by which meeting planners select a hotel is also important information for owners and operators of lodging facilities. According to the U.S. Travel Data Center, the primary factors in hotel selection for meetings and conventions are the following:

1. Food service
2. Meeting facilities
3. Billing procedures
4. Guestrooms
5. Meeting coordination
6. Audio-visual equipment
7. Recreational facilities
8. Convenient transportation
9. Exhibit space
10. Number and caliber of suites

Meetings and conventions are unquestionably an important market for the lodging industry. Most of these events make use of all of the facilities within a hotel, including meeting rooms, banquet rooms, lounges, restaurants, and recreational facilities. In addition, some groups are willing to meet on weekends and holidays, thus complementing commercial demand, which falls off during these periods. Another advantage is that meeting plans are typically made by a small committee that can consolidate and facilitate a hotel's marketing and selling activities. In addition, group arrangements such as banquets, centralized booking, check-in, and billing increase the efficiency of convention hotel operations.

As the economy of the United States becomes increasingly service oriented, the need for meetings and conventions should continue to grow. Offsetting this trend, however, will be the greater use of video communications, which will, over time, decrease the need for meetings.

## [3] Leisure Demand Segment

Leisure travel is important to the lodging industry because it creates demand that is negatively correlated with commercial demand. In other words, leisure travel is strong during weekends, holidays, and summer, when commercial demand is weak; during periods when commercial demand is strong, leisure travel is generally at a low level. Hotels that can attract both leisure and commercial demand generally enjoy higher levels of occupancy without the peaks and valleys that plague operations that can cater to only one segment of demand.

Exhibit 4-14 contains demographic data pertaining to leisure travelers.

**Exhibit 4-14 Demographics of Leisure Travelers**

*Source: U.S. Travel Data Center*

| | |
|---|---|
| Men | 55.0% |
| Age 25-44 | 41.0 |
| College graduate | 40.0 |
| Professional or managerial | 32.0 |
| Two or more wage earners | 43.0 |
| Use airline for trip | 18.0 |
| Use rental car | 9.0 |
| Stay in hotel or motel | 40.0 |
| Use travel agent | 8.0 |
| Average miles per trip | 858 |
| Average nights per trip | 4.0 |
| Average household members per trip | 1.8 |

## [4] Comparison of Demand Characteristics

Exhibit 4-15 contains listings of customer preference items, which have been ranked according to the importance with which they are regarded by the three main demand segments (1 being most important and 6 least important). The six preference items surveyed are price, travel time, quality, management, amenities, and image. Price simply represents what is charged by lodging facilities for their guestrooms. Travel time is the time it takes to travel to the facility if it is not the primary destination of the traveller, and is primarily a measure of convenience. Quality is a measure of the grade of the accommodations offered by a facility; a high-quality hotel generally has larger guestrooms, better furnishings, and more personalized service. Management is largely responsible for a lodging facility's atmosphere, which can affect guest comfort and the perceived status of the facility. Amenities are items provided above and beyond the normal necessities found in a lodging facility; they usually become more elaborate as the level of quality rises. Image is an intangible that describes the feeling that is created by a facility and its management and that is augmented through marketing and guest experience.

**Exhibit 4-15 Customer Preference**

| | Class of Hotel | | |
|---|---|---|---|
| **Demand Segment** | **Economy** | **Midrate** | **Luxury** |
| **Commercial** | 1. Price | Travel Time | Image |
| | 2. Travel Time | Quality | Quality |
| | 3. Quality | Price | Management |
| | 4. Management | Image | Travel Time |
| | 5. Amenities | Management | Amenities |
| | 6. Image | Amenities | Price |
| **Meeting and Convention** | 1. Price | Amenities | Image |
| | 2. Amenities | Quality | Amenities |
| | 3. Quality | Price | Quality |
| | 4. Management | Image | Management |
| | 5. Travel Time | Management | Travel Time |
| | 6. Image | Travel Time | Price |
| **Leisure** | 1. Price | Amenities | Image |
| | 2. Amenities | Quality | Amenities |
| | 3. Quality | Price | Quality |
| | 4. Management | Image | Management |
| | 5. Travel Time | Management | Travel Time |
| | 6. Image | Travel Time | Price |

CHAPTER 5

# Market, Product, and Site Selection



## ¶ 5.01 LONG-TERM TRENDS

Hotel development or acquisition begins with three basic steps:

1. Identifying market areas that show long-term potential for hotel investment.
2. Choosing a lodging product that will take best advantage of the local supply and demand characteristics.
3. Search for an appropriate site.

When looking at market areas in which to develop or acquire a lodging facility, the investor should first focus on long-term economic trends and on future supply-and-demand characteristics rather than historical factors. A knowledge of the economic history of a market area is useful, but the ability of a new hotel (whether recently constructed or acquired and renovated) to survive and succeed depends on the long-term supply and demand conditions in the market area. The economic life of a lodging facility typically ranges from twenty to sixty years, with a median of thirty-five to forty years. A long-term evaluation is necessary to determine whether the current economic characteristics of the market are likely to continue or whether some development could take place that would alter the economic climate.

For example, one of the trends presently affecting the economy of the United States is a gradual decline in manufacturing industries and a concurrent increase in service-oriented businesses. This trend has negatively affected the regional economies of many of the major manufacturing centers in the country. One aspect of a decline in a local economic base is that the lodging market in the area is apt to experience a loss in room-night demand. The reverse takes place, however, when an area is able to grow by attracting service-oriented industries.

Other long-term trends that may have a significant effect on both the lodging industry as a whole and on individual market areas during the next thirty to forty years include:

- Decline in the manufacturing and production industries may have a negative affect on market areas that are dependent on this business activity.
- Increase in the service and technology industries will benefit market areas that attract these businesses.
- The aging of the population will result in a greater number of senior citizens who have both the time and the money to travel and to make use of transient lodging facilities. Resort-, leisure-, and tourist-oriented markets should benefit the most from increased travel by the retired population.
- Greater family income, generated by two wage-earners, coupled with generally smaller family size, will stimulate increased leisure travel. Resort, leisure, and tourist markets should prosper from this business.
- The deregulation of the airline industry has reduced the cost of travel to many destinations, with the result that more people can now afford to travel greater distances and patronize more lodging facilities. Technological advances should further increase the speed and range of travel, thus making it easier for people to reach their destinations.
- Faster transportation will, however, in some ways reduce lodging demand. New technology will enable commercial travelers to reach their destinations more rapidly, and thus reduce the amount of time it takes to conduct their business and then return home. At present, for example, a trip from New York to Los Angeles involves five hours in transit, which means a business trip from New York almost always includes one night in a Los Angeles hotel. With the inevitable introduction of supersonic air travel between the coasts, trips to Los Angeles and all points in between will require only one day; consequently, lodging facilities in markets served by this form of high-speed transportation will lose commercial demand.
- Video communication technology is rapidly approaching the point at which businesses will be able to eliminate some of their face-to-face meetings by substituting live video communications, or "videoconferencing." This may reduce the need for people to travel to hold meetings, conferences, seminars, and conventions when the same activities can be accomplished from each party's individual office. However, people still value face-to-face meetings to measure or develop personal "chemistry" for business transactions and to network during larger gatherings. In addition, people report that they enjoy experiencing new places. Therefore, videoconferencing is expected to supplement but not replace business- and meeting-related travel; the potential negative impact on such travel is not expected to be significant.

- It is likely that an increasing percentage of the world's population will be free to travel to more destinations and will also have the financial ability to do so. This trend could benefit lodging facilities, particularly those located in tourist-oriented destinations.

## ¶ 5.02 TRENDS IN THE BUDGET AND ECONOMY SEGMENTS

Budget and economy hotels offer lodging without the extra amenities typically found in full-service hotels, such as restaurants and bars, and depending on their location, their price for a guestroom usually ranges from $30 to $65. The customer groups that use these products are normally business travelers, families, and value-oriented vacationers and seniors.

**Exhibit 5-1 Hotel Industry Segments**

*Source: Smith Travel Research*

| Segment | Range | Average Rate |
|---|---|---|
| Luxury | 85%–100% | $129 |
| Upscale | 70%–85% | 88 |
| Mid-Price | 40%–70% | 68 |
| Economy | 20%–40% | 52 |
| Budget | 0%–20% | 42 |

Exhibit 5-1 segments budget and economy lodging products on a market-by-market basis by average rate.

**Exhibit 5-2 Typical Economy and Budget Segment Hotel Brands**

*Source: Smith Travel Research*

| Economy Segment | Budget Segment |
|---|---|
| Amerihost Inn | Best Inns |
| Budgetel | Budget Host Inn |
| Days Inn | Econo Lodge |
| Fairfield Inn | Extended Stay America |
| Hojo Inn | Inn Town Suites |
| Homestead Village | Knights Inn |
| Howard Johnson | Microtel |
| Ramada Limited | Motel 6 |
| Red Roof Inns | Super 8 |
| Rodeway Inns | Red Carpet Inn |
| Shoney's Inns | Suburban Lodge |
| Signature Inn | Thriftlodge |
| Sleep Inn | Villager Lodge |
| Suisse Chalet | |
| Travelodge | |
| Vagabond Inn | |
| Wellesley Inn | |

**Exhibit 5-2(A) Budget Segment**

*Source: Bear, Sterns & Co. Inc., Smith Travel Research; Coopers & Lybrand L.L.P.*

| Brand | # of Hotels | # of Rooms | Brand | # of Hotels | # of Rooms |
|---|---|---|---|---|---|
| Super 8 | 1,580 | 96,873 | National 9 | 52 | 1,935 |
| Motel 6 | 746 | 83,183 | Thriftlodge | 37 | 1,884 |
| Econo Lodge | 735 | 47,849 | Good Nite Inn | 14 | 1,692 |
| Knights Inn | 229 | 19,552 | Select Inn | 14 | 1,364 |
| Howard Johnson Express Inn | 173 | 13,174 | Budget Inn | 16 | 1,264 |
| Sleep Inn | 154 | 11,426 | Admiral Benbow | 10 | 1,163 |
| Red Carpet Inn | 129 | 7,774 | Motel Orleans | 13 | 844 |
| Budget Host Inn | 186 | 7,500 | Friendship Inn | 18 | 685 |
| Scottish Inn | 140 | 7,010 | Ha' Penny | 6 | 631 |
| Microtel | 66 | 5,502 | Passport Inn | 13 | 607 |
| Travelers Inn | 35 | 4,256 | Cricket Inn | 4 | 598 |
| Masters Inn | 32 | 3,828 | Wynfield Inn | 3 | 578 |
| Excel Inn | 27 | 3,013 | Sixpence Inn | 6 | 577 |
| Cross Country Inn | 25 | 3,009 | Roadstar Inn | 7 | 576 |
| E-Z 8 | 27 | 2,728 | Hometown Inn | 5 | 332 |
| Economy Inns Of America | 22 | 2,474 | Great Western | 7 | 323 |
| Wilson | 15 | 2,405 | Thrifty Inn | 4 | 315 |
| Family Inns Of America | 26 | 2,291 | Travel Inn | 4 | 204 |
| Little America | 6 | 2,276 | | | |
| | | | **Segment Totals:** | **4,586** | **341,695** |

**Exhibit 5-2(B) Economy Segment**

*Source: Bear, Sterns & Co. Inc., Smith Travel Research; Coopers & Lybrand L.L.P.*

| Brand | # of Hotels | # of Rooms | Brand | # of Hotels | # of Rooms |
|---|---|---|---|---|---|
| Days Inn | 1,738 | 155,795 | Vagabond Inn | 49 | 3,419 |
| Travelodge | 443 | 35,089 | Best Inns Of America | 33 | 3,129 |
| Fairfield Inn | 345 | 33,231 | Innkeeper | 23 | 1,903 |
| Red Roof Inn | 259 | 29,725 | Country Hearth Inn | 30 | 1,755 |
| Ramada Limited | 218 | 16,065 | Jameson Inn | 37 | 1,659 |
| Budgetel | 153 | 15,930 | Mcintosh Motor Inn | 12 | 1,410 |
| Rodeway Inn | 210 | 13,331 | Nendels | 16 | 1,072 |
| Shoney's Inn | 87 | 8,836 | Key West Inn | 13 | 590 |
| Americinn | 90 | 4,177 | L-K Motel | 5 | 190 |
| Susse Chalet | 33 | 3,714 | | | |
| | | | **Segment Totals:** | **3,794** | **331,020** |

The average rates of budget hotels typically fall in the 20th percentile range and lower in a given marketplace, while the average rates of economy properties typically range from the 20th to 40th percentile.

Exhibit 5-2 outlines the hotel brands that are typically found in the economy and budget segments of the industry.

Presently, construction and supply-side increases are more prevalent in the limited service segments (economy, budget, and mid-scale without food and beverage) in select markets across the United States, as compared with other price tiers. This situation differs from the hotel construction boom of the 1980s where over-building of lodging properties occurred in a more or less simultaneous manner across most segments of the hotel industry. This current trend of overbuilding in select markets is expected to result in varied performance across the segments, and in individual markets across the country.

Because of the recent construction activity within the budget and economy segments of the lodging industry, supply in these segments is currently outpacing demand. This trend has changed somewhat from 1994 and 1995, when the opposite was true: at that time, demand for these lodging products outpaced supply. On a macro level, supply is currently outpacing demand in the budget and economy segments of the lodging industry. However, on a micro level, some regions of the country are more affected by the oversupply than others; there are regions where it is still appropriate to build new budget and economy facilities.

## [1] Regional Performance

As previously mentioned, performance in the budget and economy segments of the lodging industry varies by market and by region. Exhibit 5-3 illustrates recent historical occupancy and average rates for nine regions.

As shown in Exhibit 5-3, the New England markets of Connecticut, Maine, Massachusetts, New Hampshire, Vermont, and Rhode Island recorded both the strongest demand and resulting revenue increases in the nation for the year ended October 1997, while supply in this region is estimated to have decreased by approximately 0.04 percent for the same period. The Middle Atlantic region, which includes New Jersey, Pennsylvania, and New York, posted demand increases of 1.1 percent for the year ended October 1997, which exceeded the 1.01 percent increase in supply for the same period. These increases resulted in a 10.30 percent increase in revenue over the same period in 1996.

The areas that posted the greatest increases in supply include the Mountain, East North Central, and West North Central regions of the country. The Mountain region's 3.54 percent increase in supply was coupled with a 0.3 percent increase in demand. The East North Central and West North Central regions posted supply increases of 3.13 and 2.42 percent, respectively, with a zero and 0.1 percent respective increase in demand. While each of the nine census markets posted positive revenue increases for the year ended October 1997, the market that recorded the lowest revenue increase was the East South Central market, where a 1.07 percent increase in revenue was reported.

Overall, as compared to the previous years, the budget and economy segments achieved a 1.70 percent increase in supply for the year ended October 1997, but they experienced no demand growth. This trend of supply surpassing demand is expected to continue for the foreseeable future, until such time when the construction of new properties in the budget and economy segments is no longer feasible. This occurs when the per-room construction costs exceed the values per room of these products. Simply put, new construction occurs when the value of a new hotel is higher than the cost to build it. This positive feasibility draws capital into lodging development; as more and more hotels are built, occupancies fall and values begin to decline. Feasibility becomes negative when it costs more to build a new hotel than to purchase an existing property with the same utility. At that point, the supply of capital evaporates and new construction ceases.

**Exhibit 5-3 Performance of the U.S. Regional Budget and Economy Lodging Markets**

*Sources: HVS International and Smith Travel Research*

| | Occupancy | | Average Daily Rate | | Percent Change | | |
|---|---|---|---|---|---|---|---|
| Region | Year Ended Oct. 1997 | Year Ended Oct. 1996 | Year Ended Oct. 1997 | Year Ended Oct. 1996 | Demand | Supply | Revenue |
| New England | 61.6% | 59.4% | $54.68 | $50.88 | 3.7% | –0.04% | 11.49% |
| Middle Atlantic | 64.4 | 64.3 | 66.66 | 61.09 | 1.1 | 1.01 | 10.30 |
| Pacific | 64.1 | 64.0 | 50.66 | 46.84 | 0.6 | 0.32 | 8.80 |
| East North Central | 56.8 | 58.6 | 45.52 | 42.62 | –0.0 | 3.13 | 6.80 |
| West South Central | 57.8 | 59.1 | 39.50 | 37.41 | 0.1 | 2.42 | 5.67 |
| West North Central | 56.5 | 57.7 | 41.38 | 39.49 | –0.1 | 2.04 | 4.66 |
| South Atlantic | 60.5 | 61.9 | 43.56 | 41.28 | –1.1 | 1.20 | 4.33 |
| Mountain | 62.4 | 64.4 | 41.74 | 40.59 | 0.3 | 3.54 | 3.16 |
| East South Central | 56.2 | 58.1 | 38.79 | 37.56 | –2.1 | 1.17 | 1.07 |
| **U.S. Total** | 60.3% | 61.35% | $46.53 | $43.76 | –0.0% | 1.70% | 6.34% |

## [2] Hotel Valuation Index

A method of measuring these cyclical changes in hotel values has been developed. Through the use of a valuation model known as the hotel valuation index (HVI), hotel value trends in major markets and in various average rate categories can be monitored. Hotel values change over time as a result of differing capitalization rates and earnings expectations. The HVI was designed to illustrate these changes and to quantify the value attributable to movements in earnings and changes in the costs of debt and equity capital. The HVI also enables hotel investors to compare values among different market areas and product types. By considering historical development cycles and projecting values through the application of the HVI, investors can determine their entrance and exit strategies and take advantage of the inevitable fluctuations in market values.

The HVI is a sophisticated hotel valuation benchmark that covers 47 individual markets, the United States as a whole, and five industry price tiers. The index is calculated based on actual occupancy and average rate data supplied by Smith Travel Research, along with local P&L operating performance, projections of supply and demand, and capitalization rates derived by HVS International. The HVI, which was initiated by HVS International in 1986, reflects trends in market value over time, and assumes a willing buyer and a willing seller rather than a distressed, liquidation-type transaction. It gives the greatest weight to the income capitalization approach, and secondary support is provided by the sales comparison and cost approaches.

In 1997, HVS International began projecting the HVI four years into the future. These forecasts are based on our extensive knowledge of local markets and product types. As is the case with any forecast, actual performance may differ from projected performance as a result of events that were unforeseen at the time the projections were made.

Exhibit 5-4 shows per-room values for the budget and economy rate categories nationwide. Values from 1988 to 1996 are based on actual occupancies and room rates; projected figures were used to arrive at values for 1997 through the year 2000. The annual percent changes in each rate category has also been presented.

**Exhibit 5-4 Per-Room Values for Budget and Economy Rate Categories 1988–2000**

*Sources: HVS International and Smith Travel Service*

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Economy** | $31,003 | $33,213 | $29,572 | $26,245 | $27,784 | $28,085 | $29,498 | $35,367 | $36,121 | $36,411 | $37,726 | $37,485 | $36,241 |
| Percent Change | — | 7% | –11% | –11% | 6% | 1% | 5% | 20% | 2% | 1% | 4% | –1% | –3% |
| **Budget** | $26,944 | $26,952 | $25,400 | $21,818 | $22,679 | $24,998 | $27,498 | $33,003 | $34,797 | $37,168 | $33,984 | $33,472 | $31,496 |
| Percent Change | — | 0% | –6% | –14% | 4% | 10% | 10% | 20% | 5% | 7% | –9% | –2% | –6% |

In addition to this valuation data, graphs have been developed for the economy and budget rate categories comparing per-room values and replacement costs. These graphs show historical values and cost data from 1989 to 1996, along with projected data to the year 2000.

The market value and replacement cost graphs illustrate the points in time when feasibility was either positive or negative. In addition, these graphs identify when new hotel development is likely to commence and when it is likely to decline. As the market value line moves upward and passes through the replacement cost line, new hotel projects become feasible, lenders and investors gain interest, and development begins. Savvy hotel developers will anticipate this trend and start new construction before the two lines actually cross. On the downside, new development is curtailed when the market value line falls below the replacement cost line. Generally, new hotel development does not begin to slow down until the market value line crosses the replacement cost line. Exhibit 5-5 and 5-6 illustrate these feasibility and development timing concepts.

**Exhibit 5-5 Economy Hotels: Replacement Cost vs. Value per Room**

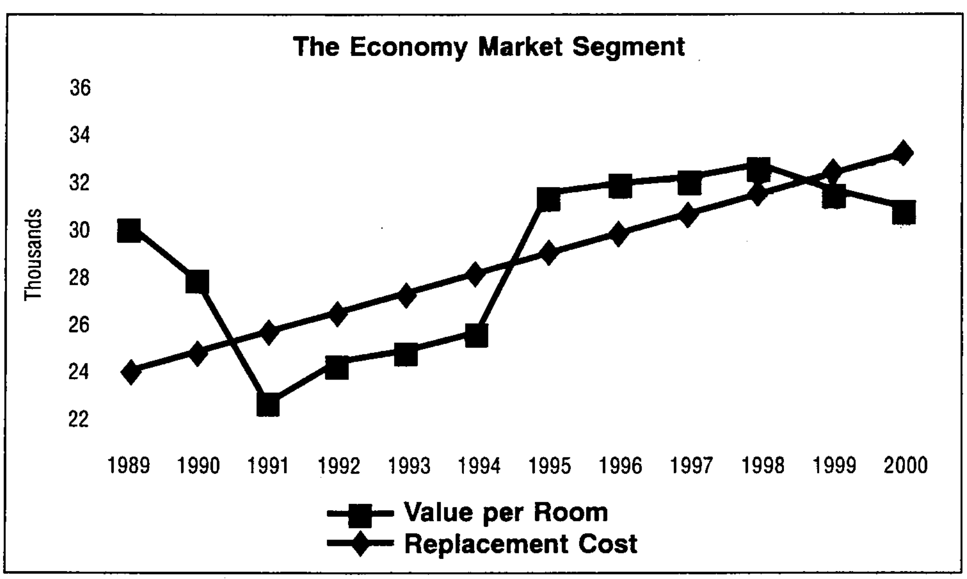
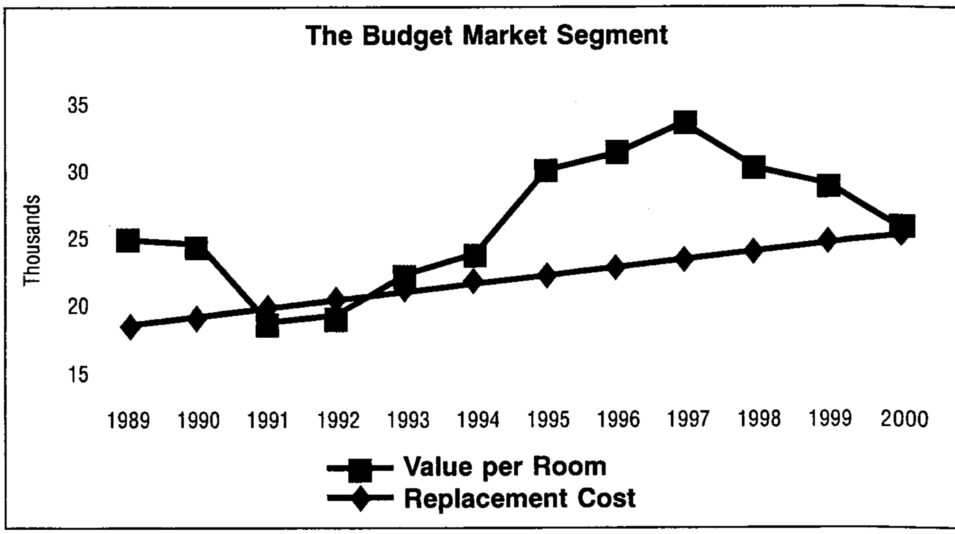


**Exhibit 5-6 Budget Hotels: Replacement Cost vs. Value per Room**




The economy segment experienced a significant drop in value between 1989 and 1991. During that period, the market value line crossed the replacement cost line, indicating that hotel investors could buy existing properties at a cost lower than what would be required to develop new ones. This buying opportunity continued until 1994, when the market value line rose rapidly and crossed the replacement cost line, signaling the start of new development. We project values to begin to decline in 1998, as this rate category becomes overbuilt, and we expect the replacement cost line to be crossed again in 1999. At that time, over-building in the economy category is expected to result in negative feasibility, and new development should slow down.

Per-room values in the budget segment declined from 1988 to 1991. The replacement cost line was crossed in 1991, which meant that investors could buy an existing budget hotel for less than the price to construct a new one. As a result, development slowed and investors began to focus on acquisitions. As a result of the low occupancies caused by the recession, prices were very attractive, and the RTC flooded the market with hundreds of foreclosed properties. As Exhibit 5-6 shows, those buyers who could foresee an upturn in the value of budget properties realized a significant amount of appreciation. As values for budget-oriented lodging facilities escalated during the early to mid-1990s (exceeding replacement costs in 1993), it again became feasible to develop these types of properties, and construction in the budget segment rose. Exhibit 5-6 shows that values are expected to peak in 1997 and will begin to decline as over-building erodes occupancy levels. By the year 2000, the market value line is expected to cross the replacement cost line indicating possible over-building, which should greatly reduce new development in this category.

## [3] Challenges Facing the Budget and Economy Segments

It appears that there are two additional challenges facing the budget and economy segments of the lodging industry. The first challenge is the introduction of budget and economy-oriented extended-stay products. According to F.W. Dodge (a firm that tracks new construction in markets throughout the country), as of the third quarter 1997, there were approximately 229 budget and economy extended-stay products that were in the "start" stage of development. This is the stage of development after planning and typically is at the point of, or close to ground breaking. These 229 projects amounted to an estimated 28,572 new rooms. Additionally, there were approximately 60 budget and economy extended-stay products in the planning stage. These new additions to supply in the extended-stay arena are expected to magnify the threat of oversupply and erode demand in the budget and economy transient segments.

The second challenge facing the budget and economy segments appears to be posed by the midprice segment of the lodging industry. According to Smith Travel Research, the mid-price segment is comprised of properties in a lodging market with average rates in the 40th to 70th percentile range. This segment typically includes hotel brands such as Courtyard by Marriott, Wyndham Garden Hotel, Doubletree Club, and Hilton Garden Inn. The challenge from this segment is that in 1996, they experienced a 2.9 percent increase in supply, which outpaced their 2.5 percent increase in demand for the same period. It is forecast that this trend will continue through 1999. Due to this supply increase in the mid-price segment, we believe that these properties may have to compete with the budget and economy segments for business by lowering their room rates.

Overall, construction of new hotels is occurring at a moderate pace in the budget and economy segments of the lodging industry, resulting in supply growth that is anticipated to surpass demand growth. It is anticipated, through the use of the Hotel Valuation Index, that as of 1999, it will no longer be feasible to build hotels in the economy segment of the lodging industry due to the per-room construction cost exceeding the per-room value. The same is anticipated to be true for the budget segment as of 2000. The majority of the new construction has occurred in the central and mountain regions of the country, while the Pacific, New England, and Middle Atlantic regions have experienced lower increases to supply. It is, however, important to remember that the lodging industry is a market-by-market business with individual markets often acting in contradiction with overall national industry trends. It is, therefore, imperative for investors to take note of these individual market trends through the use of available information, and to pay attention to the overall state of the economy and budget segments of the industry when forming their investment decisions.

## ¶ 5.03 MARKET POTENTIAL

Any market analysis is based on an evaluation of potential supply and demand. In a hotel market study, supply represents all of the competitive lodging facilities in the area, and demand represents the travelers visiting the area who will use these facilities. When there is a balance between supply and demand, area hotels and motels achieve a sufficient level of occupancy to generate a reasonable profit. The relation between supply and demand can sometimes become unbalanced, causing a low level of profit (e.g., oversupply or decline in demand) or a high level of profit (e.g., undersupply or increase in demand). Most markets experience cyclical changes in the relation between supply and demand, with levels of occupancy and profits rising and falling over extended periods of time.

In their search for hotel development or acquisition opportunities, investors should seek out the following:

1. *Market areas with an undersupply of lodging facilities relative to the amount of available demand.* This situation develops when demand increases rapidly because of such circumstances as the arrival of a major new business in the area (e.g., Disney moving into Orlando, Florida); significant growth of an existing business (e.g., Hughes Aircraft receiving a large government contract); or the improved attractiveness of a city as a destination (e.g., Atlantic City af-

ter the approval of casino gambling). An undersupply of lodging facilities can sometimes occur when existing hotels are withdrawn from the market. An example of this undersupply occurred in New York City during the 1980s, when a number of lodging facilities were torn down and replaced by office buildings.

2. *A cyclical market experiencing an upward trend in occupancy.* Care must be taken not to overestimate the length of the upward trend; such an error could lead the investor to enter the market just as occupancies are peaking before they decline. The best time to develop or acquire a lodging facility is when the cycle is nearing its lowest point. In these situations, prices tend to be depressed and a property can be acquired under the most favorable terms. For example, by the end of the 1980s depressed hotel markets in Houston, Tulsa, and Denver seemed to have hit the low point in their occupancy cycle; consequently, this period was a good time either to acquire an existing hotel or to start developing a new one in these markets. Although this strategy is theoretically sound, it takes both personal determination and strong financial staying power to actually follow such a course.

3. *Markets in which newly-constructed additions to lodging supply have been restricted or inhibited (i.e., where there are barriers to entry).* Barriers to entry tend to favor existing hotels, which benefit directly from a stable supply of competitive rooms. The most common barriers are zoning restrictions, which can sometimes actually bar new hotel development or make it so time-consuming and expensive that developers choose a different use of the property. Zoning can also reduce the feasibility of a hotel project by limiting the number of rooms or by requiring unnecessary facilities such as excessive parking. Other governmental regulations that can restrict development include building moratoriums brought about by a lack of sewage capacity or available water, adverse environmental impact (e.g., traffic congestion), and zero-growth policies. Lack of developable land on a site and proposals of a higher and better use of the land are also forms of barriers to entry. In New York City, the high cost of construction brought about by escalating land values and development costs makes it difficult to economically justify new hotel projects. Investors should be aware of market areas in which barriers to entry are likely to arise in the near future and should look into developing a new lodging facility or acquiring an existing one before the barrier takes effect.

4. *Markets that offer diversity of demand.* Over the long term, hotel markets that cater to a wide spectrum of lodging demand generally suffer fewer significant downturns than areas that are dependent on a small number of demand generators. Cities that depend on one type of industry run the risk that eventually the industry may decline or even go out of business. Markets in the midwest, for example, have suffered considerably when steel and automotive plants have closed. Houston and Tulsa were severely affected by the decline in domestic oil production. In addition to looking for locations with a number of different industries and businesses, hotel investors should also seek areas that attract a variety of market segments. An ideal hotel location caters heavily to all three of the major market segments: commercial, meeting and convention, and leisure. These segments tend to have complementary usage patterns. For example, when commercial demand is weak (weekends and summer months), leisure travel demand is strong, and vice versa. Meeting and convention demand tends to fill the gaps between the strong commercial travel and leisure travel periods. San Francisco, Boston, New York, and New Orleans are examples of cities that have been able to attract strong patronage from all three major market segments.

## ¶ 5.04 MARKET OVERVIEW STUDY

To identify a market area with the necessary long-term characteristics to support a lodging facility, the prospective investor should conduct a market overview study. Market overview studies are performed either directly by the hotel investor or by an independent hotel consulting and appraisal firm. A market overview study should include:

- *Discussion of the subject area's economic base and generators of transient visitation.* The long-term outlook for the area is the most important consideration in this discussion, although historical trends should also be examined. The study may determine what the economy of the market will be during the next five to ten years, what will attract transient visitation to the area over that time period, and what the expected economic growth trends for the area will be over the long term.
- *An investigation into the supply of lodging facilities and operating characteristics of hotels and motels in the subject area.* Ideally, the study will contain data regarding historic occupancy cycles during the past ten to twenty years, the typical length of such a cycle, and the high and low occupancy levels during a full cycle. In addition, the study should pinpoint where the area currently stands in the cycle, and whether the cycle is likely to change over the long term. If such extensive data is unavailable, typically a five-year analysis is provided. Finally, the study should discuss the short-term outlook for additions to supply and identify any potential barriers to entry in the market area.

The market overview study should be designed to provide a broad view that will enable the investor to identify market areas with the potential for long-term success. Once a market exhibiting such potential has been selected, a more in-depth, short-term study, known as an economic market study and appraisal, is usually performed. The case study elements at the end of Chapters 6 through 14 illustrate the various features of the economic market study and appraisal.

## ¶ 5.05 PRODUCT SELECTION

Once a market area exhibiting the required long-term characteristics has been identified, the hotel investor should make a preliminary selection of the type of lodging product best suited for that particular market. A preliminary selection is made at this point in the process to provide criteria for selecting potential sites. A final product selection is made later, using the information contained in the economic market study and appraisal.

Like market areas, hotel products tend to go through definite cycles. During the past forty years, there has been a recurring phenomenon in the lodging industry known as "amenity creep." Amenity creep has occurred in several major hotel chains; Holiday Inn provides a prime example. When Kemmons Wilson started this chain during the 1950s, his aim was inexpensive lodging for the traveling public. He provided clean, comfortable accommodations at a reasonable price. Over time, however, the chain has upgraded Wilson's initial concept by adding amenities such as meeting space, large restaurants and entertainment lounges, Holidomes, health clubs, and recreational facilities.

The addition of each new amenity or service required economic justification, such as improved occupancy or average room rate. The general trend became a slight upward adjustment in room rate whenever a new amenity was added. Over time, an economy-oriented lodging chain became a mid-rate chain with some individual facilities achieving first-class status. Other chains, such as TraveLodge, Ramada Inns, and Days Inns also began in the economy segment of the lodging industry, but through amenity creep have become established as mid-rate chains.

Franchise chains tend to encourage amenity creep for economic reasons. Because franchise fees are generally computed as a percentage of rooms revenue, when amenity creep drives room rates upward, franchisors benefit directly by collecting additional franchise fees. A swimming pool added by a hotel in order to match competitive facilities might increase the room rate by $5, and thus could be generating $80 per room per year in additional franchise fees.

Hotel investors can benefit by understanding the cycle of amenity creep and the opportunities it produces. Each hotel chain that succumbs to amenity creep creates a void in the market. For example, Days Inns' strategy of moving up from the economy segment into the mid-rate market has left fewer products available for the economy traveler. However, this void is currently being filled by the proliferation of new development in the economy sector, primarily because of lower barriers to entry.

## [1] New Hotel Products

Occasionally, a new product appears in the hotel industry that creates its own market niche and is able to capture market share and fend off competition. The following are some of the unique hotel products that have been introduced over the years.

*All-suite hotels.* The all-suite product is a hotel with oversized guestrooms containing both a bedroom and a living room area. The all-suite concept includes a limited number of meeting rooms, down-sized food and beverage outlets, and a free breakfast, plus a complimentary cocktail hour in the evening. All-suite hotels attract mostly commercial and leisure travelers. This concept has not created any new hotel demand, but rather has redistributed existing demand over more properties.

*Extended-stay hotels.* Extended-stay hotels are designed to attract the extended-stay (seven nights and more) market by offering large units with separate living and bedrooms, full kitchen facilities, and dining areas. Their layouts resemble those of garden apartments. This concept has created new hotel demand by attracting extended-stay travelers whose previous lodging options were chiefly limited to renting apartments.

*Micro-budget motels.* A micro-budget motel room is actually a down-sized motel unit that is usually no larger than 190 square feet in area. A micro-budget motel facility is designed to offer accommodations at prices 15 percent to 25 percent lower than the traditional economy-type motel. A micro-budget motel is able to offer this low price by eliminating such amenities as the restaurant, lounge, meeting rooms, lobby area, and swimming pool. This concept has created new hotel demand by providing price-conscious travelers with a lodging product that meets their particular needs. Micro-budget motels attract patronage from rooming houses, mom-and-pop motels, and campgrounds.

*Mega-resorts.* A mega-resort is an all-inclusive resort hotel offering a wide variety of activities, services, and amenities. Disney World is an example of a mega-resort on the largest scale. The Hilton Waikoloa Village on the island of Hawaii is a mega-resort without a theme park. This concept has created new leisure demand by attracting people who would not be satisfied with normal resort hotels.

## [2] Success Factors for Unique Hotel Products

As with any hotel product, the supply and demand characteristics of the local market are one of the primary keys to success. Other factors that are important to making a unique lodging product economically viable include:

- *Ability to create new hotel demand.* A unique hotel product that merely reallocates existing hotel demand among more hotel rooms is not as competitively viable as one that, like residence hotels, actually generates new hotel demand; and
- *Price/value relationship.* Hotel products that achieve the greatest success in the marketplace generally offer a good price/value relationship. This does not mean that only economy properties fit this criteria; for example, all-suite products offer a good price/value relationship to commercial travelers who may not require such amenities as meeting rooms, entertainment lounges, or room service. With a pricing structure that is similar to that of a full-service hotel, an all-suite product can provide the traveler a larger guestroom unit with the benefits of a separate living area and in-room kitchen facilities.

## ¶ 5.06 MATCHING THE PRODUCT TO THE MARKET

Before starting the search for sites for a proposed hotel, a preliminary product selection should be made to determine which product would be best suited for a particular market area.

The factors that should be considered in making this preliminary selection include the primary characteristics of the area's existing transient lodging demand:

- Price
- Facility requirements
- Seasonality
- Size, by market segment
- Future growth potential

In making the preliminary selection, the following primary characteristics of the area's existing lodging supply should also be considered:

- Number of competitive hotels
- Current levels of occupancy and average rates
- Orientations to particular market segments
- Analysis of facilities, amenities, and services
- Relative competitiveness, by market segment
- Probability of new additions to lodging supply

Finally, the type of lodging product that appears to be capturing the largest share of the market in the area and the reasons for this product's success must be taken into account. Examples of possible reasons include:

- Superior location
- Superior management
- Superior affiliation
- Superior product (facilities and amenities)
- Lack of competition

If the success factors cited can be duplicated, then two issues remain to be dealt with: (1) whether or not there is sufficient demand to justify another product of this type; and (2) the likelihood that other, similar products will enter the market over the short and the long term, given expected barriers to entry. If there are any market segments that are not being adequately served by area lodging facilities, the following considerations should be explored: the depths of these market segments, their expected growth, and the probability of competition for these segments.

On the basis of an analysis of the factors described, the following list provides, in descending order, the most desirable product traits and market conditions for preliminary product selection.

1. A product that does not currently exist in the local market but for which there is sufficient demand to justify its addition to the market. In addition, barriers to entry limit other new additions.
2. A product that exists in the local market, but that, because of a high level of demand and limited competition, outperforms all other products, and for which there is sufficient demand to justify the addition of more products of this type to the market. The product enjoys the protection of barriers to entry.
3. A product that exists in the local market and that experiences strong and growing demand. Competition within this product is also strong, but because barriers to entry discourage entirely new products, another product of the same type could be readily absorbed into the market.
4. An existing product for which there is strong demand in the local market. Competition within this product is present, but if the competition suffers from poor location, poor quality of facilities, poor management, or a weak franchise affiliation, a new lodging facility (or an existing hotel that has been repositioned) with positive attributes should be able to attract sufficient existing demand away from the underperforming competition.

The markets described in items 1, 2, and 3, while worth looking for, are rarely found. Most market areas exhibit characteristics similar to those described in item 4. While this type of market does not display all the optimum characteristics, it does represent favorable investment potential if a good site can be obtained along with strong management, competitive facilities, and a desirable franchise affiliation.

Markets with more than one negative characteristic, such as a combination of stable or declining demand, no barriers to entry of new competition, overbuilding over the foreseeable future, saturation by all existing products, and unfavorable long-term outlook should not be given further consideration unless there are mitigating circumstances.

## ¶ 5.07 HOTEL SITE SELECTION

Hotel site selection is the step of the hotel development or acquisition process that follows the identification of a favorable market area and the preliminary selection of a type of hotel product. Generally, the site selection takes place prior to performing an economic market study and appraisal, because this type of analysis is site-specific.

Chapter 7 describes in detail the various characteristics of a desirable hotel site; consequently, only the basic considerations necessary for initial selection are discussed here.

There are three basic locations that are considered suitable as sites of transient lodging facilities:

1. *Locations near transient demand generators.* Most travelers look for lodging facilities that are close to the demand generator that has brought them to the area.
2. *Locations near transportation.* Travelers generally prefer to be accommodated in facilities near the mode of transportation that they use.
3. *Locations near restaurants and entertainment.* Many travelers prefer lodging near the activity center of a market. These areas typically provide restaurants, lounges, shopping, theater, and other types of entertainment.

Hotel sites that are either near or within one or more of these three basic location types are the most desirable, particularly if other positive elements (e.g., easy access and good visibility) are also present. Hotel sites that do not enjoy these basic locational attributes may not be sufficiently competitive to warrant further consideration or the investment in an economic market study and appraisal.

Although this discussion concentrates on potential hotel construction sites, the locational criteria described in the foregoing list also apply to the selection process for existing lodging facilities.

The process of finding a potential market, identifying a suitable product, and locating either a desirable site or an existing facility constitutes the first major step in developing or acquiring a hotel or motel. In most instances, the effort involved in taking this step is made by the hotel investor with the assistance of an outside hotel consultant and appraiser.

The key considerations involved in selecting a consulting and appraisal firm are discussed in Chapter 6.

CHAPTER 6

# Site Analysis



## ¶ 6.01 PHYSICAL SUITABILITY

Analyzing the site of a proposed or existing facility is the first step in the fieldwork phase of a market study and appraisal. The purpose of a site analysis is to determine the suitability of the subject parcel for the development or continued use of a lodging facility.

The primary considerations in a site analysis are (1) the physical suitability of the property (i.e., size, shape, and topography); (2) access and visibility; (3) availability of utilities and essential services; (4) applicable zoning laws, permit requirements, and restrictions; and (5) the disposition of excess land. Each of these factors must be weighed before a conclusion is reached regarding the suitability of the site for a proposed development or the continued use of an existing facility. The case study at the end of this chapter examines all of these considerations in a real-world setting.

Factors such as the size, shape, and topography of a site must be considered in determining its overall desirability and usefulness for development purposes. The size of a parcel, for example, dictates to a certain extent the number of guest rooms and amount of public space that can ultimately be built.

Local zoning codes that set floor/area ratios (FARs), height limitations, and parking requirements are a key consideration in determining the suitable size for a facility. A FAR indicates the maximum total size of a building construction permitted on a particular site based on the total square feet in the parcel. For example, if the area of a parcel is 40,000 square feet and local zoning permits a FAR of 5:1, a building with 200,000 square feet of floor space can be built. This would typically provide for approximately 400 rooms for a commercially oriented property—300 if the hotel is to cater to groups and conventions.

Height limitations and parking space requirements also affect the how a site is used. For example, if a six-story restriction applied to the site previously described, some of the 200,000 square feet of floor space would probably have to be sacrificed.

Parking requirements can also restrict building size, if the configuration of the plot and the number of parking spaces required necessitate the use of a significant amount of area.

The topography and shape of a land parcel directly affect site preparation and development costs. Unusual site conditions that require additional expenditures for site clearing, removal of rock, grading, pilings, special foundations, bulkheads, retaining walls, and the like can significantly increase total development cost and reduce the economic feasibility of a project. In most instances, once the cost of the land acquisition and necessary site improvements exceeds 20 percent of the total project cost, the economic feasibility of the project diminishes considerably. Early in the development process, a soil and structural engineer should survey the site and perform the borings and testing necessary to determine whether any conditions are present that may require special attention prior to construction. Investigation into flood zones, water tables, percolation, drainage, air rights, subsurface rights, water rights, and easements is also advisable, so that any hidden problem can be exposed. To cite one example, hotels situated in flood zones often require special flood hazard insurance.

For an existing facility, similar site research should be made. A qualified engineer should be brought in to evaluate the integrity of the foundation support components and to review any other conditions that affect the site.

## ¶ 6.02 ACCESS AND VISIBILITY

Although the adequacy of a hotel's access and visibility is a largely subjective judgment, there are some basic requirements that every lodging facility should meet.

The kind of guests that a hotel generally attracts and the mode of transportation generally used by the guests are the primary determinants of whether access and visibility are important considerations. A highway-oriented hotel catering to commercial and/or leisure patronage passing through an area en route to a destination outside of the immediate local market requires a visible location with quick and easy access. A highly visible location is one that a driver can readily see while traveling at the posted speed limit and that allows for a sufficient amount of reaction time so that the driver can exit safely. The visibility of a site can be increased by the hotel's improvements and signage.

Quick and easy access means a route that leads directly to the property without requiring any complicated turns or direction changes. Access is greatly enhanced if the property is continuously visible while the driver is approaching it.

In other cases, however, access and visibility are not important factors—consider, for example, a convention-oriented destination resort hotel, where most of the guests travel by air, are prebooked, and have guaranteed their arrival with substantial deposits. Because patrons of such a facility often prefer seclusion, a great deal of visibility is generally not required. And while access must of course be available, it need not be quick or easy.

The location of the proposed property in relation to demand generators is as important a consideration as the access factor. A commercial traveler who must visit several firms within a given geographic area will usually seek a centralized location as a base of operation. Most travelers are willing to travel as long as twenty minutes between a demand generator and their lodging facility, but if other competitive hotels have a more central location than the property under consideration for development, it is clearly a less attractive choice.

## Exhibit 6-1 Access and Visibility

| | Rating[1] |
|---|---|
| **Market Segments** | |
| Commercial—in transit[2] | +2 |
| Commercial—destination[3] | 0 |
| Meeting—in-house[4] | –3 |
| Meeting—outside[5] | +1 |
| Leisure—in transit[2] | +3 |
| Leisure—destination[3] | –4 |
| **Primary Mode of Transportation** | |
| Automobile | +2 |
| Air | –2 |
| Train | –2 |
| Bus | –3 |

[1] Scale: –5 = not important; +5 = very important
[2] Passing through an area en route to primary destination
[3] Primary destination of the trip
[4] Most of the meetings held in the subject property
[5] Most of the meetings held at another hotel or convention facility

The rating system in Exhibit 6-1 illustrates the relative importance of access and visibility for several different segments of demand along with various modes of transportation. When the scale number for the appropriate market segment is added to the scale number for the primary mode of transportation, the result is the overall relative importance of access and visibility. For example, for a hotel that caters primarily to commercial destination travelers arriving by automobile, access and visibility has a somewhat important +2 (0 + 2 = 2) rating, while for a similar property catering to leisure destination travelers arriving by bus, the rating is a strongly unimportant: 7 (–4 + –3 = –7).

Other factors that work against drawing patronage, such as not having a chain affiliation or a reservation system, being situated in a highly competitive market, or being a new property with no local reputation, may be offset to a degree by ease of access and high visibility. Economy and luxury lodging facilities typically are less strongly affected by access and visibility than mid-rate and first-class hotels because they cater to their own specialized market segments, and their customers generally tolerate somewhat less convenient access in order to use their facilities.

The access and visibility of a property being considered for development should be further evaluated with respect to the same qualities offered by competitive hotels. For example, assume that a particular property lacks highway visibility and is not centrally located with respect to the primary business centers in the area. If the nearby competitive hotels offer better visibility or a more convenient location, the access and visibility of the property in question must be considered detrimental to its marketability. On the other hand, if the competing hotels have similar visibility and access difficulties, the locational characteristics of the proposed property relative to the others would not result in a competitive disadvantage. The long-term competitive environment must be considered, however, and with it the probability that new hotels with better access and visibility may well be developed.

In a market study and appraisal, the access and visibility of the proposed property should be thoroughly analyzed, and a determination should be made regarding how well the property compares with competing lodging facilities. Specific reference should be made to access and visibility for all normal modes of transportation as well as the local generators of transient visitation. The conclusions regarding the proposed site's access and visibility should then be reflected in the selection of competitive indexes for the room-night analysis. (See ¶ 11.03.)

## ¶ 6.03 UTILITIES AND OTHER SERVICES

The availability of utilities and other essential services is an important consideration for proposed lodging facilities, particularly those situated in remote locations. The utilities and services that should be investigated include:

- Electricity
- Water
- Sewer
- Telephone
- Natural gas
- Oil
- LPG or propane
- Steam
- Refuse removal
- Storm drainage

It is not always essential for oil or gas to be available because electricity can usually be substituted. However, the cost of an all-electric hotel is generally higher, and this additional expense could adversely affect bottom-line profits. During the fieldwork stage of a market study and appraisal, the appraiser should consult with local utility companies, municipalities, and providers of essential services to determine the availability of all necessary utilities and essential services. Care should be taken to determine not only whether a utility is available but also whether a connection to the utility is actually permitted. In some areas of the country, for example, municipalities have imposed sewer moratoriums that prohibit any new sewer connections until the capacity of the system is enlarged. These moratoriums may represent only brief interruptions or may extend the project development time for many years. The cost of bringing a utility to the site or waiting for a moratorium to be lifted can sometimes have a significant negative effect on total cost.

## ¶ 6.04 APPLICABLE REGULATIONS

In addition to the FAR requirements, height restrictions, and parking requirements discussed previously, there are other types of zoning regulations as well as permit and license requirements that control the development and operation of lodging facilities, food and beverage outlets, and other services provided by hotels and motels. Zoning codes govern the development of new hotels and the expansion of existing properties by regulating the permitted use of a site, setting limits on density, and requiring essential amenities such as parking. Although the ultimate responsibility for conforming to the local zoning requirements lies with the developer, the appraiser should be aware of the imposed limitations so that the property can be valued in accordance with the exisiting zoning codes, unless there is a reasonable expectation that the zoning will be modified or a that variance will be obtained. Some of the provisions that should be investigated include:

- Is a transient hotel a permitted use?
- Are a restaurant and cocktail lounge also permitted?
- How many hotel rooms can be developed?
- What constitutes a room?
- Is a unit considered to be one or two rooms?
- Are kitchens permitted?
- What are the parking requirements?
- Are there any restrictions involving:
  —Building height?
  —Building bulk (total square footage)?
  —Building setbacks?
  —Signage?
  —Curb cuts and access?
  —Architectural design?

While zoning codes control the use of real property, permits and licenses typically control business activities. One license that is essential for most full-facility hotel operations is a bar or liquor license. Liquor laws vary considerably from one jurisdiction to another, and the availability of a liquor license should not be taken for granted. Most hotels are at a competitive disadvantage without a liquor license. Other permits and licenses typically required for a hotel operation include:

- Health certificates;
- Occupancy permits;
- Sign permits;
- Food service licenses;
- Fire safety permits; and
- Business licenses.

Although zoning codes, permits, and licenses generally appear restrictive, they can often create value by limiting competition, improving the neighborhood environment, protecting the health and safety of the guests, and regulating operational quality. Appraisers should have an understanding of these regulations in order to assess their impact on future earnings potential and property value.

## ¶ 6.05 EXCESS LAND

Land surrounding a hotel is classified as excess if it is not utilized by the current hotel operation. When evaluating a hotel site, the appraiser should consider the potential existence of excess land not currently required for the development or operation of the subject property. Such excess land will often increase the value of a property when separated from the existing hotel component and either sold or developed.

Whether or not an apparently unused parcel is actually used is often a subjective decision. Vacant land often provides aesthetic qualities—such as increased visibility, reduced noise, and greater privacy—that are difficult to quantify but that generally improve the property's overall value. If the value enhancement of not using the excess land is less than the land's independent market value if sold separately, then the land can be considered excess and should be used in some manner. Favorable uses f excess land situated near a lodging facility include expanding the existing hotel, creating an amenity such as a health club or a retail activity, or developing a demand generator, such as office space.

As noted at the beginning of this chapter, site analysis is usually the first step taken by an appraiser when fieldwork for a market study and appraisal begins. The site is literally the foundation of a hotel project, so it is only when the strengths of a particular site are shown to offset its weaknesses that fieldwork should continue. If it becomes apparent that major site problems exist, further work on the study generally ceases while the overall viability of the project is reconsidered.

# CASE STUDY Site Analysis

## DESCRIPTION OF LAND

The land under consideration for the development of the subject hotel consists of a ±8.64-acre parcel located at the northwestern corner of the intersection formed by Central Avenue (State Route 59) and Exit 14 of the New York State Thruway (Interstate I-86/I-286). The municipal jurisdictions governing the property are the City of Spring Valley, the Town of Clarkstown, the County of Rockland, and the State of New York.

According to a survey prepared by Thomas E. Downs, Surveyor and Engineer, Inc., dated June 10, 1994, the subject parcel contains approximately 380,614 square feet (8.64 acres) of land. The site is an irregular rectangle, with 826.3 linear feet of frontage and access on Central Avenue to the east and 468.2 linear feet along the New York State Thruway to the south. The northern and western property lines face adjoining parcels and measure 866.4 feet and 462.3 feet, respectively. The topography of the parcel is generally flat, with a gentle slope downward from west to east. Assuming that the hotel will be set back approximately 150 feet from Central Avenue, the natural slope of the property would place the first floor of the building roughly eight feet above street level, thus producing an attractive, highly visible entryway.

The New York State Thruway is situated on an elevated embankment that rises approximately 15 feet above the southern border of the property. The subject property's land starts at the base of this steeply graded slope, so the view of passing traffic and much of the noise would be minimized for anyone using ground-level exterior facilities such as swimming pools and tennis courts. However, a building two or more stories in height would rise above the Thruway and would be fully visible to traffic in both directions.

The parcel is currently vacant of any improvements. A dense grove of trees and brush would have to be removed prior to construction. A five-foot-deep ditch running parallel and adjacent to Central Avenue on the property's eastern border must be replaced with a metal conduit and filled so that the entrance roadway will be on-grade. Surface observations show no rock outcroppings, streams, ponds, or springs. A preliminary test-boring report by Subsurface Survey, Inc., dated May 10, 1995, indicates no unusual rock formations or other adverse site conditions, and suggests that a mid-rise structure would pose no major engineering problems. According to Federal Emergency Management Agency (FEMA) panel No. 050396 0069C, effective September 5, 1993, the subject site is located in flood zone C, which is defined as "areas of moderate or minimal hazard from the principal source of flood in the area." Flood insurance on the subject site is not required by federal regulations.

The size and topography of the subject parcel appear well-suited for hotel development. Sufficient acreage is available to permit either a low-rise or mid-rise facility of as nany as approximately 400 units, providing on-grade parking and necessary facilities and amenities. If a 300- to 400-room hotel were developed, the site would be fully utilized, and none of the land would be considered excess.

## ACCESS AND VISIBILITY

The subject property is readily accessible to a mixture of local, county, state, and interstate highways. The New York State Thruway, the Garden State Parkway, the Palisades Parkway, and Routes 9W and 16 all pass within several miles of the subject property and serve as major commutation and intra-regional transport routes linking New England with the Mid-Atlantic states. Routes 45, 59, 202, 303 and 304 are used mainly as local commuting arteries within the county. The following description of the county's major highways demonstrates that the area is well-served by a variety of vehicular routes.

At the point at which I-86/I-286 passes adjacent to the subject property, it is part of the New York State Thruway system, a limited-access toll route originating in New York City, extending north to Albany, continuing west through Utica, Syracuse, and Rochester, and terminating in Buffalo. At Albany, I-86 departs from the Thruway system and continues northward to the U.S.-Canadian border, where it becomes Quebec Highway 15 leading to Montreal. Several miles east of the subject property, I-286 crosses the Hudson River at the Tappan Zee Bridge and also leaves the Thruway system to become the Cross Westchester Expressway, which ties in directly with the New England Turnpike (I-95) in Rye, New York. Continuing south from the Tappan Zee Bridge, I-86 becomes the Major Deegan Expressway when it enters New York City.

Virtually all highway traffic between New York City and western, central, and northern New York State and northwestern New England funnels through the New York State Thruway as it crosses the Tappan Zee Bridge. The subject site should, therefore, derive a sizable degree of recognition from its exposure to the thousands of passing motorists. More important, however, the high-speed access provided by the Thruway to the many communities and business centers in northern New Jersey and southern New York should make the proposed subject hotel a convenient gathering point for meetings, conventions, banquets, and transient visitors.

The Garden State Parkway is a north/south, limited-access toll route that extends from Cape May at the southern tip of New Jersey to its northern terminus, the New York State Thruway, approximately one half of a mile west of the subject property. The Parkway is restricted to noncommercial automobiles, and is one of the preferred passenger vehicular routes through New Jersey. As with the Thruway, the Garden State Parkway significantly increases the size of the subject property's market area by facilitating high-speed access from many nearby business centers and communities.

The Palisades Interstate Parkway is another major north/south noncommercial highway, extending from Bear Mountain Bridge in Upper Rockland County to its southern terminus at the George Washington Bridge, which connects New Jersey with Manhattan. The Palisades Parkway intersects the New York State Thruway and State Route 59 approximately 2.5 miles east of the subject property.

U.S. Route 9W, also a north/south highway, generally parallels the Hudson River in the easterly portion of Rockland County. It originates in Albany, extends southward to intersect the Palisades Parkway, the New York State Thruway, and State Route 59 (approximately five miles east of the subject property), and terminates at the George Washington Bridge.

State Route 16 originates in Kearny, New Jersey, near the Lincoln Tunnel (which provides access to Manhattan) and extends northwestward through the western end of Rockland County, paralleling the New York State Thruway. At Harriman, Route 16 heads westward along the southern tier of New York State, where it terminates at the Pennsylvania border near Erie, Pennsylvania.

In conclusion, area access to the subject property is excellent. The well-developed network of high-speed highways and parkways, along with superior local roadways, significantly increases the subject property's primary market area and facilitates the capture of both transient travelers for room business and local residents for food and beverage sales.

Direct access to the site is from Central Avenue (State Route 59), which forms the eastern boundary of the subject parcel. As it passes the property, Central Avenue is a four-lane, two-directional, undivided highway. The area speed limit is 40 miles per hour, and the unobstructed one-half-mile view in both directions would easily allow left- and right-hand turns entering and exiting the subject property.

Visibility from Central Avenue is good to excellent in both directions. At the southeastern corner of the subject property, Central Avenue passes under the elevated New York State Thruway. The underpass is approximately 100 feet long (in order to accommodate the six-lane Thruway above) so northbound Central Avenue drivers would not see the subject property until they emerge from the northern end of the underpass. However, the subject parcel has more than 800 feet of frontage along Central Avenue, which means that northbound motorists would have sufficient time to negotiate a left-hand turn after leaving the underpass and sighting the subject property.

Southbound Central Avenue drivers descend a long hill that begins approximately three quarters of a mile north of the subject property. From the southbound direction, the site is fully visible over the entire downhill grade, which means that a mid-rise building on the site would be quite prominent. The commercial-type improvements along Central Avenue are one and two stories in height and so would not impair the subject property's visibility.

The New York State Thruway is a six-lane, divided superhighway that is elevated approximately 15 feet as it passes along the subject's southern property line. While the unimproved site itself has minimal visibility to westbound Thruway traffic and no visibility to vehicles heading toward the east, any improvements two or more stories in height would be readily visible from both directions. It is estimated that a three- to five-story mid-rise hotel would be recognizable to Thruway motorists from one mile in either direction.

Central Avenue (State Route 59) forms Exit 14 of the New York State Thruway. Along this portion of the Thruway, tolls are collected at a central toll plaza approximately two miles to the east of Exit 14, rather than at the exit. As a result, traffic is unimpaired and flows freely between the Thruway and Central Avenue.

A sign for Exit 14 can be seen by motorists heading west on the Thruway two miles before the turnoff point. This sign indicates that the exit is for Spring Valley and Nanuet, with the crossroad being Central Avenue (State Route 59). A similar sign one mile from the turnoff relates the same information. At this point, a mid-rise structure on the subject property would be fully visible. A third sign provides a one-quarter-mile warning and advises exiting traffic to bear left.

Upon exiting the Thruway, westbound drivers slow to a posted 25-mile-per-hour speed limit and proceed down a semicircular ramp that drops approximately 15 feet to the grade of Central Avenue. Because the intersection of the westbound Thruway exit ramp and Central Avenue is situated directly across from the subject parcel, the entire site is highly visible to all traffic using this ramp. The exit road intersects the eastern side of Central Avenue perpendicularly at a traffic signal, allowing drivers about to head southbound on Central Avenue to make a left turn, and northbound traffic to yield and turn right. This signal provides an additional benefit to the subject property by slowing traffic on Central Avenue, which would facilitate access to and from the site.

Eastbound motorists on the Thruway meet a similar set of directional signs at the same two-mile, one-mile, and quarter-mile intervals, which indicate that Exit 14 is used for Spring Valley and Nanuet via Central Avenue (State Route 59). A mid-rise structure situated on the subject parcel would become visible approximately three quarters of a mile prior to this exit, providing ample time for motorists to react and safely exit to the right.

The eastbound exit ramp is also situated on the eastern side of Central Avenue. Exiting traffic passes over Central Avenue and loops around to the right, descending approximately fourteen feet in order to reach grade level. Because the subject property is completely obscured by the elevated Thruway during this exiting maneuver, it would be advisable to have some type of signage to guide drivers. A traffic light at the perpendicular intersection of the Thruway exit road and Central Avenue allows safe left and right turns. To reach the subject property, a motorist would turn right at this light, proceeding under the Thruway overpass and left into the subject property's entryway.

Reaching the subject property by way of Central Avenue (State Route 59) and/or the New York State Thruway is a simple procedure. A mid-rise hotel structure would be fully visible to all approaching motorists, and the extensive highway signage, convenient exit ramps, and traffic lights would further facilitate access to the subject property. This location, from the viewpoint of highway access and visibility, would make a highly desirable transient lodging site.

After highway transportation, the second primary mode of transportation into the area is air travel to Stewart Airport, situated sixteen miles north, in Newburgh, New York. The subject property is not considered well-located with respect to this facility, and would probably not receive much in the way of direct airport-related visitation, such as airline crews or delayed passengers. However, the airport does bring transient visitors into the area who rent automobiles and drive to demand generators near the subject property.

Access to demand generators of visitation is excellent. Numerous commercial businesses are located nearby as well as a convention center and some tourist attractions. Exhibit 6-2 shows some of the generators of transient visitation in the area, along with the distance in miles from the subject property.

**Exhibit 6-2**
**Transient Visitation Generators**

| Transient Visitation Generators | Distance from subject property (miles) | Driving time (minutes) |
|---|---|---|
| Lederle Laboratories | 2.0 | 6 |
| Avon Products | 2.0 | 6 |
| Chromalloy Corp. | 0.5 | 3 |
| BSR | 0.5 | 3 |
| Ciba-Geigy | 2.0 | 6 |
| Materials Research | 0.5 | 3 |
| Chrysler Motors | 12.0 | 15 |
| Volkswagen | 12.0 | 15 |
| Rockland County Convention Center | 8.0 | 10 |
| U.S. Military Academy—West Point | 15.0 | 25 |
| Sunnyside Tourist Attraction | 8.0 | 15 |

As Exhibit 6-2 indicates, the subject property is centrally located in relation to many of the area's businesses. With the excellent highway system throughout the immediate market area and the proximity of the subject property to the New York State Thruway, access to most of the nearby generators of visitation is equal to, if not better than, that of competitive lodging facilities.

## UTILITIES AND OTHER SERVICES

The subject property is currently served by water, electricity, and telephone utilities. A sewer line is available approximately 100 yards north on Central Avenue but it would, of course, need to be extended to reach the subject property. Likewise, a natural gas line runs within a half-mile of the site to the west, but because of a moratorium on new gas connections and the expense of acquiring easements over adjoining property, it is unlikely that the subject property would use natural gas service. Heating oil, however, could be easily delivered to the property by one of several distributors. Garbage and trash removal could be arranged through a local carting company. (On-site incinerators are not allowed.) Exhibit 6-3 shows the local utility companies that serve the subject property. The unavailability of natural gas decreases the flexibility of alternating between gas and oil on the basis of availability and price, and forces a greater dependence on electricity, which tends to be more expensive and less desirable, for cooking and laundry operations.

**Exhibit 6-3**
**Local Utility Companies**

| Utility | Company Providing Service |
|---|---|
| Water | Spring Valley Water Corp. |
| Electricity | Rockland Power and Light |
| Telephone | New York Telephone |
| Sewer | Town of Clarkston |
| Oil | Various private suppliers |
| Refuse removal | Various private carriers |
| Storm drainage | Town of Clarkston |

## APPLICABLE REGULATIONS

According to the Town of Clarkstown Zoning Regulations and Map, dated July 1992, the subject property is currently zoned as RS (regional shopping district). This class of zoning predominates in the immediate area and extends for several miles along Central Avenue on both sides of the subject property. Motels, hotels, boarding houses, and tourist homes are permitted only by special permit from the Board of Appeals.

Discussions with the Town of Clarkstown Building Department indicate that the RS zoning and the size of the subject parcel would permit the construction of a hotel with approximately 400 units, along with associated facilities and amenities. The maximum allowable building height is ten stories, so a mid-rise structure would be permitted. One parking space per guestroom is required, plus an additional space for each twenty square feet of restaurant, lounge, and banquet space.

It is assumed that all necessary special permits and approvals would be secured and the facility constructed in accordance with the local zoning ordinances, building codes, and all other applicable regulations. Verification of this zoning analysis should be made by the developer before further work on this project takes place.

Discussions with local hotel operators and the New York State Liquor Authority indicate that liquor licenses are readily available for full-service hotels. It is assumed that an appropriate liquor license would be issued prior to the opening of the subject property.

## SITE SUITABILITY

The subject parcel of land is well suited for its proposed use as a site for a transient lodging facility. Its size, topography, access, and visibility as well as the availability of utilities have been examined and evaluated, and the parcel has been determined to have the following advantages and disadvantages:

*Advantages:*

- Site is large and has good frontage on two major highways.
- Topography is smooth and has no apparent subsoil conditions that would impair construction.
- Highly developed area roadway system of interstate highways and parkways passes either adjacent to or close to the subject property.
- Site has excellent and direct access and visibility from State Route 59 and the New York State Thruway and local generators of transient visitation.
- Necessary utilities are easily available.

*Disadvantages:*

- The elevated Thruway requires development of mid-rise (three- to five-story) improvements to achieve necessary visibility. A less expensive low-rise structure would not be suitable.
- Visibility of the site from the eastbound Thruway exit ramp is restricted by the elevated roadway. Some type of signage would probably be necessary in order to reorient exiting motorists as they approach Central Avenue.
- A sewer line would have to be extended in order to reach the subject property.
- Natural gas is presently unavailable.

Nearly all the disadvantages are curable, and the advantages represent highly desirable locational attributes; accordingly, the general conclusion is that the subject parcel is well suited for hotel development.

CHAPTER 7

# Neighborhood and Market Area Analysis

## ¶ 7.01 INTRODUCTION

A neighborhood and market area analysis, which assesses the economic climate in which the proposed lodging facility would operate, is an essential step in a market study and appraisal. The neighborhood portion of the analysis involves the evaluation of current and projected land uses and the identification of economic and demographic trends within the immediate area of the proposed property. The market area portion incorporates a broader range of economic and demographic data; it involves a much larger geographic area and identifies probable future changes. Historical and projected data pertaining to both the economy and the population of the area are employed, first to evaluate current conditions and identify probable future changes, and then to forecast future growth or decline in transient visitation to the area by market segment and thereby predict future demand for transient lodging.

An actual example of a neighborhood and market area analysis is provided by the case study located at the end of this chapter.

## ¶ 7.02 NEIGHBORHOOD ANALYSIS

A neighborhood can be defined as a grouping of complementary land uses that are similarly influenced by any forces that affect property value. Neighborhoods usually have an observable uniformity and exhibit a greater degree of commonality than the larger market area in which they are found.

Neighborhood boundaries are generally delineated by changes in land use, types of building occupants, or street patterns; natural boundaries, such as bodies of water or abrupt changes in topography; and man-made improvements, such as highways, railroad tracks, or power lines. The neighborhood of a lodging facility does not usually extend more than five driving minutes from the facility and typically includes areas of commercial zoning occupied by office buildings and retail businesses.

### [1] Observation

The basis of a neighborhood analysis is a survey of the salient characteristics of the neighborhood in which the proposed property is located. To perform this survey, the appraiser, using a local street map, usually drives around the immediate area and determines the apparent boundaries of the neighborhood by noting changes in land use around the subject property on the map. The finished map might be accompanied by the following information:

- A list of different land uses in the neighborhood, categorized in broad terms (e.g., retail, office, industrial, rural, suburban, or urban).
- An inventory of specific land uses within one-quarter to one-half of a mile (depending on density) of the subject property (e.g., strip shopping center) with the following tenants:
  —Single-use office building
  —Free-standing mid-price chain restaurant
  —Driving range (among others)
- Characteristics of properties situated near the subject property, including:
  —Age
  —Condition
  —Style
  —Class
  —Image
- A review of neighborhood development, including:
  —Density of existing development in the area
  —Description of any development in progress
  —Identification of vacant land that could be developed
- An evaluation of the competitive environment, including the identification of other lodging facilities and food, beverage, and entertainment establishments.

## [2] Economic Trends

After identifying and analyzing the salient characteristics of the subject property's neighborhood, the appraiser should obtain information on local economic trends from the municipality's planning and building departments, zoning officials, economic development agencies, real esıate counselors, and Chamber of Commerce. In most instances, these sources provide information for a large area rather than for a specific locale, but important data can usually be obtained, including the following:

- The history of the neighborhood's development and growth.
- Sites of likely future development.
- Current vacancy rates for different types of properties along with historical and projected data for vacancies.
- Types of new businesses moving into the area and other types of demand generators likely to be developed in the neighborhood.
- A master plan for the neighborhood, including any recent zoning changes; if there have been changes, a description of trends in use and density.

The statistical data and other information obtained from local sources, in conjunction with personal observations regarding the characteristics and composition of the neighborhood, should allow the appraiser to provide answers to the following essential questions.

- What is the present character of the neighborhood, and how might it change in the future? (Local land uses should be identified and the condition, style, and class of neighborhood buildings should be described.)
- How will the characteristics of the neighborhood affect the local demand for transient accommodations and the operation of a lodging facility?
- What is the current economic base of the neighborhood and how will it change in the future? (The existing types of business concerns and other demand-generating growth trends and new development potential should be discussed.)
- How will the local economy affect the quality and desirability of the neighborhood, the demand for transient accommodations, and the operation of a lodging facility?

The answers to these questions will help in the decision whether or not the local area is suited over the long term to the proposed subject property. The most important neighborhood characteristics in terms of support for a transient lodging facility are:

- Land uses that generate transient visitation
- Land uses that provide recreation and entertainment
- Land uses that provide attractive surroundings
- Newly-developed areas, or those showing rapidly improving trends
- Safe, low-crime areas
- Class and style similar to that of the subject property

If the neighborhood of the subject property has one or more of these characteristics, and it can be shown that a positive economic climate exists and will continue to exist, conducting the market area analysis is generally warranted.

## ¶ 7.03 MARKET AREA ANALYSIS

A market area includes the immediate neighborhood surrounding a lodging facility as well as the larger geographic territory within most of the lodging demand for which a hotel will compete is found. The market area defines the boundaries of lodging demand and includes most of the lodging facilities that would compete with the subject property.

### [1] Boundary Definition

The first task in the market area analysis is to define the boundaries of the market area in geographic terms. The perimeter of a market area is set by the farthest generators of transient visitation whose visitors would be likely to utilize the subject property. Most of the subject property's competition is also located within the market area.

Overnight travelers generally seek lodging accommodations that are convenient with respect to the demand generator that they are visiting. In most instances, transient visitors will travel up to twenty minutes from a generator of visitation, or demand generator, to their lodging accommodations. Therefore, the market area perimeter surrounding the subject property generally has a radius of approximately twenty travel minutes. In most instances, where the primary mode of transportation is the automobile, twenty travel minutes is the same as twenty driving minutes. Depending on the highway patterns, the market area perimeter may take on a variety of shapes showing the various distances that can be traveled over a twenty-minute period. It will, for example, be elongated along the path of an interstate highway, and shortened where travel is restricted to local streets.

The twenty-travel-minute rule of thumb generally applies in suburban areas. In rural regions, the travel time radius is often significantly increased, while a central business district might have a more compact market area. The appraiser can verify the local market area radius by conducting interviews with overnight travelers.

## [2] Economic and Demographic Data

Once the boundaries of the market area have been defined, the appraiser should start to collect economic and demographic data in order to identify and analyze future trends in transient lodging demand. (See Appendix 1 for a checklist of the type used by appraisers when they collect this sort of information.) The importance of information about future trends cannot be overemphasized. Because of a constantly changing economic environment, historical results may not accurately portray future trends. For an appraiser, reliable projections of demographic and economic data are the most useful sort of information on which to base predictions of future market demand. Unfortunately, this kind of information is scarce; appraisers usually develop their demand projections using, for the most part, historical economic data.

Some of the data that an appraiser collects may not, at first, appear to have much bearing on the condition of the lodging market, but categories such as the age distribution of the population, characteristics of the area work force, and the types of businesses and industries in the area constitute economic elements that, taken together, assist in determining the strength of lodging demand and the likelihood of success for a new facility in the lodging market.

### [a] Population Age Distribution

While there is no direct correlation between the composition of a local population and the level of transient visitation in a market area, historical data and future expectations regarding changes in population often reflect the economic climate of a locale; from this consideration an experienced appraiser can draw general conclusions regarding the vitality of the lodging market in the area.

The age distribution of the population in a market area provides an indication of the probable spending patterns in locally generated food, beverage, and banquet patronage. A growing population under the age of 24 should produce greater banquet business in the form of weddings, proms, bar mitzvahs, award dinners, and the like. Growth in the 25- to 34-year-old age group is likely to create increased lounge and entertainment patronage. The 35- to 49-year-old age group generally has the largest disposable income and represents potentially the most significant restaurant-related food and beverage business.

### [b] Retail Sales

Trends in retail sales reflect overall changes in population and changes in the ability and desire of area inhabitants and visitors to spend money for retail goods. As with population trends, retail sales have no direct correlation with hotel room-night demand; rather, they gauge the economic health and vitality of a market area.

Another statistic often cited in conjunction with retail sales figures is effective buying income (EBI), the amount of an individual's gross income that is available after taxes to purchase goods and services. Trends in EBI reflect the ability of area residents to spend money on the goods and services offered by lodging facilities.

### [c] Work Force Characteristics

The characteristics of an area's work force provide an indication of the type and amount of transient visitation likely to be generated by local businesses. Sectors such as finance, insurance, and real estate (FIRE), wholesale trade, and service generally produce a high level of visitation, which is typically not rate sensitive. The governmental sector often generates transient room-nights, but the low per-diem reimbursement allowance typically given government employees limits the accommodations they select to budget and mid-priced lodging facilities. The manufacturing and construction sectors, as well as the transportation, communications, and public utilities (TCPU) sectors are least likely to generate significant numbers of transient visitors.

### [d] Major Businesses and Industries

The types and sizes of major businesses and industries within a market area provide an indication of the potential for commercial transient visitation. For example, nationally oriented firms attract more visitors than local companies serving nearby areas. Labor-intensive and financial activities are also more likely to create overnight visitation than are highly mechanized firms employing few people.

### [e] Office Space

Trends in occupied office space often directly reflect transient lodging demand within a market area because businesses that occupy office space are generally the strongest generators of commercial visitation. While it is difficult to directly quantify commercial transient demand on the basis of the amount of occupied office space in a particular area, any increase or decrease in the amount of occupied space generally has a proportional impact on commercial lodging demand and a less direct effect on transient meeting demand.

### [f] Highway Traffic

The quantity of highway traffic that passes through a market area sometimes relates directly to the level of transient commercial and leisure demand. It also has an indirect effect on meeting demand because of later recognition of the facility as a possible site when a decision is made regarding where a meeting will be held.

### [g] Airport Statistics

Airport passenger counts are important indicators of transient lodging demand. Depending on the type and location of a particular airfield, a sizable percentage of arriving passengers may have need for hotel and motel accommodations. Trends in passenger counts also reflect local business activity and the overall economic health of an area.

## [3] Data Collection

Most published economic and demographic data are subdivided by county, Metropolitan Statistical Area (MSA), or Consolidated Metropolitan Statistical Area (CMSA). If the market area is contained within one county, MSA, or CMSA, only this data is generally used. If the market area overlaps two or more counties, it may be necessary to consider a broader range of data that would include each county.

Much of the economic and demographic data can be obtained from governmental agencies, chambers of commerce, and various specialized publications. Exhibit 7-1 lists several valuable publications that provide economic and demographic data and the types of information that each publication offers.

**Exhibit 7-1 Published Sources of Economic and Demographic Data**

| BL Sources | Data |
|---|---|
| **Sales and Marketing Management** | Population levels<br>Age Distribution<br>Retail Sales<br>Eating and drinking place sites<br>Effective buying income (EBI) |
| **Woods & Poole, Inc.** | Population levels (general and by age group)<br>Income levels (by source, e.g. wages, dividends)<br>Household (number of households, persons/ household, mean income)<br>Employment (by sector: agriculture, mining, construction, etc.) |
| **Federal Aviation Administration** | Air carrier emplanements<br>Operations projections |
| **Restaurant Business** | Restaurant activity index (RAI)<br>Restaurant growth index (RGI) |

Exhibit 7-2 lists information and data commonly used in a hotel economic market study and appraisal that may not be available from published sources. Most of this information can be gathered during the fieldwork phase of a market study and appraisal through discussions and interviews with local officials and other knowledgeable people.

## [4] Data Analysis

After the appraiser collects the necessary data, the data should be put into tabular form for analysis. The primary purpose of the analysis is to develop a basis for forecasting future trends or changes in lodging demand. To do so, the appraiser should focus not only on the direction of change in a given category (i.e., growing, stable, or declining) but also on the probable rate of change. To accomplish these objectives, the data collected should reflect a span of at least two years and should be uniform in quality over the period of time during which it was collected. For example, in the case of traffic counts as set forth in Exhibit 7-3, the counter used to collect data should be placed in the same location during the same periods each year it is used.

**Exhibit 7-2 Other Sources of Economic and Demographic Data**

| Types of Data | Sources |
|---|---|
| Office space absorption | Real estate brokers<br>Chamber of Commerce |
| Office vacancies | Real estate brokers<br>Chamber of Commerce |
| Office space under development | Real estate brokers<br>Chamber of Commerce Building department |
| Inventory of: | |
| Office space | Real estate brokers<br>Chamber of Commerce |
| Retail space | Real estate brokers<br>Chamber of Commerce |
| Industrial space | Real estate brokers<br>Chamber of Commerce |
| Highway traffic counts | Highway department |
| Origination and destination studies | Highway department |
| Major businesses by employment sector | Chamber of commerce |
| Number of employees | Economic Development Authority<br>Department of Labor |
| Unemployment percentages | Department of Labor |
| Building permits | Building Department |
| Housing starts | Building Department |
| Hotel rooms tax | Tax Collector |
| Visitor counts to area attractions | Visitors' and Convention Bureau |
| New businesses entering area | Chamber of Commerce<br>Economic Development Authority |
| Businesses leaving area | Chamber of Commerce<br>Economic Development Authority |
| Convention center usage | Visitors' and Convention Bureau |
| Number of groups | |
| Number of attendees | |
| Types of events | |
| Expenditure per attendee | |
| Average length of stay | |
| Headquarters hotels | |
| Advertising budget | |
| Assessed values of real estate | Assessor |
| Air cargo data | Federal Aviation Authority<br>Airport Authority |
| Tourist visitation | Tourism Authority<br>Visitors' and Convention Bureau |

**Exhibit 7-3 State Thruway Traffic Counts**

| Year | Count | Percent Change From Previous Year |
|---|---|---|
| 1991 | 12,566,764 | — |
| 1992 | 12,943,767 | 3.0% |
| 1993 | 12,614,836 | (2.5) |
| 1994 | 13,522,145 | 7.2 |
| 1995 | 14,377,202 | 6.3 |

Direction and rate of change are determined by dividing the data for the more recent year by that of an earlier year. For example, using the data in Exhibit 7-3, the change in highway traffic between 1991 and 1992 is calculated as follows:

$$1992 \div 1991 = 12{,}943{,}767 \div 12{,}566{,}764 = 1.03 - 1.00 = +3\%$$

The change between 1992 and 1993 was

$$1993 \div 1992 = 12{,}614{,}736 \div 12{,}943{,}767 = 0.975 - 1.00 = -2.5\%$$

Between 1991 and 1992, the direction of change was positive, which suggests growth; between 1992 and 1993, however, the direction of change was negative, which indicates a decline.

Calculating change over a period of years is somewhat more complicated because the appraiser must determine annual compounded percent change. The basic components of market studies and appraisals, such as projected demand, should be shown as annual compounded percent change.

For example, using again the data in Exhibit 7-3, the annual compounded percent change in traffic counts between 1991 and 1995 is determined by the following formula:

$$-1 + (A \div B)^{(1/(N-1))} = C$$

where: A = Data for last year
B = Data for first year
N = Number of years of compounding
C = Annual compounded percent change

Thus, the annual compounded percent change for the years 1991 through 1995 is

$$-1 + (14{,}377{,}202 \div 12{,}566{,}764)^{(1/(5-1))} = 3.4\%$$

Annual compounded percent change calculations are particularly useful for projections that involve lodging demand. The unit of lodging demand (room-night) is a real number that is unaffected by factors such as inflation; therefore, it is necessary to calculate all growth rates in real terms, using constant, rather than current, inflated dollars.

**Exhibit 7-4 Rockland County Retail Sales ($000,000)**

| Year | Retail Sales (current $) | Retail Sales (1995 $) | % Change From Previous Year |
|---|---|---|---|
| 1991 | $1,118,539 | $1,251,581 | — |
| 1992 | 1,223,391 | 1,328,901 | 6.2% |
| 1993 | 1,310,534 | 1,382,183 | 4.0 |
| 1994 | 1,407,998 | 1,447,901 | 4.8 |
| 1995 | 1,451,832 | 1,451,832 | 0.3 |
| Annual compounded percent change (1991–1995) | | | 3.8% |

Exhibit 7-4 shows retail sales in Rockland County from 1991 to 1995. According to this information, sales increased a total of 30 percent, using current (inflated) dollars. Performing the same calculation using 1995 (constant) dollars shows a 16 percent increase, which is the amount of real growth in retail sales during the same period. The difference between the inflated dollar calculation (30 percent) and the constant dollar calculation (16 percent) is attributed to inflation rather than real growth in retail demand. The annual compounded percent change in real terms over this period is 3.7 percent.

To determine constant dollar amounts, calculations are made using the Consumer Price Index (CPI). Exhibit 7-5 shows the CPI for the eleven-year period from 1975 to 1995.

**Exhibit 7-5 Consumer Price Index**

*Sources: Bureau of Labor Statistics*

| Year | CPI | Percent Change From Previous Year |
|---|---|---|
| 1985 | 107.6 | — |
| 1986 | 109.6 | 1.9% |
| 1987 | 113.6 | 3.6 |
| 1988 | 118.3 | 4.1 |
| 1989 | 124.0 | 4.8 |
| 1990 | 130.7 | 5.4 |
| 1991 | 136.2 | 4.2 |
| 1992 | 140.3 | 3.0 |
| 1993 | 144.5 | 3.0 |
| 1994 | 148.2 | 2.6 |
| 1995 | 152.4 | 2.8 |
| 1996 | 156.9 | 3.0 |
| 1997 | 160.5 | 2.3 |
| 1998 | 163.0 | 1.6 |

To adjust 1994 current dollars to 1995 constant dollars, the 1995 CPI is divided by the 1994 CPI:

1995 CPI ÷ 1994 CPI = (152.4 ÷ 147.2) × ($1,407,997 ÷ 1) = $1,447,901

The current dollar amount for 1993 is converted to 1995 constant dollars in the same way:

1995 CPI ÷ 1993 CPI = (152.4 ÷ 144.5) × ($1,310,534 ÷ 1) = $1,372,173

It is important when performing these calculations to avoid basing an annual compounded percent change calculation on a starting point that goes too far back in time. The analysis should focus on recent trends and movements in economic and demographic data; extending the historical term beyond five to eight years may sometimes yield misleading findings. For example, a new suburban area may experience rapid growth for the first ten years of its existence and then settle down to a 3 percent annual increase. The annual compounded percent change in the early years might be extremely high because the initial population base is so small and new development so intense. However, if the same calculation is performed later, the growth rate might be only 3 percent, which is a more realistic indication for the future. The use of shorter periods also more clearly shows the impacts of normal business cycles, which often contain periodic downturns.

## [5] Estimate of Future Transient Demand

After all the economic and demographic data have been accumulated and the annual compounded percent change calculated for each type of data, the appraiser analyzes the resulting historical and projected trends, along with other pertinent information gathered during the study, in order to estimate the probable direction and future rate of change in hotel transient demand. The accuracy of these projections depends on the accuracy with which the various types of economic and demographic data reflect changes in hotel room-night demand. Naturally, the data that most closely reflect trends in transient visitation are given the greatest weight in this analysis. Changes in hotel demand generally depend on the type of visitation, so this analysis is usually performed for individual market segments (i.e., commercial, meeting and convention, leisure, or other specialized segments if relevant). Exhibit 7-6 shows the three primary market segments and the types of data that best reflect changes in the hotel room-night demand that they generate.

**Exhibit 7-6 Data Used for Analysis of Transient Visitation**

| Commercial | Meeting and Convention | Leisure |
|---|---|---|
| Total employment by sector | Convention center partronage | Tourist visitation |
| Office space absorption | Total employment by sector | Highway traffic counts |
| Office vacancy rates | Airport emplanements | Visitor counts at attractions |
| Office space being developed | Air cargo data | Total employment by sector |
| Inventory of office space | Tourist visitation | Restaurant Activity Index (RAI) |
| Inventory of retail space | Retail sales | Restaurant Growth Index (RGI) |
| Inventory of industrial space | Visitor counts at attractions | |
| New businesses entering area | Office space absorption | |
| Highway traffic counts | Office vacancy rates | |
| Airport emplanements | Office space being developed | |
| Air cargo data | Inventory of office space | |
| Commercial building permits | Inventory of retail space | |
| Housing starts | Inventory of industrial space | |
| Assessed values | New businesses entering area | |
| Population | | |
| Retail sales | | |
| Effective buying income | | |
| Personal income | | |

### [a] Commercial Market Segment

The commercial market segment is composed of businesspeople visiting the various firms within the subject property's market area. Commercial demand is strongest Monday through Thursday nights, declines significantly Friday and Saturday, and increases somewhat on Sunday. The typical length of stay ranges from one to three days and the rate of double occupancy is a low 1.2 to 1.3 percent. Commercial demand is relatively constant throughout the year, with some drop-off noticeable in late December and during other holiday periods.

Individual business travelers tend not to be overly price sensitive and generally use a hotel's food, beverage, and recreational facilities. The commercial segment represents a highly desirable and lucrative market segment for hotels and motels because it provides a consistent level of demand at room rates approaching the upper limit for the area.

Commercial hotel demand is largely influenced by trends related to business activity such as office space absorption; employment (particularly wholesale and retail trade, FIRE, and services); new businesses established in the area; and airport activity. Population growth, although not a strong indicator of changes in commercial demand, usually sets the floor for potential growth in commercial visitation. For example, if an area's population is expected to grow at an annual compounded rate of 1.5 percent, it is likely that commercial hotel demand will grow at least at the same rate.

### [b] Meeting and Convention Market Segment

The meeting and convention market includes attendees of meetings, seminars, trade association shows, and similar gatherings of ten or more people. Peak demand typically occurs in the spring and fall. The summer months represent the slowest period for this market segment because so many people take vacations during that time; winter demand can be variable. The average length of stay typically ranges from three to five days. Most commercial groups meet during the weekday period of Monday through Thursday, but associations and social groups sometimes meet on weekends. Commercial groups tend to have a low double occupancy rate (1.3 percent to 1.5 percent) whereas social groups are likely to have somewhat higher double occupancy rates, ranging from 1.5 percent to 1.9 percent.

Meeting and convention patronage is generally quite profitable for hotels and motels. Although room rates are sometimes discounted for large groups, the hotel benefits from use of meeting space and the inclusion of in-house banquets and cocktail receptions. Facilities required to attract meetings and conventions include meeting and banquet rooms with adequate space for breakout rooms, meal functions, and receptions; recreational amenities; and an adequate number of guestrooms to house the attendees.

There are fewer economic and demographic indicators of meeting and convention demand than there are for the commercial segment. Most provide only an indirect indication of demand trends. Convention center activity, particularly usage that generates visitation from outside the area, is probably the best indicator of meeting and convention demand. Commercial activity, such as employment trends and office and industrial space absorption provides an indirect indication of meeting and convention demand because many meetings are the result of business activity. Meeting and convention demand is also created through the efforts of individual hotels using their in-house sales departments; this is known as induced demand. (For a discussion of the methods used to forecast induced demand, see Chapter 10.)

### [c] Leisure Market Segment

The leisure market segment consists of individuals and families either visiting a particular location or passing through en route to other destinations. Their purpose for travel may be, among others, sightseeing, recreation, relaxation, or visiting friends or relatives. Leisure demand is strongest Friday through Saturday nights and all week during holiday periods and the summer months. These peak periods of demand are nearly the opposite of those generated by the commercial market segments, which means that if a lodging facility can attract both segments it will experience stable occupancy rates throughout the year.

The typical length of stay for leisure travelers ranges from one to four days, depending on the guests' destination and purpose for traveling. The rate of double occupancy is generally a high 1.7 percent to 2.5 percent.

Leisure travelers tend to be the most price-sensitive segment in the lodging market. They typically prefer low-rise accommodations where parking is convenient to the rooms and require extensive recreational facilities and amenities. Ease of highway access and proximity to vacation-related attractions are important hotel locational considerations for this segment.

Leisure demand has the fewest indicators on which to rely. However, if visitor statistics are available, particularly in resort areas, some good indications of leisure demand trends can be obtained from them. Attendance data for area tourist attractions can also be useful.

### [d] Conclusion

The actual estimated change in hotel demand is generally projected by market segment for periods ranging from 3 to 10 years. When forecasting lodging demand, the projection period should be kept as short as possible. The annual percent change should reflect the most probable trend in hotel room-night demand. Many studies project a positive growth in lodging demand, but growth is not necessarily always positive, nor does growth always increase at the same percentage each year.

The end result of the market area analysis should be a yearly estimate by market segment of the percentage growth or decline in transient lodging demand. The analysis should also conclude with an evaluation of how well suited the market area is for proposed hotel development over the long term, or in the case of an existing hotel, for continued use.

# CASE STUDY Neighborhood and Market Area Analysis

## NEIGHBORHOOD ANALYSIS

This section of the study investigates the subject property's neighborhood and evaluates pertinent locational factors that could affect its occupancy, average rate, food and beverage revenues, and overall profitability.

### Character of Surrounding Area

The neighborhood surrounding the subject property is characterized by a mixture of first-class retail and office space along Central Avenue (State Route 59) and middle-income residential housing on the secondary streets leading from and running parallel to Central Avenue. This area has a suburban character, compared with the more developed downtown district situated two miles north of the Embassy Suites. The commercial strip on Central Avenue extends from a regional shopping mall just south of the subject property to the southern perimeter of Spring Valley's central business district.

### Development of Neighborhood

Development in the subject property's neighborhood began approximately twenty-five years ago as a result of the natural expansion of the Spring Valley area. Growth occurred rapidly; within ten years, most of the property along Central Avenue north of the New York State Thruway was improved with high-quality retail outlets and mid-rise office buildings. Tract developers undertook construction in the surrounding residential areas at the same time.

The subject parcel was formerly a drive-in movie theater constructed forty years ago, shortly after the opening of the New York State Thruway. Because the theater was removed from the improved areas of Spring Valley and easily accessible from the Thruway, it achieved a high level of success during its early years. As the neighborhood became more improved and drive-in theaters declined in popularity, normal economic pressure was exerted to discontinue movie operations and upgrade the property's image. The parcel was sold to its current owners three years ago; these individuals were successful in obtaining the RS (regional shopping district) zoning classification, which permits hotel use.

Property along Central Avenue south of the Thruway only recently captured the interest of developers. Historically, the Thruway inhibited the southward expansion of Spring Valley. This situation changed rapidly in the mid-1970s, when a 500,000–square foot regional shopping center known as the Spring Valley Mall was constructed just south of the subject property, in the southwestern quadrant of the intersection formed by Central Avenue and the New York State Thruway. The mall is anchored by Saks Fifth Avenue and Macy's and contains sixty-seven outlets typical of those found in regional malls throughout the United States. These first-class retail establishments enhance the image of the area. The parcels adjoining the mall to the west are improved with well-maintained single-family homes.

Several office complexes and multifamily apartment buildings are under construction on sites surrounding the mall. Although the area south of the Thruway maintains a favorable image, property located here is still not considered the equal of sites situated farther north on Central Avenue.

### Commercial Properties in Neighborhood

The following real estate inventory of the neighborhood provides an overview of the various types of commercial improvements located along Central Avenue.

A one-story strip shopping center containing approximately fifteen retail outlets is located immediately north of the subject property, on the western side of Central Avenue. The tenants include a men's wear shop, a women's lingerie boutique, a travel agent, a real estate broker, a jeweler, an ice cream shop, a liquor store, and an antique dealer. The quality and variety of these shops would complement a nearby lodging facility, though they would also compete with similar facilities contained in a nearby hotel. Facilities located immediately north of the strip mall include a Mercedes-Benz dealer, a three-story medical building, and an office building housing the regional headquarters of IBM Office Equipment Marketing. This branch of the national computer firm is responsible for developing marketing programs in the northeastern United States and training all sales representatives. Numerous conferences are held in this building as a result of these training programs; a majority of the attendees are housed in nearby commercial lodging facilities.

Eight additional retail outlets are clustered north of the IBM building; these buildings were among the first commercial improvements constructed south of the downtown district. This shopping center is intended to serve local residents and includes a grocery store, a pharmacy, a hairdresser, and a bank branch. Similar retail, office, and commercial improvements stretch north into downtown Spring Valley.

The land on the eastern side of Central Avenue, directly across from the Spring Valley Mall, is unimproved. Proposals for future development include office space, a fast-food restaurant, and strip-type retail establishments. Planning officials predict that most of this property will be fully developed during the next five years.

The residential neighborhoods that flank Central Avenue are characterized by attractive middle-income housing. Most of the residents living in this area are employed by local businesses; approximately 10 percent commute to jobs in New York City.

### Conclusion

The neighborhood surrounding the proposed subject property appears to be well suited for the operation of a transient lodging facility. A base level of commercial and meeting visitation can be expected to be generated by the nearby offices, particularly the IBM meeting complex. The retail improvements, including the nearby regional mall, would provide a source of both entertainment and diversion for the hotel's guests. The neighborhood's attractive and safe surroundings along with its first-class image would enhance the subject property's market position, and we observed no adverse influences that are likely to have a detrimental impact on the hotel's attainable occupancy, average rate, or food and beverage volume. Some vacant land is available south of the Thruway, which may encourage additional development and have a beneficial impact on local lodging facilities.

## MARKET AREA ANALYSIS

The purpose of the market area analysis is to review all available historical and projected economic and demographic data to determine whether the local market area will experience future economic growth, stability, or decline. In addition to predicting the direction of the economy, the rate of future change must be quantified. These trends are then correlated on the basis of their propensity to reflect variances in lodging demand with the objective of forecasting the amount of growth or decline in transient visitation by individual market segments (i.e., commercial, meeting and convention, leisure).

### Definition and Geographic Character

The primary market area encompassing the subject property is mostly suburban in character, and can be defined generally as southern New York State and northern New Jersey. More specifically, the subject property's market area consists of Rockland County in New York and the northern portion of the neighboring Bergen County in New Jersey. Some demand may also originate from the New York Counties of Westchester, Putnam, and Orange and the New Jersey County of Passaic, all of which surround Rockland County; their impact on transient visitation would be minimal, however.

Overall, the area is mainly a rolling terrain composed of somewhat rocky and rugged hills ranging from 200 to 500 feet in height. With the exception of its geographically undefined border with New Jersey, Rockland County is isolated from its neighboring counties by the Hudson River on the east and the Ramapo Mountains along the western border. The county is a natural extension of northeastern New Jersey by virtue of the Ramapo Mountains, the Hackensack, Passaic, Saddle, and Ramapo River Valleys, and its proximity to the Hudson River. The Palisades sill, which lies along the eastern edge of the county bordering on the Hudson River, turns inland just south of the Town of Haverstraw, forming an east-west mastiff known as South Mountain and High Tor. Within the bowl formed by the Palisades on the east and the Ramapo Mountains on the west, the topography rises in a series of steps toward the west in a north-south orientation.

The natural north-south contours of the land have had a significant impact on the development of a transportation system of highways and railways that generally conforms to this geographic model. The significant exception to the north-south highway pattern is the New York State Thruway (I-77/I-277), which traverses the southern part of Rockland County in a mostly east-west direction, cutting through the rugged hills and intersecting with each of the north-south highways. The fact that virtually all east- and westbound traffic occurs on a single roadway benefits the adjacent subject property in terms of both access and visibility.

Rockland County, representing a major portion of the proposed subject property's market area, is the state's smallest county north of New York City. Its triangle-shaped area contains approximately 176 square miles, with borders measuring 17 by 19 by 20 miles. The county is politically divided into 5 towns, 13 villages, and numerous hamlets.

Rockland County is part of the New York City Metropolitan Statistical Area (MSA). The MSA is the most standard definition used in comparative studies of metropolitan areas. The federal government defines an MSA as a large population nucleus, which, together with adjacent counties, has a high degree of social integration. The subject MSA contains the counties of Bronx, Kings, New York, Putnam, Queens, Richmond, Rockland, and Westchester, all of which are located in the state of New York.

In recent decades, Rockland County's economy has been characterized by its role as a distribution and industrial center, a function of the area's proximity to New York City. In the 1950s, the construction of the Tappan Zee Bridge, the New York State Thruway, the Garden State Parkway, and the Palisades Interstate Parkway opened the county to many new firms seeking the benefits of a suburban location with ready access to New York City and its regional markets. Since the development of this infrastructure, the subject market area has experienced normal cyclical swings over the short term, while a strong positive growth trend has been observed over the long term.

## Population

Although there is no direct correlation between an area's population and its specific level of transient visitation, historical and projected population trends often reflect the economic climate of a locale. Exhibit 7-7 sets forth historical and projected population data for Rockland County, the New York MSA, New York State, and the United States as a whole.

Between 1970 and 1994, Rockland County, the New York MSA, and the State of New York all registered average annual population growth factors of 0.3 percent, a level considerably lower than the 1.0 percent annual average gain registered by the nation during the same period. The subject county's population actually decreased in 1977 and 1978, before beginning to record stronger positive gains in 1991 and 1992. At the same time, the New York MSA's population growth has remained flat in recent years, below state and national levels. The region's limited population gains are partially attributable to the high cost of living and doing business in the northeastern United States and the taxes paid by New York State residents, which have discouraged large-scale migration to the area in recent years. Forecasts indicate that the population of Rockland County will continue to increase at a slow rate through 2020, with growth rates generally above those of the MSA and in line with those of the state.

Although these demographic trends are not particularly auspicious, the slight population gains anticipated in Rockland County suggest that lodging demand in the local market will rise slowly. The rate of population growth generally establishes a minimum rate of increase for commercial segment hotel demand; this observation also holds true for the meeting and convention segment if a majority of the meetings are business-oriented.

## Age Distribution

The age distribution of an area's population provides an indication of probable spending patterns, food, beverage and banquet patronage, and the propensity to travel. A growing local population under the age of 20 is likely to yield greater banquet business in the form of weddings, proms, award dinners, and similar functions. Growth in the 20- to 39-year age group is likely to create increased lounge patronage and demand for entertainment facilities. Individuals aged 40 to 64 generally have the largest amount of disposable income, and thus represent potential restaurant and lounge patrons. Exhibit 7-8 shows the expected trends in the population age distribution for Rockland County as compared with those of the United States.

**Exhibit 7-7 Historical and Projected Population Trends**

*Source: Woods & Poole Economics, Inc.*

| | Rockland County | | | New York, NY MSA | | | State of New York | | | United States | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Population | Percent Change[1] | Percent Change[2] | Population | Percent Change[1] | Percent Change[2] | Population | Percent Change[1] | Percent Change[2] | Population | Percent Change[1] | Percent Change[2] |
| 1970 | 231.1 | — | — | 9,078.7 | — | — | 18,264.5 | — | — | 203,982.3 | — | — |
| 1975 | 247.6 | 1.4% | — | 8,694.9 | (0.9)% | — | 18,044.0 | (0.2)% | — | 215,465.2 | 1.1% | — |
| 1980 | 259.6 | 1.0 | — | 8,277.1 | (1.0) | — | 17,566.4 | (0.5) | — | 227,225.6 | 1.1 | — |
| 1985 | 264.4 | 0.4 | 0.4% | 8,491.4 | 0.5 | 0.5% | 17,791.8 | 0.3 | 0.3% | 237,924.8 | 0.9 | 0.9% |
| 1986 | 265.5 | 0.4 | 0.4 | 8,536.8 | 0.5 | 0.5 | 17,833.5 | 0.2 | 0.3 | 240,133.9 | 0.9 | 0.9 |
| 1987 | 264.6 | (0.3) | 0.3 | 8,560.9 | 0.3 | 0.5 | 17868.9 | 0.2 | 0.2 | 242,289.9 | 0.9 | 0.9 |
| 1988 | 264.6 | (0.0) | 0.2 | 8,575.9 | 0.2 | 0.4 | 17,941.4 | 0.4 | 0.3 | 244,499.8 | 0.9 | 0.9 |
| 1989 | 264.8 | 0.1 | 0.2 | 8,567.4 | (0.1) | 0.4 | 17,983.1 | 0.2 | 0.3 | 246,819.8 | 0.9 | 0.9 |
| 1990 | 265.9 | 0.4 | 0.2 | 8,547.5 | (0.2) | 0.3 | 18,001.6 | 0.1 | 0.2 | 249,399.4 | 1.0 | 0.9 |
| 1991 | 268.4 | 0.9 | 0.3 | 8,540.6 | (0.1) | 0.3 | 18,046.9 | 0.3 | 0.2 | 252,137.0 | 1.1 | 1.0 |
| 1992 | 270.9 | 0.9 | 0.4 | 8,551.8 | 0.1 | 0.3 | 18,109.5 | 0.3 | 0.3 | 255,077.4 | 1.2 | 1.0 |
| 1993 | 271.6 | 0.3 | 0.3 | 8,564.5 | 0.1 | 0.3 | 18,163.5 | 0.3 | 0.3 | 257,919.5 | 1.1 | 1.0 |
| 1994 | 272.4 | 0.3 | 0.3 | 8,574.5 | 0.1 | 0.3 | 18,211.8 | 0.3 | 0.3 | 260,663.9 | 1.1 | 1.0 |
| 1995 | 272.9 | 0.2 | 0.3 | 8,577.7 | 0.0 | 0.2 | 18,245.9 | 0.2 | 0.3 | 263,211.0 | 1.0 | 1.0 |
| 2000 | 274.7 | 0.1 | 0.3 | 8,571.1 | (0.0) | 0.2 | 18,368.1 | 0.1 | 0.2 | 275,260.0 | 0.9 | 1.0 |
| 2005 | 276.0 | 0.1 | 0.2 | 8,548.8 | (0.1) | 0.1 | 18,455.8 | 0.1 | 0.2 | 286,757.8 | 0.8 | 0.9 |
| 2010 | 277.6 | 0.1 | 0.2 | 8,536.1 | (0.0) | 0.1 | 18,564.1 | 0.1 | 0.2 | 298,528.7 | 0.8 | 0.9 |
| 2015 | 279.7 | 0.1 | 0.2 | 8,537.8 | 0.0 | 0.1 | 18,703.6 | 0.1 | 0.2 | 310,788.2 | 0.8 | 0.9 |
| 2020 | 281.7 | 0.1 | 0.2 | 8,538.9 | 0.0 | 0.1 | 18,841.9 | 0.1 | 0.2 | 323.023.5 | 0.8 | 0.9 |

[1]Annual average compounded percentage change from previous year shown
[2]Annual average compounded percentage change from 1980

**Exhibit 7-8**
**Population Age Distribution**
*Source: Woods and Poole Economics, Inc.*

| | Rockland County | | | | USA |
|---|---|---|---|---|---|
| **Age Group** | **1980** | **1990** | **1994** | **2000** | **1994** |
| Under 20 | 34.2% | 28.9% | 28.6% | 28.3% | 28.7% |
| 20–39 | 29.7 | 30.1 | 28.9 | 26.9 | 31.4 |
| 40–64 | 26.1 | 30.4 | 33.1 | 36.2 | 23.2 |
| 65 and over | 10.0 | 10.6 | 9.5 | 8.6 | 16.6 |
| Median Age | 31.2 | 34.0 | 35.1 | 36.7 | 34.1 |

Between 1970 and 1994, the median age of the Rockland County population increased from 31.1 to 35.2 years, a median age slightly higher than the 1994 national median age of 34.1 years. The shift in the county's age distribution during this period was associated with a decline in the percentage of residents under 20 and an increase in the percentage of the county population in the age groups of 40 to 64 and 65 and over. Projections suggest continued aging of the county population through the year 2000 with the median age expected to reach 36.7. The percentage of county residents in age groups of under 20, 20 to 39, and 65 and over are expected to decline between 1993 and 2000, while the 40-to-64 age group increases substantially.

The under-20 age group typically represents entry-level workers, and its growth or decline can have mixed effects. Workers in this age group typically earn lower wages than older members of the work force; thus, a lack of available employees in this age range may cause an increase in the area's cost of doing business. Conversely, this group is associated with a relatively high level of unemployment.

The baby boom generation, which is represented in both the 20-to-39 and 40-to-64 age categories, has become an important factor in national spending patterns. These residents typically represent a strong market for homes, consumable and durable goods, leisure activities, and other products and services. Growth in this age group is a favorable trend for the lodging industry, because these individuals are associated with a disproportionately large share of total travel expenditures in the United States. Increases in the number of two-worker households and the attendant rise in income levels are expected to further contribute to this group's propensity to travel. The increasing affluence of these well-educated Americans and subsidiary trends such as smaller and double-income families are expected to engender a greater consumption of meals away from home. Primary beneficiaries of these events are the nation's hotel's and restaurants, which will accommodate the added patronage.

With the 40-to-64 age group becoming more prominent in Rockland County, local restaurants and lounges should benefit from the higher spending patterns typically exhibited by this group. In addition, local hotels and motels will probably experience some increased demand from children and grandchildren of the older local residents returning home during vacation and holiday periods.

### Retail Sales

Retail sales levels reflect both population trends and the propensity to spend money on retail goods. Although there is no direct correlation between retail sales and hotel demand, retail sales trends tend to gauge the economic health and vitality of the market. Retail sales growth should cause local businesses to prosper and make it more likely for new firms to enter the market, thus causing an increase in the demand for lodging facilities. In areas in which tourism is a significant economic factor, retail sales also reflect the amount of visitation. Exhibit 7-9 shows historical and projected retail sales trends in Rockland County, the New York MSA, New York State, and the United States as a whole. All figures have been adjusted to reflect 1977 dollars; thus, the growth rates represent real change.

Between 1970 and 1994, retail sales in Rockland County increased at a real average annual compounded rate of 0.7 percent, slightly exceeding the 0.5 percent growth factor recorded by the New York MSA, and slightly behind the 0.9 percent growth factor recorded by New York State. All of these indicators lagged behind the national average annual growth rate: 1.3 percent. The impact of the national economic recession on retail sales in all statistical areas was noted in 1990 and 1991, while Rockland County's retail sales also declined in 1993.

Projections indicate a recovery in retail sales between 1995 and 2000; Rockland County, the New York MSA, and the state of New York are all expected to post real annual gains above 2.0 percent, while the national growth rate is expected to exceed 3.0 percent in future years.

**Exhibit 7-9 Historical and Projected Retail Sales Trends**

*Source: Woods & Poole Economics, Inc.*

| | Rockland County | | | New York, NY MSA | | | New York State | | | United States | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Retail Sales | Percent Change[1] | Percent Change[2] | Retail Sales | Percent Change[1] | Percent Change[2] | Retail Sales | Percent Change[1] | Percent Change[2] | Retail Sales | Percent Change[1] | Percent Change[2] |
| 1970 | $1,141 | — | — | $43,572 | — | — | $92,696 | — | — | $1,053,857 | — | — |
| 1975 | 1,281 | 2.3% | — | 38,979 | (2.2)% | — | 89,766 | (0.6)% | — | 1,202,708 | 2.7% | — |
| 1980 | 1,395 | 1.7 | — | 38,577 | (0.2) | — | 91,866 | 0.5 | — | 1,340,769 | 2.2 | — |
| 1985 | 1,547 | 2.1 | 2.1% | 41,554 | 1.5 | 1.5% | 101,416 | 2.0 | 2.0% | 1,481,856 | 2.0 | 2.0% |
| 1986 | 1,569 | 1.4 | 2.0 | 42,042 | 1.2 | 1.4 | 103,970 | 2.5 | 2.1 | 1,511,054 | 2.0 | 2.0 |
| 1987 | 1,545 | (1.5) | 1.5 | 41,295 | (1.8) | 1.0 | 103,212 | (0.7) | 1.7 | 1,493,286 | (1.2) | 1.6 |
| 1988 | 1,578 | 2.1 | 1.6 | 42,251 | 2.3 | 1.1 | 105,848 | 2.6 | 1.8 | 1,540,698 | 3.2 | 1.8 |
| 1989 | 1,584 | 0.4 | 1.4 | 42,361 | 0.3 | 1.0 | 106,424 | 0.5 | 1.6 | 1,561,073 | 1.3 | 1.7 |
| 1990 | 1,569 | (0.9) | 1.2 | 41,784 | (1.4) | 0.8 | 105,209 | (1.1) | 1.4 | 1,558,277 | (0.2) | 1.5 |
| 1991 | 1,515 | (3.4) | 0.8 | 39,972 | (4.3) | 0.3 | 100,986 | (4.0) | 0.9 | 1,507,861 | (3.2) | 1.1 |
| 1992 | 1,541 | 1.7 | 0.8 | 40,376 | 1.0 | 0.4 | 102,179 | 1.2 | 0.9 | 1,613,742 | 1.3 | 1.3 |
| 1993 | 1,532 | (0.6) | 0.7 | 41,646 | 3.1 | 0.6 | 104,867 | 2.6 | 1.0 | 1,593,432 | 3.7 | 1.3 |
| 1994 | 1,535 | 0.2 | 0.7 | 41,397 | (0.6) | 0.5 | 104,822 | (0.0) | 0.9 | 1,613,742 | 1.3 | 1.3 |
| 1995 | 1,576 | 2.7 | 0.8 | 42,114 | 1.7 | 0.6 | 107,453 | 2.5 | 1.1 | 1,674,273 | 3.8 | 1.5 |
| 2000 | 1,774 | 2.3 | 1.2 | 46,499 | 2.0 | 0.9 | 121,632 | 2.5 | 1.4 | 1,991,623 | 3.4 | 2.0 |
| 2005 | 1,978 | 2.2 | 1.4 | 51,369 | 2.0 | 1.2 | 136,969 | 2.4 | 1.6 | 2,336,845 | 3.2 | 2.2 |
| 2010 | 2,196 | 2.1 | 1.5 | 56,760 | 2.0 | 1.3 | 153,868 | 2.4 | 1.7 | 2,718,832 | 3.1 | 2.4 |
| 2015 | 2,395 | 1.8 | 1.6 | 61,836 | 1.7 | 1.4 | 169,989 | 2.0 | 1.8 | 3,093,334 | 2.6 | 2.4 |
| 2020 | 2,624 | 1.8 | 1.6 | 67,905 | 1.9 | 1.4 | 188,855 | 2.1 | 1.8 | 3,520,729 | 2.6 | 2.4 |

[1] Annual average compounded percentage change from previous year shown
[2] Annual average compounded percentage change from 1980

### Personal Income

According to the procedures outlined in the National Income and Product Accounts, personal income is calculated by totaling earned income (wages, salaries, other labor income, and proprietor's income), non-earned income, and residence adjustments and subtracting personal contributions to social insurance. Trends in personal income reflect the spending ability of local residents. Like population trends, personal income has no direct correlation with hotel room night demand, but rather tends to gauge the economic health and vitality of a market area. Exhibit 7-10 sets forth historical and projected per-capita personal income levels in Rockland County, the New York MSA, New York State, and the United States.

Rockland County's 1994 per-capita personal income level was higher than those of the New York CMSA, New York State, and the nation. This relationship suggests that Rockland County residents are more affluent than typical Americans and more able to spend money on retail goods, travel, dining, and services. In addition, recent growth factors for the subject county have exceeded those of the MSA and the state, slightly trailing those of the nation. Projections indicate continued strong gains in personal income per capita, with growth factors remaining in the range of 1.5 percent per year over the long term. These trends are favorable, and reflect growth in the potential spending patterns for local residents.

Exhibit 7-11 shows the historical and projected total personal income in Rockland County, the New York MSA, New York State and the United States.

### Workforce Characteristics

Exhibit 7-12 sets forth the Rockland County workforce distribution by business sector in 1970, 1990, and 1994, as well as a forecast for 2000. As the exhibit illustrates, the most rapid growth between 1970 to 1994 occurred in the services, TCPU, FIRE, wholesale trade, and construction sectors. Moderate growth was recorded in the agricultural services and retail trade sectors, whereas a decline in employment was noted in the farm, mining, manufacturing, and government sectors. Projections indicate a continuation of this slow rate of growth, with total employment expected to increase by only 0.1 percent per year between 1994 and 2000. Although total employment growth is anticipated to be sluggish, the wholesale trade and FIRE sectors are expected to record moderate gains; this is a positive indicator of future transient lodging demand.

The exhibit demonstrates the diversification of the Rockland County economy. In 1994, the services sector accounted for approximately 34 percent of the overall employment base, with trade, government, and manufacturing contributing 19 percent, 17 percent, and 11 percent, respectively. Because the local economy is not tied to the prosperity of any single sector, the impact of normal business cycles is cushioned.

### Farm, Agricultural Services, Mining

The farm, agricultural services and mining employment sectors taken together represented only 0.7 percent of the total employment in Rockland County in 1994. Generally, these three sectors do not generate an appreciable amount of hotel demand, so their small presence as area employers is not a significant factor in this analysis.

### Construction

The construction industry represents a relatively small portion of the Rockland County economy. Between 1970 and 1994, employment in the construction sector increased from 3,700 to 4,700, yielding an average annual compounded growth rate of 1.7 percent. However, analysis of this longer term is deceiving. Because of the recession and the fact that many real estate types were oversupplied in the late 1980s and early 1990s, construction employment receded substantially between 1990 and 1994, declining at an average annual rate of nearly 5 percent per year.

As illustrated in Exhibit 7-13, the number of residential construction permits issued in Rockland County has exhibited a downward trend since 1985. The sharpest drops occurred in the early 1990s, which reflects impact of the national recession and overbuilding during the 1980s.

Nonresidential construction has a greater impact on lodging demand than activity in the residential sector, because new commercial, industrial, and retail space generally foreshadows a favorable business climate. The introduction of new firms or the expansion of existing companies may result in increased visitation from individuals conducting business in the area; the direct effect on local hotels depends on the type of activity generated by those firms.

Exhibit 7-14 outlines the assessed value of all non-residential property in Rockland County. The figures are expressed in constant 1995 dollars, and thus percent change represents real growth or

**Exhibit 7-10 Historical and Projected Personal Income per Capita**

*Source: Woods & Poole Economics, Inc.*

| Year | Rockland County | | | New York, NY MSA | | | New York State | | | United States | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Per Capita | Percent Change[1] | Percent Change[2] | Per Capita | Percent Change[1] | Percent Change[2] | Per Capita | Percent Change[1] | Percent Change[2] | Per Capita | Percent Change[1] | Percent Change[2] |
| 1970 | $13,239 | — | — | $15,125 | — | — | $13,658 | — | — | $11,358 | — | — |
| 1975 | 15,004 | 2.5% | — | 15,386 | 0.3% | — | 14,081 | 0.6% | — | 12,362 | 1.7% | — |
| 1980 | 17,188 | 2.8 | — | 16,424 | 1.3 | — | 15,274 | 1.6 | — | 13,924 | 2.4 | — |
| 1985 | 19,537 | 2.6 | 2.6% | 18,856 | 2.8 | 2.8% | 17,459 | 2.7 | 2.7% | 15,205 | 1.8 | 1.8% |
| 1986 | 20,101 | 2.9 | 2.6 | 19,535 | 3.6 | 2.9 | 18,143 | 3.9 | 2.9 | 15,529 | 2.1 | 1.8 |
| 1987 | 20,796 | 3.5 | 2.8 | 19,967 | 2.2 | 2.8 | 18,443 | 1.7 | 2.7 | 15,640 | 0.7 | 1.7 |
| 1988 | 21,705 | 4.4 | 3.0 | 20,690 | 3.6 | 2.9 | 18,917 | 2.6 | 2.7 | 15,943 | 1.9 | 1.7 |
| 1989 | 21,838 | 0.6 | 2.7 | 21,020 | 1.6 | 2.8 | 19,198 | 1.5 | 2.6 | 16,184 | 1.5 | 1.7 |
| 1990 | 21,898 | 0.3 | 2.5 | 21,463 | 2.1 | 2.7 | 19,427 | 1.2 | 2.4 | 16,246 | 0.4 | 1.6 |
| 1991 | 21,087 | (3.7) | 1.9 | 21,188 | 1.3 | 2.3 | 19,103 | (1.7) | 2.1 | 16,009 | (1.5) | 1.3 |
| 1992 | 21,314 | 1.1 | 1.8 | 21,894 | 3.3 | 2.4 | 19,510 | 2.1 | 2.1 | 16,279 | 1.7 | 1.3 |
| 1993 | 21,558 | 1.1 | 1.8 | 21,653 | (1.1) | 2.1 | 19,594 | 0.4 | 1.9 | 16,505 | 1.4 | 1.3 |
| 1994 | 21,687 | 0.6 | 1.7 | 21,658 | 0.0 | 2.0 | 19,653 | 0.3 | 1.8 | 16,630 | 0.8 | 1.3 |
| 1995 | 21,977 | 1.3 | 1.7 | 21,777 | 0.5 | 1.9 | 19,852 | 1.0 | 1.8 | 16,862 | 1.4 | 1.3 |
| 2000 | 23,625 | 1.5 | 1.6 | 23,165 | 1.5 | 1.7 | 21,363 | 1.6 | 1.7 | 18,315 | 1.7 | 1.4 |
| 2005 | 25,525 | 1.6 | 1.6 | 25.040 | 1.6 | 1.7 | 23,249 | 1.7 | 1.7 | 19,993 | 1.8 | 1.5 |
| 2010 | 27,639 | 1.6 | 1.6 | 27,247 | 1.7 | 1.7 | 25,416 | 1.8 | 1.7 | 21,836 | 1.8 | 1.5 |
| 2015 | 29,988 | 1.6 | 1.6 | 29,820 | 1.8 | 1.7 | 27,890 | 1.9 | 1.7 | 23,846 | 1.8 | 1.5 |
| 2020 | 32,633 | 1.7 | 1.6 | 32,841 | 1.9 | 1.7 | 30,738 | 2.0 | 1.8 | 26.063 | 1.8 | 1.6 |

[1]Annual average compounded percentage change from previous year shown
[2]Annual average compounded percentage change from 1980

**Exhibit 7-11 Historical and Projected Personal Income**

*Source: Woods & Poole Economics, Inc.*

| Year | Rockland County Personal Income | Rockland County Percent Change[1] | Rockland County Percent Change[2] | New York, NY MSA Personal Income | New York, NY MSA Percent Change[1] | New York, NY MSA Percent Change[2] | New York State Personal Income | New York State Percent Change[1] | New York State Percent Change[2] | United States Personal Income | United States Percent Change[1] | United States Percent Change[2] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1970 | $3,059 | — | — | $137,318 | — | — | $249,460 | — | — | $2,316,919 | — | — |
| 1975 | 3,715 | 4.0% | — | 133,778 | (0.5)% | — | $254,076 | 0.4% | — | $2,663,665 | 2.8% | — |
| 1980 | 4,462 | 3.7 | — | 135,939 | 0.3 | — | 268,310 | 1.1 | — | 3,163,874 | 3.5 | — |
| 1985 | 5,165 | 3.0 | 3.0% | 160,114 | 3.3 | 3.3% | 310,633 | 3.0 | 3.0% | 3,617,690 | 2.7 | 2.7% |
| 1986 | 5,337 | 3.3 | 3.0 | 168,769 | 4.2 | 3.5 | 323,550 | 4.2 | 3.2 | 3,728,942 | 3.1 | 2.8 |
| 1987 | 5,503 | 3.1 | 3.0 | 170,931 | 2.5 | 3.3 | 329,553 | 1.9 | 3.0 | 3,789,297 | 1.6 | 2.6 |
| 1988 | 5,743 | 4.4 | 3.2 | 177,437 | 3.8 | 3.4 | 339,403 | 3.0 | 3.0 | 3,898,086 | 2.9 | 2.6 |
| 1989 | 5,783 | 0.7 | 2.9 | 180,087 | 1.5 | 3.2 | 345,236 | 1.7 | 2.8 | 3,994,634 | 2.5 | 2.6 |
| 1990 | 5,823 | 0.7 | 2.7 | 183,455 | 1.9 | 3.0 | 349,724 | 1.3 | 2.7 | 4,051,715 | 1.4 | 2.5 |
| 1991 | 5,659 | (2.8) | 2.2 | 180,957 | (1.4) | 2.6 | 344,748 | (1.4) | 2.3 | 4,036,505 | (0.4) | 2.2 |
| 1992 | 5,773 | 2.0 | 2.2 | 187,233 | 3.5 | 2.7 | 353,323 | 2.5 | 2.3 | 4,152,529 | 2.9 | 2.3 |
| 1993 | 5,856 | 1.4 | 2.1 | 185,450 | (1.0) | 2.4 | 355,902 | 0.7 | 2.2 | 4,256,884 | 2.5 | 2.3 |
| 1994 | 5,907 | 0.9 | 2.0 | 185,703 | 0.1 | 2.3 | 357,908 | 0.6 | 2.1 | 4,334,933 | 1.8 | 2.3 |
| 1995 | 5,997 | 1.5 | 2.0 | 186,796 | 0.6 | 2.1 | 362,220 | 1.2 | 2.0 | 4,438,159 | 2.4 | 2.3 |
| 2000 | 6,489 | 1.6 | 1.9 | 198,555 | 1.4 | 1.9 | 392,395 | 1.7 | 1.9 | 5,041,480 | 2.6 | 2.4 |
| 2005 | 7,045 | 1.7 | 1.8 | 214,061 | 1.5 | 1.8 | 429,073 | 1.8 | 1.9 | 5,733,093 | 2.6 | 2.4 |
| 2010 | 7,673 | 1.7 | 1.8 | 232,584 | 1.7 | 1.8 | 471,832 | 1.9 | 1.9 | 6,518,595 | 1.6 | 2.4 |
| 2015 | 8,387 | 1.8 | 1.8 | 254,599 | 1.8 | 1.8 | 521,641 | 2.0 | 1.9 | 7,411,153 | 2.6 | 2.5 |
| 2020 | 9,194 | 1.9 | 1.8 | 280,424 | 2.0 | 1.8 | 579,156 | 2.1 | 1.9 | 8,419,104 | 2.6 | 2.5 |

[1]Annual average compounded percentage change from previous year shown
[2]Annual average compounded percentage change from 1980

**Exhibit 7-12 Rockland County Historical and Projected Employment**

*Source: Woods & Poole Economics, Inc.*

| | | | | | | | | | Average Annual Compounded Percent Change | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Industry** | **1980** | **Percent of Total** | **1990** | **Percent of Total** | **1994** | **Percent of Total** | **2000** | **Percent of Total** | **1980–1994** | **1990–1994** | **1994–2000** |
| Farm | 0.1 | 0.1% | 0.1 | 0.0% | 0.1 | 0.0% | 0.1 | 0.0% | (3.3)% | 0.0% | 0.0% |
| Agriculture Services, Other | 0.6 | 0.6 | 0.8 | 0.6 | 0.8 | 0.6 | 0.8 | 0.6 | 1.6 | (0.7) | 0.4 |
| Mining | 0.4 | 0.4 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | (4.2) | (5.9) | 0.7 |
| Construction | 3.7 | 3.6 | 5.6 | 4.5 | 4.7 | 3.7 | 4.6 | 3.6 | 1.7 | (4.7) | (0.1) |
| Manufacturing | 16.4 | 15.9 | 15.3 | 12.1 | 14.6 | 11.5 | 14.4 | 11.2 | (0.8) | (1.2) | (0.2) |
| Trans., Comm. & Public Utils. | 4.1 | 4.0 | 5.9 | 4.7 | 6.6 | 5.2 | 6.6 | 5.1 | 3.5 | 2.7 | 0.0 |
| Total Trade | 22.2 | 21.6 | 25.7 | 20.3 | 24.5 | 19.3 | 24.4 | 19.0 | 0.7 | (1.1) | (0.1) |
| Wholesale Trade | 4.9 | 4.8 | 7.1 | 5.6 | 6.6 | 5.2 | 7.4 | 5.8 | 2.2 | (1.8) | 1.9 |
| Retail Trade | 17.3 | 16.8 | 18.6 | 14.7 | 17.9 | 14.1 | 17.0 | 13.3 | 0.3 | (0.9) | (0.9) |
| Finance, Insurance & Real Estate | 7.2 | 7.0 | 11.0 | 8.7 | 11.1 | 8.7 | 11.6 | 9.0 | 3.2 | 0.1 | 0.8 |
| Services | 26.8 | 26.1 | 39.5 | 31.3 | 43.9 | 34.4 | 44.6 | 34.7 | 3.6 | 2.7 | 0.3 |
| Total Government | 21.4 | 20.9 | 22.1 | 17.5 | 21.1 | 16.6 | 21.2 | 16.5 | (0.1) | (1.1) | 0.0 |
| Federal Civilian Govt. | 0.8 | 0.8 | 1.0 | 0.8 | 0.9 | 0.7 | 0.9 | 0.7 | 0.8 | (3.6) | (0.2) |
| Federal Military Govt. | 0.8 | 0.7 | 0.8 | 0.7 | 0.8 | 0.6 | 0.8 | 0.6 | 0.3 | (1.5) | 0.0 |
| State & Local Govt. | 19.9 | 19.3 | 20.2 | 16.0 | 19.5 | 15.3 | 19.5 | 15.2 | (0.1) | (1.0) | 0.0 |
| TOTAL | 102.7 | 100.0% | 126.3 | 100.0% | 127.5 | 100.0% | 128.4 | 100.0% | 1.6% | 0.2% | 0.1% |

**Exhibit 7-13 Rockland County Dwelling Units Authorized by Building Permit**

*Source: Rockland County Economic Development Authority*

| | Single Family | | Multi-Family | | Total | |
|---|---|---|---|---|---|---|
| Year | Number of Units | Percent Change | Number of Units | Percent Change | Number of Units | Percent Change |
| 1985 | 529 | — | 1,144 | — | 1,673 | — |
| 1986 | 508 | (4.0)% | 972 | (15.0)% | 1,480 | (11.5)% |
| 1987 | 467 | (8.1) | 875 | (10.0) | 1,342 | (9.3) |
| 1988 | 475 | 1.7 | 770 | (12.0) | 1,245 | (7.2) |
| 1989 | 502 | 5.7 | 768 | (0.3) | 1,270 | 2.0 |
| 1990 | 460 | (8.4) | 624 | (18.8) | 1,084 | (14.6) |
| 1991 | 367 | (20.2) | 525 | (15.9) | 892 | (17.7) |
| 1992 | 287 | (21.8) | 492 | (6.3) | 779 | (12.7) |
| 1993 | 285 | (0.7) | 497 | 1.0 | 782 | 0.4 |
| 1994 | 302 | 6.0 | 510 | 2.6 | 812 | 3.8 |
| 1995 | 325 | 7.6 | 535 | 4.9 | 860 | 5.9 |
| Average Annual percent Change 1985–1995 | | (4.8)% | | (7.3)% | | (6.4)% |
| Proj. 1996–2000 annual increases | 330 | — | 545 | — | 875 | — |

**Exhibit 7-14**
**Total Rockland County Nonresidential Property Assessment**

*Source: Rockland County Assessment Department*

| Year | Assessed Value in 1995 Dollars | Percent Change |
|---|---|---|
| 1985 | $1,105,000 | — |
| 1986 | 1,116,000 | 1.0% |
| 1987 | 1,149,000 | 3.0 |
| 1988 | 1,195,000 | 4.0 |
| 1989 | 1,208,000 | 1.1 |
| 1990 | 1,198,000 | (0.8) |
| 1991 | 1,164,000 | (2.8) |
| 1992 | 1,102,000 | (5.3) |
| 1993 | 1,057,000 | (4.1) |
| 1994 | 1,105,000 | 4.5 |
| 1995 | 1,207,000 | 9.2 |
| Avg. Annual percent Change 1985–1995 | | 0.9% |

decline after adjustment for inflation from factors such as new construction.

Between 1985 and 1995, Rockland County's nonresidential tax base increased a total of 9 percent, or an average annual compound increase of 0.9 percent per year after adjustment for inflation. After consistent increases through the mid- to late 1970s, the assessed value of nonresidential real estate declined in each year between 1990 and 1993, owing to the adverse impact of the recession. In 1994 and 1995, strong increases in the assessed value of nonresidential real estate were noted. Projections suggest a continuation of the recovery, and construction employment in Rockland County is expected to increase at an average annual compounded rate of 0.7 percent between 1994 and 2000. This moderate growth should result in some increases in lodging demand.

### Manufacturing

Employment in Rockland County's manufacturing firms declined at an average annual compounded rate of 4.2 percent between 1970 and 1994, and a more severe drop of 5.9 percent annually occurred from 1990 to 1994. According to information provided by the Chamber of Commerce, there were more than 100 manufacturing plants in Rockland County in 1994 and these plants shipped products worth more than $1.2 billion out of the area, representing an approximate 9 percent increase from 1977. Rockland represents slightly more than 4 percent of total manufacturing production in the New York metropolitan area. Between 1972 and 1994, two manufacturing plants terminated operations in Rockland County. A total of 407 major manufacturing plants closed in the New York metropolitan area during this ten-year period. Projections indicate a further decline of 0.1 percent per year in manufacturing employment in Rockland County between 1994 and 2000.

Rockland County's manufacturing base is relatively diversified, although pharmaceutical and cosmetics firms show some prominence. This diversification is beneficial, and helps to offset declines in any one industry. Exhibit 7-15 lists the major manufacturing firms in Rockland County.

**Exhibit 7-15**
**Major Manufacturing Firms—Rockland County**
*Source: Rockland County Chamber of Commerce*

| Firm | Product | Number of Employees |
|---|---|---|
| Lederle Laboratories | Pharmaceuticals | 3,600 |
| Avon Products, Inc. | Cosmetics | 1,200 |
| Chromalloy Corp. | Metals | 650 |
| BSR | Electronics | 600 |
| Ciba-Geigy | Pharmaceuticals | 500 |
| Materials Research | Plastics | 460 |
| RCA | Electronics | 350 |

The division of manufacturing employment between the production of durable and nondurable goods can also have an impact on an area's stability; during periods of economic downturn, durable goods manufacturers tend to suffer more than firms engaged in the production of nondurable goods. According to the New York State Department of Labor, approximately 60 percent of Rockland County's manufacturing employees are involved in the production of nondurable goods.

A 1994 survey, conducted by the Private Industry Council of Rockland County, found that 35 percent of local manufacturing firms anticipated an increase in their number of employees, and 22 percent had plans for plant expansions. New manufacturing capacity, particularly in high technology industries, often has a favorable impact on local hotels. Manufacturing firms tend to attract visitors such as superintendents, auditors, and salespeople; high-technology manufacturers also attract engineers and consultants who are likely to need lodging accommodations.

It is important to consider the subject property's distance from the county's manufacturing firms. Although most out-of-town visitors are willing to travel a reasonable distance from their hotel to their final destination, a twenty-minute drive is usually the maximum limit. The subject site's central location adjacent to the New York State Thruway enhances its ability to attract demand generated by the county's manufacturing firms. A survey of local manufacturers shows that more than 90 percent are located within a twenty-minute drive of the subject site.

### Transportation, Communications, and Public Utilities

In 1994, the transportation, communications, and public utilities sector represented a minor portion of the Rockland County employment base; most of these employees work for either postal services or telephone companies. Between 1970 and 1994, employment in this sector increased at an average annual compounded rate of 3.5 percent. Firms in this sector have a mixed propensity to generate hotel demand. Communications firms and utilities are not highly labor intensive and are unlikely to produce significant lodging demand. Projections indicate that TCPU employment will remain flat between 1994 and 2000.

### Wholesale and Retail Trade

In 1994, trade was the second largest sector in the Rockland County economy. Retail trade contributed approximately 75 percent of this sector's employment, and the remaining 25 percent represented wholesale activity. Firms engaged in trade (and wholesale trade in particular) often generate considerable hotel demand. Rockland County's trade sector is well diversified, and no particular industry exhibits a dominance in terms of employment.

The trade sector's prominent position in the local economy is attributable to Rockland County's role as a regional market for the tri-state area formed by New York, Pennsylvania, and New Jersey. The well-established transportation network and the presence of a number of industrial parks and distribution centers further enhance the dominance of the trade sector.

Between 1970 and 1994, trade employment in Rockland County increased at an average annual compounded rate of 0.7 percent; largely as a result of the national recession, a 1.1 percent decline was registered between 1990 and 1994. No real growth is projected through the remainder of the decade.

### Finance, Insurance, and Real Estate (FIRE)

The finance, insurance, and real estate sector occupies a strategic position with respect to the control of investment capital, property transfers, and the provision of insurance. The professional firms operating in this sector often generate a considerable amount of commercial hotel demand. Despite flat growth from 1990 to 1994, Rockland County's FIRE sector enjoyed one of highest employment growth rates from 1970 to 1994; projections indicate a moderate increase of 0.7 percent annually between 1994 and 2000. Because FIRE employment is highly correlated to hotel demand, this increase should have a favorable impact on the local lodging industry.

### Services

The services industry is the largest employment sector in Rockland County, and health care contributes a significant share of this category. Between 1970 and 1994, services sector employment increased at a strong 3.6 percent average annual compounded rate.

A strong services sector is generally a favorable indicator of lodging demand. Firms engaged in service-related activities tend to attract out-of-town visitors who must use local lodging facilities. In addition, many service firms are relatively immune to fluctuations in the national economy, and thus provide a stabilizing influence. Between 1994 and 2000, services employment in Rockland County is expected to increase at an average annual compounded rate of 0.3 percent, which is considerably lower than the gains registered historically.

### Government

Employing more than 21,000 people, government was the third-largest employment sector in Rockland County in 1994. This category includes employees of local municipalities and state, regional, and federal agencies. Between 1970 and 1994, government employment in Rockland County declined at an average annual compounded rate of 0.1 percent, with more rapid declines registered between 1990 and 1994. Projections indicate no real growth between 1994 and 2000.

Although the government sector generates significant hotel demand, which has a favorable impact on local lodging facilities, much of this business is tied to a governmental per diem that is lower than the prevailing rates charged by moderate-rate and first-class lodging facilities. Although this rate-sensitivity characteristic may limit the number of government employees accommodated by the subject property, this type of demand does contribute room nights in lower-rated facilities, and thus serves to increase the area's overall occupancy level.

### Major Businesses and Industries

An analysis of the market's major businesses and industries can provide an indication of the potential for commercial hotel demand. For example, more visitors are attracted by national firms than by local companies serving nearby areas. Labor-intensive businesses and financial activities are more likely to generate hotel demand than are highly mechanized firms that employ few people.

The major employers in Rockland County represent a cross-section of hotel demand potential. Some are national in scope, while others operate on a more local basis; some are engaged in product manufacturing, and others are active in research and development. Although this diversification may not maximize the area's hotel demand, it does tend to stabilize the local economy during its various cycles. Exhibit 7-16 outlines some of the major employers in Rockland County.

Most of Rockland County's major employers operate from office and industrial parks situated along the New York State Thruway. All are within a twenty-minute drive of the subject property and can be considered primary demand generators.

### Office Space

Trends in occupied office space are among the most reliable indicators of lodging demand; firms that occupy office space often exhibit a strong propensity to attract commercial visitors. Although it is difficult to quantify hotel demand on the basis of the amount of occupied office space, trends that cause changes in the amount of occupied office space or office space vacancy rates may have a proportional impact on commercial lodging demand and a less direct effect on meeting demand.

**Exhibit 7-16**
**Major Employers in Rockland County**
*Source: Rockland County Chamber of Commerce*

| Firm | Product | Number of Employees |
|---|---|---|
| Lederle Laboratories | Pharmaceuticals | 3,600 |
| Avon Products, Inc. | Cosmetics | 1,200 |
| Chromalloy Corp. | Metals | 650 |
| BSR | Electronics | 600 |
| Lamon Geological | Geological Research | 600 |
| Ciba-Geigy | Pharmaceuticals | 500 |
| Swivelieri Co. | Light Fixtures | 500 |
| Le Croy | Electronics | 475 |
| Materials Research | Plastics | 460 |
| Grant Hardware Co. | Hardware | 450 |
| St. Regis Paper | Research | 450 |
| Federal Paper | Cartons | 425 |
| Prentice Hall | Publishing | 425 |
| Xerox | Research | 400 |
| IBM | Research | 400 |
| Chrysler Motors | Automobiles | 390 |
| RCA | Electronics | 350 |

Office space in Rockland County is concentrated in several office parks located along the New York State Thruway in Nyack, Spring Valley, and Suffern. Some additional office developments are located in the downtown districts of these areas. Most of the companies occupying office space in Rockland County are local firms or branch offices of national organizations. The area's largest office parks are summarized as follows:

*Nyack Office Center:*

Location: Exit 11, N.Y.S. Thruway, Nyack, New York

Size: 500 acres

Number of Firms: 250

Occupied Office Space: 2,145,400 square feet

Total Office Space: 2,524,500 square feet

Vacancy Rate: 15 percent

Major Tenants: Avon Products, Inc., Ciba-Geigy, Lederle Laboratories, U.S. Polychemical

Comments: This office park, situated approximately two miles east of the subject property, is considered the top corporate location in Rockland County. Approximately 75 percent of the available land is currently utilized and park owners expect occupied office space to increase at a rate of 2 percent to 3 percent annually.

*Eastwood Office Park:*

Location: Exit 14A, N.Y.S. Thruway, Spring Valley, New York

Size: 300 acres

Number of Firms: 125

Occupied Office Space: 752,300 square feet

Total Office Space: 947,000 square feet

Vacancy Rate: 10 percent

Major Tenants: Chromalloy American Corp., Materials Research, BSR

Comments: This office park typically attracts research-oriented companies. It is the largest concentration of office space closest to the subject property, which benefits directly from the transient commercial and meeting demand generated by the tenants. Approximately 60 percent of the Eastwood Office Park is currently developed, and the owners expect the amount of occupied office space to increase at an annual rate of 2 percent to 3 percent.

*Suffern Corporate Center:*

Location: Exit 14, N.Y.S. Thruway, Suffern, New York

Size: 600 acres

Number of Firms: 73

Occupied Office Space: 367,700 square feet

Total Office Space: 461,000 square feet

Vacancy Rate: 20 percent

Major Tenants: Chrysler Motors, World-Wide Volkswagen

Comments: This new office park, situated approximately twelve miles west of the subject property, opened in 1973. It is currently 25 percent developed, primarily with manufacturing firms. Future growth expectations for this area are 1 percent to 2 percent annually.

The Rockland County Real Estate Board maintains an inventory of occupied and available office space in the county. Exhibit 7-17 summarizes this information.

Between 1975 and 1995, available office space in Rockland County increased from approximately 6,545,000 to 7,735,000 square feet, which yields an average annual compounded growth rate of 1.7 percent. During the same period, occupied office space increased from 5,745,000 to 6,637,000 square feet, or 1.3 percent compounded annually. As growth in supply outstripped the pace of absorption, the vacancy

**Exhibit 7-17 Inventory of Rockland County Office Space in Square Feet**

*Source: Rockland County Real Estate Board*

| Year | Available Space | Percent Change | Occupied Space | Percent Change | Vacancy Rate |
|---|---|---|---|---|---|
| 1985 | 6,545,000 | — | 5,845,000 | — | 10.7% |
| 1986 | 6,617,000 | 1.1% | 6,200,000 | 6.1% | 6.3 |
| 1987 | 6,637,000 | 0.3 | 6,278,000 | 1.3 | 5.4 |
| 1988 | 6,697,000 | 0.9 | 6,362,000 | 1.3 | 5.0 |
| 1989 | 7,234,000 | 8.0 | 6,398,000 | 0.6 | 11.6 |
| 1990 | 7,459,000 | 3.1 | 6,278,000 | (1.9) | 15.8 |
| 1991 | 7,601,000 | 1.9 | 6,123,000 | (2.5) | 19.4 |
| 1992 | 7,639,000 | 0.5 | 6,145,000 | 0.4 | 19.6 |
| 1993 | 7,635,000 | (0.1) | 6,232,000 | 1.4 | 18.4 |
| 1994 | 7,669,000 | 0.4 | 6,452,000 | 3.5 | 15.9 |
| 1995 | 7,735,000 | 0.9 | 6,637,000 | 2.9 | 14.2 |
| Avg. Annual percent Change 1985–1995 | | 1.7% | | 1.3% | |

rate increased from 10.7 percent in 1975 to 14.2 percent in 1995. Nevertheless, the most recent trends indicate that the pace of new supply additions has slowed dramatically, allowing market conditions to become more balanced. Vacancy rates reached nearly 20 percent in 1992 because of oversupply and recessionary influences. Despite somewhat unfavorable trends in the local office space market, the subject site occupies a strong location with respect to a number of local business concentrations. Furthermore, the fact that a significant portion of available office space exists suggests that there is capacity for further growth in the amount of occupied space.

### Highway Traffic

The subject site occupies a prominent location adjacent to the New York State Thruway and within several miles of the Garden State and Palisades Parkways. The amount of traffic passing through the market area has a direct impact on commercial and leisure demand and an indirect effect on meeting demand. Exhibit 7-18 illustrates annual traffic counts on the New York State Thruway at the Spring Valley toll plaza, on the Garden State Parkway at its intersection with the New York State Thruway, and on the Palisades Parkway at its intersection with the New York State Thruway.

Between 1974 and 1995, traffic on the New York State Thruway, the Garden State Parkway, and the Palisades Parkway increased at average annual compounded rates of 1.3 percent, 1.4 percent, and 1.6 percent, respectively. Much of the rising traffic volume can be attributed to an increase in commercial activity in the subject property's vicinity, a conclusion that is supported by the lower growth rates, and, in some cases, declines registered between 1979 and 1992, when the region was struggling through an economic recession. Traffic count trends at each location have generally been positive since 1992, though the gains have been considerably more modest than in prior years.

### Airport Traffic

Airport passenger counts are important indicators of lodging demand. Depending on the type of service provided by a particular airfield, a sizable percentage of arriving passengers may require hotel accommodations. Trends showing changes in passenger counts also reflect local business activity and the overall economic health of the area.

The subject property is situated approximately ten miles south of Stewart Airport, which is located in Newburgh, New York. This regional air facility is served by American and Delta Airlines, as well as

**Exhibit 7-18 Highway Traffic Counts**

*Source: New York State Department of Highways*

| Year | New York State Thruway[1] | Percent Change | Garden State Parkway[2] | Percent Change | Palisades Parkway[3] | Percent Change |
|---|---|---|---|---|---|---|
| 1984 | 12,566,764 | — | 6,153,928 | — | 5,431,492 | — |
| 1985 | 12,943,767 | 3.0% | 6,369,315 | 3.5% | 5,632,457 | 3.7% |
| 1986 | 13,614,836 | 5.2 | 6,604,980 | 3.7 | 5,846,490 | 3.8 |
| 1987 | 13,522,145 | (0.7) | 6,803,129 | 3.0 | 6,056,964 | 3.6 |
| 1988 | 14,377,202 | 6.3 | 7,068,451 | 3.9 | 6,299,243 | 4.0 |
| 1989 | 14,528,352 | 1.1 | 7,153,254 | 1.2 | 6,342,102 | 0.7 |
| 1990 | 14,423,351 | (0.7) | 7,159,265 | 0.1 | 6,423,012 | 1.3 |
| 1991 | 14,395,230 | (0.2) | 7,002,341 | (2.2) | 6,397,123 | (0.4) |
| 1992 | 14,412,023 | 0.1 | 7,100,256 | 1.4 | 6,445,251 | 0.8 |
| 1993 | 14,385,178 | (0.2) | 7,209,356 | 1.4 | 6,445,251 | 0.8 |
| 1994 | 14,525,108 | 1.0 | 7,211,369 | 0.0 | 6,428,798 | 0.5 |
| 1995 | 14,528,397 | 0.0 | 7,205,446 | (0.1) | 6,439,555 | 0.2 |
| Avg. Annual percent Change 1984–1995 | | 1.3% | | 1.4% | | 1.6% |

[1]Spring Valley toll plaza
[2]Intersection of Garden State Parkway and New York State Thruway
[3]Intersection of Palisades Parkway and New York State Thruway

several commuter carriers. The popularity of Stewart Airport has increased in recent years as businesses have relocated to Rockland and Putnam Counties and the New York City airports have grown more congested.

Most of the passengers arriving at Stewart Airport are commercial travelers visiting firms in Rockland and Putnam Counties. Local agencies report that airport car rentals average approximately three days, and it is reasonable to conclude that many of the arriving passengers who rent automobiles also stay in area hotels. Exhibit 7-19 shows historical and projected air passenger enplanements at Stewart Airport; cargo tonnage statistics are also presented because they provide a useful indication of manufacturing trends.

Although the actual amount of cargo shipped from Stewart Airport is small, the strong historical and projected growth rates are a favorable trend. Similarly, although the increases in enplanements are auspicious and provide some benefit to local lodging facilities, the overall impact on the area's hotel demand is minimized by the small number of passengers actually using Stewart Airport.

**Rockland County Convention and Exhibition Center**

Meeting and convention visitation took on greater significance in the local economy with the 1974 opening of the Rockland County Convention and Exhibition Center. This county-operated facility is located in downtown Suffern, approximately eight miles west of the subject property, and currently offers a 50,000-square-foot exhibition hall that can accommodate groups of 5,000 to 7,500 people. Fifteen additional meeting rooms seat between 25 and 500 people each.

Most of the functions presently held at the Rockland County Convention and Exhibition Center consist of retail trade shows and entertainment and sporting events. Although these activities do not generate significant lodging demand, the facility typically draws 40 to 50 meetings annually that do contribute room nights to area hotels. Exhibit 7-20 outlines the attendance figures and the number of conventions held at the Rockland County Convention and Exhibition Center since its opening.

**Exhibit 7-19 Stewart Airport Statistics**

*Source: Stewart Airport Authority*

| Year | Passenger Emplanement | Percent Change[1] | Percent Change[2] | Cargo Tons | Percent Change[1] | Percent Change[2] |
|---|---|---|---|---|---|---|
| 1978 | 197,105 | — | — | 53,120 | — | — |
| 1983 | 245,628 | 4.5% | 4.5% | 67,796 | 5.0% | 5.0% |
| 1988 | 297,423 | 3.9 | 4.2 | 88,189 | 5.4 | 5.2 |
| 1992 | 372,420 | 5.8 | 4.6 | 117,171 | 7.4 | 5.8 |
| 1995 | 388,876 | 1.5 | 4.1 | 133,288 | 4.4 | 5.6 |
| 1998 | 475,321 | 4.1 | 4.5 | 149,217 | 4.1 | 5.3 |
| 2003 | 609,546 | 5.1 | 4.6 | 194,099 | 5.4 | 5.3 |

[1]Annual average compounded percentage change from previous year
[2]Annual average compounded percentage change from 1978

Note: 1988 and 2003 projections provided by the Federal Aviation Administration

**Exhibit 7-20**
**Rockland County Convention and Exhibition Center Conventions Requiring Overnight Accommodations**

*Source: Rockland County Convention Bureau*

| Year | Number of Conventions | Percent Change | Number of Delegates | Percent Change |
|---|---|---|---|---|
| 1984 | 14 | — | 7,000 | — |
| 1985 | 22 | 57.1% | 12,100 | 72.9% |
| 1986 | 36 | 63.6 | 20,700 | 71.1 |
| 1987 | 30 | (16.7) | 18,000 | (13.0) |
| 1988 | 41 | 36.7 | 25,825 | 43.5 |
| 1989 | 45 | 9.8 | 29,250 | 13.3 |
| 1990 | 46 | 2.2 | 29,623 | 1.3 |
| 1991 | 49 | 6.5 | 31,875 | 7.6 |
| 1992 | 51 | 4.1 | 33,071 | 3.8 |
| 1993 | 49 | (3.9) | 32,456 | (1.9) |
| 1994 | 47 | (4.1) | 32,799 | 1.1 |
| 1995 | 58 | 23.4 | 43,799 | 33.5 |
| Avg. Annual percent Change 1984–1995 | | 13.8% | | 18.1% |

In 1993 and 1994, the Center underwent a complete renovation and expansion, designed to allow the facility to attract larger and more upscale meetings and conventions. As a result of disruptions related to this project, convention statistics declined durimg those two years. However, with the completion of the project, the center's visitation increased substantially in 1995, as the number of conventions and attending delegates each reached record highs. The center now features 75,000 square feet of space; it can now host groups of 7,500 to 10,000 people. An additional ten meeting rooms seating between 50 and 250 people provide ample breakout space. The entire facility has been upgraded with state-of-the art convention and conference amenities. Continued growth is projected through the near term as awareness of the facility's expansion grows.

### Leisure Travel

More than 35 percent of the land in Rockland County is reserved for recreational use; thus, trends in leisure travel are key indicators of the area's lodging demand. Leisure demand is extremely beneficial to hotels because these travelers often seek accommodations on weekends, holidays, and during the summer months, when commercial demand is low. This additional patronage helps to smooth operational peaks and valleys, allowing for increased efficiency and higher profits. The New York State Department of Tourism compiles data on out-of-state tourist visitation. Exhibit 7-21 outlines these trends.

Although Rockland County receives far less tourism than the metropolitan area and New York State as a whole, these travelers do represent potential demand for local lodging facilities. The exhibit shows moderate historical increases over the long term, with some fluctuations attributed to the recent recession. On a monthly basis, Rockland County tourism activity undergoes normal seasonal peaks and valleys. Exhibit 7-22 illustrates these cycles.

**Exhibit 7-21 Out-of-State Tourist Visitation (in millions)**

*Source: New York State Department of Tourism*

| Year | Rockland County | Percent Change | Metro New York | Percent Change | New York State | Percent Change |
|---|---|---|---|---|---|---|
| 1984 | 1.5 | — | 15.2 | — | 25.8 | — |
| 1985 | 1.5 | 0.0% | 17.5 | 15.1% | 28.2 | 9.3% |
| 1986 | 1.6 | 6.7 | 17.1 | (2.3) | 28.8 | 2.1 |
| 1987 | 1.7 | 6.3 | 17.0 | (0.6) | 29.1 | 1.0 |
| 1988 | 1.7 | 0.0 | 16.9 | (0.6) | 29.6 | 1.7 |
| 1989 | 1.8 | 5.9 | 17.1 | 1.2 | 31.2 | 5.4 |
| 1990 | 1.8 | 0.0 | 17.1 | 0.0 | 31.1 | (0.3) |
| 1991 | 1.7 | (5.6) | 17.0 | (0.6) | 30.6 | (1.6) |
| 1992 | 1.7 | 0.0 | 16.9 | (0.6) | 30.5 | (0.3) |
| 1993 | 1.6 | (5.9) | 16.8 | (0.6) | 30.1 | (1.3) |
| 1994 | 1.8 | 12.5 | 17.0 | 1.2 | 30.7 | 2.0 |
| 1995 | 1.9 | 5.6 | 17.5 | 2.9 | 30.9 | 0.7 |
| Avg. Annual percent Change 1984–1995 | | 2.2% | | 1.3% | | 1.7% |

**Exhibit 7-22**
**Rockland County Visitation by Month**

*Source: New York State Board of Tourism*

| Month | Percent of Annual Total |
|---|---|
| January | 7% |
| February | 8 |
| March | 4 |
| April | 3 |
| May | 3 |
| June | 12 |
| July | 15 |
| August | 15 |
| September | 11 |
| October | 12 |
| November | 4 |
| December | 6 |

Approximately 42 percent of Rockland County's leisure demand occurs during the months of June, July, and August. As a result of the region's natural beauty during the fall foliage season, weekend demand is also strong in September and October. Skiers and other winter sports enthusiasts often generate weekend hotel demand in January and February. The summer months and fall and winter weekends are slow periods for commercial visitation; the leisure demand base therefore has a stabilizing effect on the market.

The point of origin of leisure travelers influences the demand for local lodging facilities; markets that draw vacationers from distant areas enjoy stronger hotel demand and longer lengths of stay than those that attract a more local clientele. According to information provided by the New York State Tourism Commission, the five states that provide the greatest amount of leisure demand in Rockland County are New York, Pennsylvania, Massachusetts, New Jersey, and Connecticut. Because all of these states are relatively close to Rockland County, much of this visitation is likely to consist of one- or two-day stays, which may benefit local hotels to some degree.

### Tourist Attractions

The following descriptions of the area's tourist attractions show the variety of activities that draw leisure travelers to Rockland County, either as a destination or as a stopping point on a longer journey. By virtue of the area's well-developed highway system, numerous travelers pass through Rockland County bound for destinations outside of the subject property's market area; some of these individuals use local lodging facilities.

*Palisades Interstate Park System.* The Palisades Interstate Park System consists of eleven recreational areas. These parks provide more than 6,000 acres of land for a variety of recreational uses, including golf courses, tennis courts and water sports, as well as scenic spots for picnicking or hiking.

*U.S. Military Academy.* This nationally known, time-honored institution, located approximately fifteen miles north of Spring Valley in West Point, New York, is among the area's most popular tourist attractions. West Point offers a variety of visitor activities: the Information Center features films and displays on cadet training, the West Point Museum has exhibits on military history and ordinance, and nearby Fort Putnam is a fully restored Revolutionary War fortification. Visitor counts at the West Point Information Center show moderate historical growth. As Exhibit 7-23 indicates, the recent recession affected visitation during the early 1990s.

**Exhibit 7-23**
**West Point Visitor Trends**
*Source: West Point Information Center*

| Year | Number of Visitors | Percent Change |
|---|---|---|
| 1985 | 232,793 | —% |
| 1986 | 242,338 | 4.1 |
| 1987 | 237,249 | (2.1) |
| 1988 | 244,366 | 3.0 |
| 1989 | 246,890 | 1.0 |
| 1990 | 253,852 | 2.8 |
| 1991 | 248,325 | (2.2) |
| 1992 | 241,230 | (2.9) |
| 1993 | 240,339 | (0.4) |
| 1994 | 249,782 | 3.9 |
| 1995 | 250,856 | 0.4 |
| Avg. Annual percent change 1985–1995 | | 0.8% |

Between 1975 and 1995, visitation to West Point increased at an average annual compounded rate of 0.7 percent. Although the absolute visitor count has some importance in evaluating local hotel demand, the average annual compounded increase provides a solid benchmark for projecting growth in the leisure market segment. Discussions with West Point officials indicate that they expect future increases that are similar to those registered historically. It should be noted that 75 percent of West Point visitation is concentrated in the months of June, July, and August. The remaining 25 percent is largely contributed by weekend guests or individuals attending special events at the Academy.

*Sunnyside.* Washington Irving's Hudson River estate is in Tarrytown, approximately eight miles east of the subject property. This beautifully landscaped estate, which was constructed in 1735, contains Irving's furnishings, personal effects, and library.

*Philipsburg Manor.* Situated in North Tarrytown, Philipsburg Manor is a restored seventeenth-century manor house that features an operating gristmill, a granary, a wharf, and a wooden dam across a local river.

*Old Dutch Church of Sleepy Hollow.* This quaint Dutch church was built in Tarrytown in 1690 on what had been the manor of Frederick Philipse. The building is fully restored, and includes a replica of the original pulpit.

*Stony Point Battlefield and Museum.* This restoration of the historic Stony Point Battlefield is located approximately eight miles north of the subject property. The park features a number of cannons and bunkers, as well as a museum displaying an extensive collection of firearms from the Revolutionary War.

*Nyack's "antique row."* Nyack, eight miles east of Spring Valley, is a popular destination for antiques enthusiasts.

Our review of various economic and demographic data indicates that the subject property's market area has undergone moderate growth since 1970, although the national and regional recession caused some declines during the early 1990s. Projections suggest an economic recovery, although growth rates are not expected to reach the levels registered during the 1970s.

### Summary of Market Conditions

Demand for transient accommodations in the Rockland County area is primarily generated by three market segments: commercial, meeting and convention, and leisure (see Exhibit 7-24). Fieldwork, area analysis, and knowledge of the local lodging market allow the following estimate of the distribution of the accommodated hotel roomnight demand during 1995 to be made.

Using the distribution of accommodated hotel demand as a starting point, an analysis of each market segment follows that defines the various segment characteristics and presents an estimate of future trends in room-night demand. All figures in the exhibits that follow that include dollar amounts have been adjusted for inflation, and thus reflect real change.

**Exhibit 7-24**
**Market Demand Segmentation**

| Segment | Room-Nights | Percent of Total |
|---|---|---|
| Commercial | 45 | 45.0% |
| Meeting & Convention | 25 | 25.0 |
| Leisure | 20 | 20 |
| Airline | 10 | 10.0 |
| Totals | 100 | 100.0% |

### Commercial Market Demand

In the market surrounding the proposed subject property, the commercial segment consists primarily of individual business people visiting local firms. In addition, a smaller portion of commercial demand represents business travelers passing through the area en route to another destination who stop at local highway-oriented lodging facilities because they provide a convenient resting point.

Commercial demand in the subject market is generated by a wide variety of corporations, with the computer industry and other high-technology employers exhibiting some dominance. This high-technology environment is considered favorable, because these industries are likely to undergo strong growth over the long term. Large firms operating in the area include IBM; Xerox; Lederle Laboratories; Avon Products, Inc.; Chromalloy American Corp.; BSR; Lamon Geological; Ciba-Geigy; Materials Research; and Prentice Hall. Individuals visiting smaller local companies also contribute a significant portion of the area's hotel demand. In addition, business travelers passing through Spring Valley en route to other destinations may stop at local lodging facilities because they provide a convenient resting point along the area's major highways.

The recent recession had a negative impact on commercial demand throughout the United States, and the northeastern region was particularly vulnerable. A number of local firms have undergone cutbacks during the past several years, and layoffs at IBM were particularly well publicized. Despite the lingering effects of the economic downturn, some experts are beginning to note signs of recovery. Our projections reflect an economic rebound during the next several years, although growth rates are not expected to return to the levels achieved during the mid-1970s.

To reach a specific forecast of commercial demand growth, the data that most clearly reflects changes in commercial visitation has been evaluated. The data listed in Exhibit 7-25 is relevant in forecasting future trends in commercial visitation.

Projections indicate renewed growth trends, but at lower levels than those experienced during the 1970s. Between 1994 and 2000, population is expected to increase at an annual rate of only 0.1 percent. Employment in wholesale trade, FIRE, and services sectors are projected to grow at 1.9 percent, 0.7 percent, and 0.3 percent per year, which is somewhat slower than the previous decade. Office space absorption is still positive, and airport passenger enplanements are expected to increase at 6.9 percent per year between 1995 and 1997.

On the basis of this economic and demographic data, one can estimate that commercial hotel demand in the Spring Valley market probably grew at rates of 5 percent to 6 percent per year during the 1970s. A multiplier effect can generally be found between employment growth in the important sectors set forth and the actual percentage increase in commercial lodging demand (i.e. one new FIRE employee will generate more than one new transient visitor). With the recent slow-down in local economic growth, a concurrent reduction in the increase of commercial hotel demand can be anticipated. However, as the national and international economy recovers and the many prominent local businesses start to increase their levels of production and employment, commercial hotel demand can be expected to demonstrate consistent, if modest, growth. Specifically, projections indicate that the commercial segment will increase by 2.5 percent per year through 1998.

### Meeting and Convention Market Demand

Most meeting and convention demand in Rockland County is generated by local businesses; events may include training sessions, small exhibits, product announcements, meetings, and seminars. These small functions generally range from twenty to fifty people. Civic groups and professional societies are a secondary source of meeting and convention demand; attendance at these non-commercial events usually ranges from 75 to 250 people. Most meetings and conventions in the subject property's market area are held at local hotels; large groups that require more space generally use the Rockland County Convention and Exhibition Center.

**Exhibit 7-25 Commercial Visitation Data for Rockland County**

| Data Type | Period | Data Point | Data Point | Avg. Annual Comp. Change |
|---|---|---|---|---|
| Population | | | | |
| Historical | 1980–1994 | 259.6 | 272.4 | 0.3% |
| | 1990–1994 | 265.9 | 272.4 | 0.6 |
| Projected | 1994–2000 | 272.4 | 274.7 | 0.1 |
| Retail Sales | | | | |
| Historical | 1980–1994 | 1,394.7 | 1,534.8 | 0.7 |
| | 1990–1994 | 1,569.5 | 1,534.8 | (0.6) |
| Projected | 1994–2000 | 1,534.8 | 1,774.1 | 2.4 |
| Personal Income | | | | |
| Historical | 1980–1994 | 4,461.8 | 5,907.2 | 2.0 |
| | 1990–1994 | 5,823.2 | 5,907.2 | 0.4 |
| Projected | 1994–2000 | 5,907.2 | 6,489.5 | 1.6 |
| Personal Income Per Capita | | | | |
| Historical | 1980–1994 | 17,188.0 | 21,687.0 | 1.7 |
| | 1990–1994 | 21,898.0 | 21,687.0 | 0.4 |
| Projected | 1994–2000 | 21,687.0 | 23,625.0 | |
| Historical Employment | | | | |
| Construction | 1980–1994 | 3.7 | 4.7 | 1.7 |
| Manufacturing | 1980–1994 | 16.4 | 14.6 | (0.8) |
| Transportation, Communications & Public Utilities | 1980–1994 | 4.1 | 6.6 | 3.5 |
| Total Trade | 1980–1994 | 22.2 | 24.5 | 0.7 |
| Wholesale Trade | 1980–1994 | 4.9 | 6.6 | 2.2 |
| Retail Trade | 1980–1994 | 17.3 | 17.9 | 0.3 |
| Finance, Insurance & Real Estate | 1980–1994 | 7.2 | 11.1 | 3.2 |
| Services | 1980–1994 | 26.8 | 43.9 | 3.6 |
| Total Government | 1980–1994 | 21.4 | 21.1 | (0.1) |
| Total Employment | 1980–1994 | 102.7 | 127.5 | 1.6 |
| Projected Employment | | | | |
| Construction | 1994–2000 | 4.7 | 4.6 | (0.1) |
| Manufacturing | 1994–2000 | 14.6 | 14.4 | (0.2) |
| Transportation, Communications & Public Utilities | 1994–2000 | 6.6 | 6.6 | 0.0 |
| Total Trade | 1994–2000 | 24.5 | 24.4 | (0.1) |
| Wholesale Trade | 1994–2000 | 6.6 | 7.4 | 1.9 |
| Retail Trade | 1994–2000 | 17.9 | 17.0 | (0.9) |
| Finance, Insurance & Real Estate | 1994–2000 | 11.1 | 11.6 | 0.8 |
| Services | 1994–2000 | 43.9 | 44.6 | 0.3 |
| Total Government | 1994–2000 | 21.1 | 21.2 | 0.0 |
| Total Employment | 1994–2000 | 102.7 | 127.5 | 1.6 |
| Office Space | | | | |
| Available | 1985–1995 | 6,545.0 | 7,735.0 | 1.7 |
| Occupied | 1985–1995 | 5,845.0 | 6,637.0 | 1.3 |
| Non-Residential Building Activity | 1985–1995 | 1,105.0 | 1,207.0 | 0.9 |
| Traffic Counts | | | | |
| New York State Thruway | 1984–1995 | 12,566.8 | 14,528.4 | 1.3 |
| Garden State Parkway | 1984–1995 | 6,153.9 | 7,205.4 | 1.4 |
| Palisades Parkway | 1984–1995 | 5,431.5 | 6,439.6 | 1.6 |

**Exhibit 7-25 Commercial Visitation Data for Rockland County (cont.)**

| Data Type | Period | Data Point | Data Point | Avg. Annual Comp. Change |
|---|---|---|---|---|
| Airport Statistics | | | | |
| Historical Passenger Emplanements | 1978–1995 | 197.1 | 388.9 | 4.1 |
| Projected Passenger Emplanements | 1995–1998 | 388.9 | 475.3 | 6.9 |
| Historical Air Freight | 1978–1995 | 53.1 | 133.3 | 5.6 |
| Projected Air Freight | 1995–1998 | 133.3 | 149.2 | 3.8 |

Future meeting and convention demand is closely related to growth in the commercial segment. Because most meetings have either a direct or an indirect business purpose, the economic considerations that have an impact on commercial travel also affect meeting and convention demand. The exception is non-commercial meetings, which are tied to the economic factors that influence leisure travel. It should be noted that meetings and conventions are booked in advance; consequently, growth in this segment lags slightly behind increases in commercial demand. The relevant economic and demographic data for the meeting and convention market segment includes all the data used in assessing the commercial segment (see Exhibit 7-25), plus the following additional information presented in Exhibit 7-26.

Local commercial activity is expected to show a modest, consistent gain during the next several years as the national and international economies improve and local businesses start to increase their levels of production and employment. These factors will also have a positive impact on business-oriented meetings and conventions, which constitute the bulk of the demand in this segment.

Specific meeting- and convention-related data involves the Rockland County Convention and Exhibition Center. According to officials of the Rockland County Convention Bureau, the recent sales and marketing efforts have been extremely positive, and a sizable amount of new hotel demand was accommodated in 1995 as a result of this facility's increased capacity.

Meeting and convention demand in the Rockland County area has historically grown at an annual compounded rate of between 1 percent to 2 percent. Because of the recent recession, this rate of growth has not been achieved during the past several years, but indications are good that future leisure demand in the area will once again pick up to this slow to moderate level of growth.

Given this economic and demographic data, along with consideration of the demand potential of the renovated and enlarged convention and exhibition center, it is fair to estimate that meeting and convention demand in the Spring Valley market area will increase by 4.0 percent in 1996, with the rate of growth decelerating to 3.0 percent in 1997 and 2.0 percent in 1997 and each year thereafter.

**Exhibit 7-26 Meeting and Convention Visitation Data—Rockland County**

| Data Type | Period | Data Point | Data Point | Avg. Annual Comp. Change |
|---|---|---|---|---|
| Convention Activity—Rockland County Convention & Exhibition Center | | | | |
| Convention Attendance | 1984–1995 | 7.0 | 43.8 | 18.1% |
| Number of Conventions | 1984–1995 | 14.0 | 58.0 | 13.8 |
| Tourist Visitation | | | | |
| Rockland County | 1984–1995 | 1,500.0 | 1,900.0 | 2.2 |
| West Point Visitation | 1985–1995 | 232.8 | 250.9 | 0.8 |

### Leisure Market Demand

In the area surrounding the subject property, leisure demand is generated by the many sites and attractions previously described in this study. The excellent highway system and the New York State Thruway in particular create demand from travelers en route to other destinations.

Future leisure demand is related to the overall economic health of the nation. Trends showing changes in state and regional unemployment and disposable personal income generally have a strong correlation with noncommercial visitation. Traffic counts on nearby highways and attendance levels at local attractions can also form a basis for projections.

As shown by the data set forth in Exhibit 7-27, trends in tourism provide the most supportable base from which to forecast growth in leisure demand. Traffic counts are of less importance, because they are influenced by commercial travel. Leisure visitation to Rockland County between 1974 to 1995 increased at an annual compounded rate of 2.2 percent, with a recent uptick noted following the years of recession in the early 1990s. The largest local tourist destination, West Point, has experienced a 0.7 percent annual visitor growth since 1974.

On the basis of this specific economic and demographic data for the Spring Valley market area, along with a general sense of the economic recovery taking place in the regional (northeastern) economy and the nation as a whole, leisure demand can be expected to show a moderate long-term growth trend. Specifically, leisure hotel demand can be projected to increase at annual rates of 1.0 percent throughout the projection period of this case study.

### Airline Market Demand

For purposes of this case study, a fourth demand segment has been identified as being distinct and significant in size. Airline demand is generated by airline crews and delayed passengers making use of nearby airport facilities. The airlines typically contract rooms in nearby hotels and motels for extended periods of time to ensure the availability of accommodations. Because they are able to guarantee a specific usage on a daily basis, airlines are usually able to negotiate a highly discounted room rate. This type of demand can be beneficial for a lodging facility because it provides a base level of occupancy for extended periods of time, which normally include weekends and slow periods of the year. Offsetting the occupancy benefit is the low contract room rates, which will adversely affect the average rate of the property. Skilled hotel operators will use airline patronage to fill in periods of low demand and will quickly displace this type of occupancy when other, higher-rated market segments offer better potential.

As Exhibit 7-19 showed, passenger enplanements at Stewart Airport increased at an average annual compounded rate of 4.1 percent between 1977 and 1995 and projections indicate slightly stronger growth of 6.9 percent per year between 1995 and 1997. Air freight levels historically increased at 5.6 percent per annum and is expected to grow at 3.7 percent per year during the next three years.

While these figures indicate a favorable trend for future airline activity at Stewart Airport, it must be noted that this facility is situated ten miles north of the Spring Valley hotel market area. As a result of this distance, airlines generally use the Spring Valley hotels as overflow for their crews favoring lodging facilities more conveniently located near Stewart Airport. For that reason, the Spring Valley overflow airport room-night demand can be expected to grow at 1.0 percent per year.

### Conclusion

Various economic and demographic data has been evaluated here to determine how clearly it reflects future changes in transient demand. On the basis of this procedure, and adding a degree of conservatism because the subject property as yet has no track record, the following forecast of market segment growth rates has been made (see Exhibit 7-27).

**Exhibit 7-27**
**Projected Market Segment Growth Rates**

| Segment | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Commercial | 2.5% | 2.5% | 2.5% | 2.5% | 2.5% |
| Meeting and Convention | 4.0 | 3.0 | 2.0 | 2.0 | 2.0 |
| Leisure | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |

CHAPTER 8

# Lodging Supply Analysis



## ¶ 8.01 INTRODUCTION

The lodging supply in a given market area is composed of every facility within that market area that caters to transient overnight visitors, including conference centers, bed and breakfast inns, and health spas as well as hotels, motels, and microtels. All of the transient lodging facilities that operate within one market area are competitive with each other to some degree, but for the purposes of a market study and appraisal, only those that qualify as primary and secondary competitors are evaluated.

An analysis of lodging supply begins with the identification of the market area, generally considered the area within twenty travel minutes of the subject property (see Chapter 7). The market area in which the subject property is located in terms of supply is sometimes larger than the market area as determined by demand. This occurs when demand generators are located close to the outer boundary of the subject property's normal demand market area (usually no farther than five to ten travel minutes beyond its perimeter). These peripheral demand generators may neighbor other lodging facilities that though out of the market area may be to some degree competitive with the subject property. For that reason they are considered part of the supply in the subject property's area.

The analysis continues with the identification of the primary and secondary competitors of the subject property, the number of rooms currently available in the market area, and the number of rooms of proposed projects in the area. Finally, the appraiser must determine the current rate structure of area lodging facilities, their historic occupancy levels, their market orientations, and the amenities that they offer. This information is generally gathered through interviews with competing lodging facilities in the subject area.

## ¶ 8.02 EVALUATION OF COMPETITION

Primary competition includes any lodging facility that attempts to attract the same transient visitors as does the subject property. Secondary competition generally consists of lodging facilities that attract the same transient visitors as the subject property, but under special circumstances.

The categorization of competitive facilities as primary or secondary depends, for the most part, on subjective judgments. The competitive environment of a market area can be evaluated either by investigating demand and determining the accommodations transient visitors actually select or by examining the local supply and determining the facilities that are similar in market orientation. Interviews with visitors can be helpful in analyzing the criteria that travelers use to select accommodations in the local marketplace, but an experienced appraiser can often evaluate similarities in the market orientation of competitive facilities simply by visiting each property and determining whether the criteria for competitiveness are met. To judge whether a lodging facility represents primary, secondary, or negligible competition for the subject property, the appraiser must answer the following questions:

- Does the facility in question offer a location similar to that of the subject property? Is it quickly and easily accessible for the market area's demand generators? Does it have a specialized location (e.g., airport, convention center, downtown, or resort)?
- Is the hotel similar to the subject property in terms of the facilities it offers? Types of hotels offering specialized facilities include convention, resort, suite, extended-stay, conference center, and casino.
- Does the hotel offer amenities similar to those of the subject property? Distinguishing amenities include restaurants, lounges, meeting rooms, swimming pools, exercise rooms, tennis courts, and golf courses.
- Is the hotel similar to the subject property in terms of quality and price? Classes of lodging facilities include luxury, first-class, standard/mid-rate, upper-economy, and economy/budget.
- Does the hotel in question have an image similar to that of the subject property? Image can be determined by the hotel's brand name, local reputation, management expertise, and any unique or distinctive characteristics (e.g., unusual lobby decor).

To best categorize competitive hotels as either direct (primary) or indirect (secondary) competitors, an examination of the targeted orientation of each hotel's current market capture is necessary. For a hotel to be considered a primary competitor, it must often compete for the same demand pool as the subject property. Two hotels that offer similar services and facilities are typically considered 100 percent—or directly—competitive. Such hotels do not have to be located in the same geographic area. Two five-star resorts located thousands of miles apart may be more competitive with each other than with the standard hotels located in their immediate area. More commonly, two extended-stay hotels located on the opposite ends of a metropolitan statistical are a (MSA) can be considered directly competitive with each other and indirectly competitive with the traditional transient hotels adjacent to them.

Primary competition occurs among lodging facilities that are similar to the subject property with respect to the following criteria: facilities offered, class, and image. Secondary competition occurs with lodging facilities that have similar locational characteristics but share few of the other major qualities of the subject property, particularly class and image.

Properties in the secondary category are considered competitive because they sometimes attract the same customers as the subject property and the subject property's primary competition. However, this tends to happen only as a result of special circumstances, such as when all of the primary competitors are at capacity, so that travelers who would prefer that type of accommodation must settle for one of the secondary competitors. A lodging facility that is not of the same class or image as the subject property might also be a secondary competitor if it has a particularly good location—for example, one adjacent to a demand generator. Because travelers are inclined to stay at the first hotel they encounter, especially during inclement weather, a secondary competitor with a convenient location will attract a certain percentage of the market for which the subject property competes.

In today's competitive hotel markets, franchise affiliation is a strong attraction for travelers, mainly because of frequent guest programs and national corporate room night contracts. Location is not always as important a factor as it has been in the past for guests seeking a place to stay. In many cases, guests will stay at a hotel outside of the immediate market area in order to stay at their preferred franchise. This is most common among the larger hotel chains with properties catering to the different market segments—for example Choice Hotels, Holiday Inn Worldwide, Hospitality Franchise Systems, Marriott, and Promus Hotels.

Hotel companies have realized the importance of national brand recognition. Rather than having new companies enter the market and develop a new national franchise, many of the larger hotel companies have developed new franchise divisions. For example, Marriott has its Marriott brand for its full-service hotels and resorts, Fairfield Inn for upper-economy limited-service properties, Courtyard for first-class commercial properties, and Residence Inn for extended-stay properties. Brand segmentation has been a strong tendency in the hotel industry over the past decade, and the process is continuing as other hotel companies continue to develop new brands to compete in today's complex marketplace.

Some hotels in the market area offer no competition to the subject property and would not be considered in the competitor analysis. Such properties are generally so dissimilar to the subject property that any crossover of demand would be highly unlikely. For example, a five-star hotel will rarely compete directly with an economy property.

## ¶ 8.03 FIELDWORK

Hotel appraisers must rely on fieldwork to produce information that is essential for a complete market study. For example, two key elements—the definition of the market area for lodging supply and the identification of competition—can be determined only by talking to a number of people in the local area.

Whenever a hotel appraiser goes into the field to gather information, he or she will find local parties interested in having a new hotel enter the market as well as other parties interested in keeping any new competition out. Each party usually wants to advocate its position; consequently the appraiser should anticipate an individual's viewpoint on the subject before undertaking any interviews. The local visitors' and convention bureaus and Chamber of Commerce usually welcome a new lodging facility, whereas the general managers of existing hotels and the local hotel association can generally be expected to oppose a new entry into the market. Local government (e.g., building and planning departments or assessors) typically take a neutral stance.

## ¶ 8.04 BENCHMARK INFORMATION

Before an appraiser conducts competitor interviews (see the following section) he should first collect some pertinent data that is verifiably accurate. The appraiser can use this information as a benchmark to determine whether data that is gathered during the interviews, such as occupancy or room rates, is biased in any way. The most useful piece of information is an actual occupancy percentage for a competitive hotel in the market area under consideration. The following is a list of possible sources of actual occupancy information:

*Hotel association.* Local hotel associations often monitor occupancy levels of member hotels, either individually or on a composite basis.

*Local assessor.* Local assessing departments sometimes receive financial information pertaining to hotels in their jurisdictions. If a hotel appeals its assessment and a public hearing is held, the financial data generally enters the public record.

*Rooms tax collector.* Many jurisdictions collect a hotel rooms tax, which is usually based on a percentage of gross rooms revenue. The collector of this tax will sometimes make this information available to appraisers. However, the data may be available only on a composite basis, which is not very useful when the occupancy level of an individual property is required. Sometimes the collector provides this data on a property-by-property basis without identifying the properties by name. In such cases, if the market is small, the appraiser can often identify the property by the amount of tax paid.

In Texas, the hotel rooms tax by individual property is considered public record; in fact, appraisers can subscribe to a monthly publication from the Comptroller of Public Accounts, State of Texas, Austin, Texas 78774. This publication contains the names of all the hotels in the state and gives the amount of rooms tax paid by each facility in the past month.

If the rooms tax paid is a known quantity, total rooms revenue can be calculated by using the rooms tax rate. Then, if the average room rate can be determined, actual occupancy can be calculated by dividing total rooms revenue by the average room rate. Experience has shown that general managers of lodging facilities are less apt to inaccurately report average room rates than other information. Therefore, when rooms tax data for an individual property can be obtained along with an average room rate, the appraiser can usually produce a useful estimate of the occupancy rate for the property.

For example, if a 200-room hotel pays $10,416 in rooms tax for the month of January and the rooms tax is charged at a rate of 4 percent, the average room rate of the hotel can be fairly accurately estimated to be $60.00. The occupancy rate for the month can then be estimated as follows:

$$\text{January rooms revenue} = \$10{,}416 \div 0.04 = \$260{,}400$$
$$\text{Rooms revenue per day} = \$260{,}400 \div 31 = \$8{,}400$$
$$\text{Rooms revenue per room per day} = \$8{,}400 \div 200 = \$42.00$$

$$\text{Percentage of occupancy} = \$42.00/\$60.00 = 70\%$$

*Lodging 400 survey.* Every August, *Lodging Hospitality Magazine,* a leading trade journal, publishes the results of a survey of the operating results of the top 400 hotels in the United States. The magazine ranks each hotel by total revenue and occupancy, and lists the name and location of each facility, its room count, total sales, total sales per room available, total guestroom sales (rooms revenue), total food and beverage sales, total other revenue, and number of employees. It could be argued that information provided in the Lodging 400 survey contains exaggerated data because the reporting hotels are interested in achieving a ranking that is higher than it actually should be. History has shown, however, that the data reported is generally accurate. It must be remembered that the IRS has an interest in the data reported, as do franchisors who base their fees on a percentage of rooms revenue. Average room rate can be calculated from this information by dividing total guestroom sales by the product of room count and occupancy rate and multiplied by 365.

For example, if a 300-room hotel is listed as having room sales of $5,435,000 and an occupancy rate of 73 percent, its average room rate is calculated as follows:

$$\$5{,}435{,}000/300 \times 0.73 \times 365 = \$68.00$$

Because most major hotel markets have at least one hotel that is listed in the Lodging 400, it is fairly easy to find the one piece of accurate occupancy data that is necessary to verify the answers given during competitor interviews.

*Market research statistics.* Numerous organizations, like Smith Travel Research (STR), the Rocky Mountain Lodging Report, and Source Strategies gather hotel market information from hotels and make it available for purchase. There are some limitations to such data, as some hotels are added to and removed from the sample, and not every property reports statistics in a consistent and timely manner. Nonetheless, STR provides the best indicators of aggregate growth in existing supply and demand in U.S. hotel markets. The statistics supplied by STR—which include occupancy and average rates—are useful in reviewing market trends and determining a hotel's position and level of penetration in the market, as illustrated in Exhibit 8-1.

**Exhibit 8-1 Subject Property's Market Position**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| **Subject Property** | | | | | | |
| Occupancy | 67.0% | 68.0% | 68.4% | 69.3% | 70.1% | 72.1% |
| Percent Change | — | 1.5 | 0.6 | 1.3 | 1.2 | 2.9 |
| Occupancy Penetration | 102.0% | 102.4% | 104.0% | 103.9% | 98.9% | 94.4% |
| Average Rate | $54.67 | $56.78 | $57.50 | $62.23 | $63.46 | $66.44 |
| Percent Change | — | 3.9 | 1.3 | 8.2 | 2.0 | 4.7 |
| Average Rate Penetration | 106.6% | 104.2% | 99.3% | 98.8% | 95.9% | 94.8% |
| RevPAR | $36.53 | $38.61 | $39.33 | $43.13 | $44.49 | $47.90 |
| Percent Change | — | 5.4 | 1.9 | 9.7 | 3.2 | 7.7 |
| RevPAR Penetration | 108.7% | 106.7% | 103.2% | 102.6% | 94.8% | 89.5% |
| **Areawide (STR)** | | | | | | |
| Occupancy | 65.7% | 66.4% | 65.8% | 66.7% | 70.9% | 76.4% |
| Percent Change | — | 1.1 | (0.9) | 1.4 | 6.3 | 7.8 |
| Room Rate | $51.29 | $54.48 | $57.92 | $63.00 | $66.16 | $70.05 |
| Percent Change | — | 6.2 | 6.3 | 8.8 | 5.0 | 5.9 |
| RevPAR | $33.70 | $36.17 | $38.11 | $42.02 | $46.91 | $53.52 |
| Percent Change | — | 7.4 | 5.4 | 10.3 | 11.6 | 14.1 |

The exhibit shows that the subject property's market rate has been experiencing increases in both occupancy and average rate during the past few years. It also shows that the subject property, whose penetration was once greater than 100 percent in both occupancy and average rate, is now below that of the market, showing a decline in its market position.

*Previous studies performed on existing hotels.* Other hotel appraisers who have evaluated existing hotels in the area are often willing to share information.

## ¶ 8.05 COMPETITOR INTERVIEWS

Having defined the market area for lodging supply, identified the competition, and secured the benchmark piece of information, the appraiser can begin a series of interviews with selected staff members of the competitor hotels. The primary purpose of these interviews is to identify all of the competitor hotels in the market area and to determine as accurately as possible their occupancy percentages, average rates per occupied room, and market segmentations. The primary use of this information is in the performance of the competitive room-night analysis. (For a discussion of room-night analysis, see Chapter 10.)

Competitor interviews should also be used to obtain the following additional information:

- Date of opening
- Physical condition
  - —Recent and planned renovations
- Access and visibility
- Identification of franchise and management company
  - —Past and present
- Room count
- Amenities
  - —Restaurants
  - —Lounges
  - —Meeting and banquet rooms
- Room rates
  - —Published
  - —Special
- Effectiveness of reservation system
  - —Number of fill nights
  - —Number of turnaways
- Seasonality, including monthly and weekly occupancy trends
- Average restaurant and banquet checks
- Local food and beverage market capture
- Union contracts
- Area generators of transient visitation
  - —Demand generators leaving or moving into area
- Area economic trends and market outlook
- Local hotels for sale
- Proposed hotels and hotels under construction
  - —Expected opening dates
  - —Current status of each project

The interviews generally involve the general manager or other high ranking personnel of the hotel (e.g., assistant manager, front office manager, or director of sales). The information gathered is, of course, confidential and somewhat sensitive, particularly when it may be used to justify constructing a new competitive property. As a result, the interviews are often difficult to conduct and the information elicited less than accurate (e.g., occupancy rates may be stated as lower than they actually are).

The interviewees at competitor lodging facilities generally tend to be fairly candid about their average room rates and market segmentation, although an appraiser should be aware of the hotel's published room rates before the interview so that the average rate that is quoted can be checked for accuracy. In addition, when asking for information about the market segmentation of a competitor hotel, the appraiser must be sure that each segment referred to is clearly defined and that the sum of all segments mentioned is 100 percent.

As discussed previously, in order to achieve the desired results from an interview and to be able to adjust the data for any bias on the part of the person interviewed, the appraiser must possess at least one reliable piece of information regarding one of the competitive properties, preferably an accurate occupancy rate. The procedure for detecting bias and adjusting data to reflect it is fairly simple. For example, if the appraiser knows that a particular property has an occupancy rate of 80 percent, and the general manager of the property claims during an interview that it is 75 percent, the appraiser can assume that the other data given by the interviewee is likely to be overstated.

When all the competitor interviews are complete, the data should be compiled on a spreadsheet that identifies the interviewees and their responses. From this information, the upward or downward bias for individual questions can be adjusted and final estimates determined.

CHAPTER 9

# Lodging Demand Analysis



## ¶ 9.01 INTRODUCTION

Careful analysis of the demand for lodging in the subject market area is essential in determining the feasibility of a proposed facility or the value of an existing one. An appraiser should begin an analysis of lodging demand by identifying the demand generators in the area (the reasons why people who need overnight accommodation visit the subject market area). Exhibit 9-1 contains a list of typical demand generators. The unit of measurement used to quantify demand is the room-night, which represents one hotel or motel room occupied by one or more persons for one night. Exhibit 9-3, at the end of this chapter, provides an example of a lodging demand analysis.

Once the demand generators (also called generators of transient visitation) in the market area have been identified, the current amount of demand they create can be estimated. This estimate serves as a basis for projecting future demand, which is a basic component of an economic market study and appraisal. Two techniques—the demand generator build-up approach and the lodging activity build-up approach—are used to quantify current demand. The demand generator build-up approach is the more complicated and time-consuming of the two, but it is the preferred way to determine the level of demand in new market areas (i.e., those without competing facilities) for proposed facilities that would cater to untapped markets, or in markets with only one demand generator.

**Exhibit 9-1 Lodging Demand Generators**

| | | |
|---|---|---|
| Airports | County seats and state capitals | National or state parks |
| Amusement parks | Court houses | Racetracks |
| Association headquarters | Festival sites | Regional shopping malls |
| Casinos | Historical attractions | Resort areas |
| Colleges and universities | Hospitals | Sports stadiums |
| Companies and businesses | Military installations | Theaters |
| Convenient highway stopping points | Museums | Tourist attractions |
| Convention Centers | Offices and industrial parks | World and state fairs |

## ¶ 9.02 DEMAND GENERATOR BUILD-UP APPROACH

The demand generator build-up approach involves the use of interviews and statistical sampling techniques to estimate lodging demand by projecting the room-nights attributable to local demand generators. This method should be used when:

- The subject property will be situated in a new market area where there is no current competition by which to measure existing room-night demand, such as a new resort area.
- The subject property will cater to a particular market segment, such as upscale executive conferences, that does not exist in the current marketplace.
- The subject property will cater to a segment of the market that does not currently use standard hotels and motels, such as the extended-stay market.
- The market has only one demand generator (e.g., a large university situated in a small town, such as the University of North Carolina at Chapel Hill).

The demand generator build-up aproach is not usually used to quantify room-night demand in established markets, because its sampling requirements are very time-consuming, it is an expensive process to carry out, and the final results are not always as accurate as those obtained from the lodging activity build-up approach. However, even when the primary method for gathering information is the lodging activity build-up approach, it is often beneficial to conduct the demand generator interviews in order to collect data on the needs, desires, and experience of actual participants in the marketplace. The resultant "feel" for the market can be very helpful during the evaluation of the competitive environment.

### [1] Definition of Market Area

The appraiser's first step in using the demand generator build-up approach is to define the market area for the subject property. The boundaries of the market area for a lodging facility are generally considered to be the distance that can be covered in all directions from the subject property in 20 travel minutes. Normally, most of the demand generators relevant to the study are situated within this market area.

## [2] Potential Demand Generators

The appraiser's next step is to identify potential demand generators within the market area. Common sources of information that may prove to be instrumental in the identification process include the following:

- Hotel managers
- Directories of local businesses (usually available from the Chamber of Commerce)
- Visitors' and Convention Bureaus
- Car rental agents, taxi drivers, gas station operators, restaurant managers, and real estate agents
- A drive-through inspection of the area (i.e., to determine the number of out-of-state cars)

## [3] Demand Interviews and Surveys

Once all of the significant generators of overnight visitation in the market area have been identified, the appraiser conducts demand interviews. The key to obtaining useful information from demand interviews is to find and talk to the right person: an individual with firsthand knowledge about the room-night generating capability of the area demand generators. In most instances, this person is either a "seer" or a "booker."

A seer personally interacts with transient visitors to particular demand generators in the normal course of business. Purchasing agents, office managers, receptionists, security personnel, and admission ticket clerks are all seers. A seer typically can offer information that is general in nature, such as impressions of the volume and types of visitors to an individual facility.

A booker is responsible for actually booking transient visitors into local lodging facilities. In addition to travel agents and centralized reservation service agents, bookers include personnel managers, travel department personnel, office managers, training department personnel, and executive secretaries. A booker can usually provide more detailed data on lodging demand than a seer. In many instances, bookers are able to provide information concerning the preferences of travelers (e.g., the types of accommodations used and the frequency of travel).

After identifying appropriate seers and bookers, the appraiser can begin the demand interviews. Generally, the most effective interviews are those held in person or over the telephone. However, satisfactory information can occasionally be obtained from letter surveys. The following is a list of the most important questions that the appraiser should ask during demand generator interviews:

- How many visitors do you see or book during a typical week? (An important point to remember when asking questions such as this is to keep the timeframe as short as possible, because people generally have difficulty quantifying data over an extended period of time.)
- Are there any seasonal, monthly, or weekly patterns to the visitation?
- How long do the visitors stay in the area?
- Do the visitors go to other demand generators in the area?
- Where do visitors currently stay, and why?

- What would you estimate is the percentage split between single- and double-occupancy bookings?
- What facilities do visitors normally use in the hotel?
- What sort of price sensitivity do visitors generally have?
- How do visitors book their reservations?

Exhibit 9-2 is an example of the type of form that an appraiser uses to compile information elicited during a demand generator interview. The demand generator survey shown in Exhibit 9-3, at the end of this chapter, is an example of a written survey that can be used to quantify lodging demand and to learn about traveler preferences. When a written survey is used, it is essential that the most appropriate party receive the survey material. Sometimes a preliminary phone call is necessary to correctly identify the individual with the most knowledge of the material covered by the survey. The case study at the end of this chapter is based in part on the results of a battery of actual demand generator interviews.

**Exhibit 9-2 Demand Generator Interview Form**

1. Company Name: ______________________________

2. Phone Number: ______________________________

3. Location (including subsidiary office in marketplace, if any):

______________________________

______________________________

______________________________

4. Distance from site of proposed hotel: ______________________________

5. Name of contact/position: ______________________________

6. Present number of employees: ______________________________

7. Projected growth in employees: ______________________________

8. What hotels/motels does interviewee currently use?

______________________________

______________________________

______________________________

9. Reason for lodging selection (location, rate, facilities):

______________________________

______________________________

______________________________

10. Room-nights booked: ______________________________

11. What rate would interviewee be willing to pay for a suite on a daily basis?

______________________________

12. Describe the proposed hotel and ask whether interviewee would have use for this type of facility?

______________________________

______________________________

______________________________

## ¶ 9.03 LODGING ACTIVITY BUILD-UP APPROACH

The lodging activity build-up approach is the most frequently used procedure for quantifying current hotel room-night demand, because it yields the actual number of occupied hotel rooms in the subject market area. In most parts of the country, the market area for a hotel can be readily defined and the competitive facilities within it easily identified, so that once these facilities' occupancy rates have been determined, current room-night demand in the market area can be calculated and future demand projected.

The steps involved in this approach are as follows:

1. Identify the primary and secondary competitive lodging facilities situated within the market area.
2. Estimate the occupancies of the competitive lodging facilities.
3. Determine the percentage of total occupancy represented by each market segment for each facility.
4. Quantify the current accommodated room-night demand in the area.
5. Estimate total latent demand (i.e., unaccommodated and induced demand) for the area and develop a forecast of latent demand.
6. Calculate accommodatable latent demand and total usable latent demand.
7. Forecast accommodated room-night demand over the projection period and combine it with total usable latent demand to yield total usable room-night demand.
8. Quantify the area's total guestroom supply and the total room-nights available.
9. Estimate overall area occupancy over the projection period.

The procedures that must be followed to accomplish the first three steps in the approach are described in Chapter 10. The balance of this chapter outlines the tasks that an appraiser must undertake to complete the process.

### [1] Current Accommodated Room-Night Demand

The quantification of the current accommodated room-night demand is accomplished by totaling the number of occupied rooms by market segment for each of the competitive facilities in the subject market area. The formula for this calculation is as follows:

$$\text{Room count} \times \text{Occupancy percentage} \times \text{Market segmentation} \times 365 = \text{Total number of occupied rooms per year}$$

### [2] Current and Forecasted Total Latent Demand

Latent demand is defined as demand that potentially exists in a market but for any of a number of reasons, is not accommodated by the current lodging supply. Estimating the total latent demand in a market area is probably the most difficult part of the lodging activity build-up approach, because the two main components of latent demand—unaccommodated demand and induced demand—are not easily quantified.

### [a] Unaccommodated Demand

Unaccommodated demand is difficult to measure because it is made up of transient travelers who seek accommodations within a market area but must either defer their stay or settle for less desirable accommodations because the facilities where they want to stay have no vacancies.

This form of excess demand is a result of the cyclical nature of the lodging industry. In commercial markets, for example, area occupancy levels from Monday through Thursday often approach 100 percent. When occupancy reaches this level, a certain number of visitors to the area will usually go unaccommodated. Similarly, when resort areas sell out during peak vacation periods, a percentage of total room-night demand goes unaccommodated. Unaccommodated transient visitation is, in fact, a normal occurrence in every type of lodging market, because total area room supply cannot freely expand in response to surges in lodging demand.

Unaccommodated demand is an important consideration in a market study and appraisal. If it is ignored or not properly quantified, the conclusions drawn by the appraiser regarding the effect of the entry of a new facility in the market will be inaccurate.

In order to properly judge the amount of unaccommodated demand in a market area, an appraiser must assess the following factors relevant to the market area in question.

*Nature of demand.* The appraiser must determine whether demand in the market is highly cyclical, with a tendency toward concentration at particular times (e.g., Monday through Thursday, vacation periods, or during special local events).

*Area occupancy level.* The appraiser must determine whether most of the local lodging facilities are operating at or near their stabilized levels of occupancy (considering, of course, the nature of transient demand in the area). As a rule of thumb, in a typical commercial market, where demand is high Monday through Thursday and drops considerably on weekends, a strong stabilized level of occupancy would be 70 percent. Under such circumstances, an areawide occupancy rate of 78 percent would probably produce a significant amount of unaccommodated demand. If, on the other hand, most of the lodging facilities in the area were operating with an occupancy level of around 60 percent, the unaccommodated demand would probably be negligible.

*Number of fill nights.* Some of the questions asked in competitor interviews (described in Chapter 8) should be directed toward estimating the number of nights on which area hotels actually fill to capacity. Once this number has been established, the number of potential customers who are turned away can be quantified. Some hotels with centralized reservation systems generate a monthly denial report, which shows the number of people who call to make a reservation at a specific hotel but are denied a reservation because the facility is fully booked. Occasionally, individual hotels also keep track of the number of walk-ins (people who arrive without a reservation) that occur on days when the hotel is fully booked. These alternative ways of measuring unaccommodated room-night demand are useful, but unfortunately are not often available to appraisers.

*Alternative accommodations.* If it is apparent that a sizable amount of unaccommodated demand exists in the subject area, the appraiser might want to interview personnel at some of the alternative choices of accommodations to determine where their demand originates and how many of these customers would use other facilities if they were available. (Alternative accommodations typically include lodging facilities outside the subject market area or hotels within the area that are considered less desirable by these travelers.)

Unaccommodated demand is generally estimated as a percentage of the accommodated demand for each market segment. Unaccommodated demand typically ranges from zero percent to 30 percent of the accommodated demand, with the upper end of the range representing exceptionally strong markets. In good hotel markets, a reasonable level of unaccommodated demand is usually 5 percent to 10 percent. Unaccommodated demand is always difficult to quantify accurately, so a conservative estimate by the appraiser is usually warranted.

### [b] Induced Demand

In addition to unaccommodated demand, there is a second form of latent demand called induced demand. Induced demand represents customers who are attracted to the market area for one or more specific reasons, such as:

- The opening of new lodging facilities that offer previously unsupplied amenities such as extensive meeting and convention space, a golf course, skiing, or a health spa.
- The aggressive marketing efforts of individual properties. Some of the major hotel chains bring new customers into the market through other properties they operate.
- Convention-oriented lodging chains, for example, are frequently able to book convention groups in a different hotel in their system each year, thus creating induced demand.
- The opening of a new major demand generator, such as a convention center, commercial enterprise, retail complex, or recreational attraction.

The procedure for totaling induced demand is similar to the demand generator build-up approach in that the appraiser evaluates each generator of induced demand to determine the number of room-nights that will be attracted to the market area. Induced demand can enter the market either all at once or gradually over one or more years.

### [c] Final Determination of Latent Demand

The sum of unaccommodated and induced demand equals the latent demand in a market area. The method for forecasting unaccommodated latent demand over a projected period of time is based on the procedures described in Chapter 7 for evaluating economic and demographic trends in a market area and estimating future change in lodging demand. In most instances, accommodated room-night demand and unaccommodated demand change in the same direction and at the same rate over the projection period of time. Most types of induced demand, however, act independently. For example, the opening of a large convention hotel in an area that had little existing convention demand might cause a large increase in induced demand for convention room-nights. Depending on the size of the convention hotel, this additional demand usually increases rapidly over a period of time and then stabilizes as the hotel approaches its capacity. The growth in this induced demand is generally independent of the growth in the convention demand in the market area.

## [3] Accommodatable Latent Demand

Accommodatable latent demand is the portion of latent demand that can be absorbed by a market area in the future; it is based on the number of additional new rooms that are expected to become part of the market supply. In order to calculate accommodatable latent demand, the appraiser must first determine the number of competitive rooms currently proposed and the number already under construction in the area. Locating the properties under construction is easily accomplished by interviewing personnel in the local building department, which monitors all area development activities. The building department is also a good source of information for identifying proposed lodging facilities. Most market areas have several hotel projects in various stages of planning but not presently under construction. The difficulty in making predictions based on proposed projects is that very few are actually built; in fact, probably only one in ten proposed hotel projects ever makes it out of the planning stages. The question the appraiser must answer is at what point should a proposed hotel be considered an addition to the competitive supply?

Appraisers use the following criteria to make their determination:

- Is the financing package in place? The total financing, including both debt and equity, must be fully committed and in place before a project can be considered definite.
- Does the developer have all zoning approvals, building permits, and licenses? Projects are required to obtain these approvals before construction can begin.
- Does the project have a franchise and/or management company under contract?
- Does the developer have a track record of successful hotel projects? This attribute is important, because the majority of first-time developers fail to complete their projects.
- What is the current condition of the hotel market? If the local lodging market has become overbuilt or occupancy levels are depressed, proposed hotel projects generally will be reconsidered and either postponed indefinitely or terminated.
- What is the current condition of the financing market? Very few hotel projects are developed without mortgage financing. In down markets, lenders tend to pass up hotel projects in favor of other investments that carry less risk.

Using these criteria, the appraiser evaluates each proposed hotel within the market area and determines whether the project should be considered a future addition to the lodging supply or whether it should be disregarded.

An alternative to working in absolute terms is to assign a probability factor to a proposed project on the basis of the likelihood of its being developed. This procedure allows a proposed project to be considered a future addition to the competitive supply, but with a weighted room count determined by the project's probability of completion. For example, suppose that a 300-room hotel is planned for a site within the subject market area. On the basis of discussions with the building department and the developer, the appraiser estimates that there is a 50 percent chance that this project will be built. When totaling the size of the competitive supply, the appraiser includes this project, but considers it to be a 150- rather than a 300-room hotel given the 50 percent probability factor. The appraiser should be liberal in including proposed hotel projects within the competitive supply in order to arrive at a reasonable estimate.

As stated previously, identifying proposed hotels is more difficult than locating projects under construction. However, there are a number of potential sources of information on proposed hotel developments, including:

- Local building department
- Assessor

- Chamber of commerce
- Development agencies
- Hotel managers
- Local hotel association
- Association development reports
- Local real estate brokers
- Local lenders
- Hotel appraisers and consultants

Once the currently proposed additions to the lodging supply have been identified, the appraiser calculates the number of room-nights of supply that will be available to absorb latent demand. The demand that can be met by this additional new supply is the accommodatable latent demand. As an illustration, assume that a 200-room hotel is expected to open in two years in the subject market area. This addition to supply would be able to absorb the following number of latent room-nights of demand (accommodatable latent demand):

$$200 \text{ rooms} \times 365 \times 75\% = 54{,}750 \text{ room-nights}$$

The 75 percent is the estimated areawide occupancy as of the projected year. It is normally assumed that latent demand will not provide a property (or the market) any more occupancy than the average occupancy percentage for the area, although some forms of property-induced demand are exceptions to this assumption. For example, a new convention hotel that is part of a chain may receive business from its own internal resources.

## [4] Accommodated Room-Night Demand

The appraiser's forecast of accommodated room-night demand over a projected period is based on the expected changes in lodging demand determined through careful analysis of the area's economic and demographic indicators, as discussed in Chapter 7.

The combination of the forecasted accommodated room-night demand and the total usable latent demand produces the total usable room-night demand, which serves as the basis for estimating areawide and individual property occupancy levels.

## [5] Total Usable Latent Demand

Total usable latent demand represents the amount of latent demand in a market area that could be accommodated if the supply of rooms were adequate. It differs from accommodatable latent demand only in that it may be a smaller amount. In other words, although the market may have the capacity to accommodate a certain amount of latent demand, the actual "usable" latent demand may be smaller, so some capacity still remains that could absorb more latent demand if it existed.

## [6] Total Available Room-Nights

The total number of room-nights available in the market area is calculated by multiplying the number of competitive rooms for each projected year by 365. If additional rooms become operational during a projected year (either in the form of a new hotel or as an addition to an existing property), the total number of rooms must be adjusted to reflect the actual number of rooms available during the year.

## [7] Overall Occupancy

The overall area occupancy for each year during the projected period is calculated by dividing the projected usable room-night demand (i.e., accommodated room-night demand) by the annual number of available rooms.

Overall area occupancy is an important statistic for providing a preliminary indication of project feasibility. A general rule of thumb applicable to new hotels is that the occupancy level of a hotel should be somewhat below the areawide occupancy during its first year of operation. In its second year, a hotel should operate at the same level as the overall area occupancy. A hotel should exceed the area occupancy by its third year of operation. If the overall area occupancy is expected to be below profitable levels when the new hotel is scheduled to open, the potential for financial difficulties could decrease the feasibility of the project. Extreme caution should be exercised when developing a hotel in a market that shows a potential overall area occupancy of less than 55 percent to 60 percent. If the overall area occupancy is projected to fall below 50 percent, a hotel project is rarely justified.

## Exhibit 9-3 Sample Demand Generator Survey

**Spring Valley Hotel Survey**

A new hotel is planned for the Spring Valley area. It will be conveniently located for many area businesses at the northwestern corner of the intersection formed by Central Avenue (State Route 59) and Exit 14 of the New York State Thruway.

Your responses to the following questions will assist us in assessing what type of lodging facility will best serve the needs of your firm and other firms in the area. While we realize that you may not be able to precisely answer a number of the following questions, we would appreciate your best estimates. If you have any questions or comments, feel free to call John Smith at (212) 123-4567.

Your Name/Title ____________________

Company Name ____________________

Department ____________________

Street Address ____________________

City, State, Zip Code ____________________

Telephone Number ____________________

What is the current number of employees at this location? ____________
Entire Firm ____________ Your department ____________

What are the primary business activities at this location? ____________

In answering the following questions, please indicate whether your response is for your FIRM as a whole or for your DEPARTMENT individually by circling the proper word in the question.

1. Within the next year, is the number of employees in your FIRM/DEPARTMENT projected to (circle one) Increase? Decrease? By how much? ________
   Remain the same ________

2. During an average month, how many people visiting your FIRM/DEPARTMENT require overnight hotel accommodations? ____________

3. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations arrive during the following seasons?
   Winter ____ Spring ____ Summer ____ Fall ____ Total 100%

4. What percentage of the visitors described above currently:
   Book their own accommodations? ____________
   Have their own accommodations booked by someone in your company? ________
   Please indicate the name, department, and telephone number of the person in your firm responsible for booking accommodations:

   Name: ____________________

   Department: ____________________

   Telephone Number: ____________________

5. Please complete the following chart.
   a. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations do so for the reasons indicated? ____________
   b. What is the average number of nights per visit? ____________
   c. On average, how many people stay in one hotel room per visit?

| Reason for overnight stay | (a) Percent of total visitors | (b) Average length of stay | (c) Number of people per room |
|---|---|---|---|
| Relocation | | | |
| Training | | | |
| Temporary Assignment | | | |
| Consulting | | | |
| Meeting/Conference | | | |
| Other (please specify) ____________ | | | |

**6.** Which lodging facilities does your firm currently use (in order of preference)? (Please complete the following chart.)

| *Name of Facility* | *Room Rate Charged* |
|---|---|
| (1) | |
| (2) | |
| (3) | |
| (4) | |
| (5) | |

**7.** What characteristics determine how a lodging facility is chosen?

a. Please rank the following six factors in order of importance in choosing a lodging facility (1 = most important; 6 = least important).

| *Factor* | *Rating* | *Factor* | *Rating* |
|---|---|---|---|
| Price | _____ | Convenience of location | _____ |
| Quality of amenities | _____ | Chain affiliation | _____ |
| Facilities offered | _____ | Other (please specify)____________ | _____ |

b. Would the availability of a health club/fitness center be an important consideration in choosing a lodging facility? ____________________________

**8.** Do you currently use meeting and/or banquet facilities in area hotels? (Please circle whichever applies) Meeting facilities Banquet facilities Neither

(If meeting and/or banquet facilities are used, please complete the following chart.)

| | *For meetings* | *For banquets* |
|---|---|---|
| How frequently do you use these facilities? | _______ | _______ |
| What is the average size of your group? | _______ | _______ |
| What is the smallest size? | _______ | _______ |
| What is the largest size? | _______ | _______ |
| What percentage of attendees require overnight accommodation? | _______ | _______ |
| What percentage occurs on weekends? | _______ | _______ |

9. a. Are you familiar with the location of the Spring Valley project?________________
   b. How would you rank the location of the Spring Valley project as compared with the locations of the hotels you currently use? (Please circle one)
   About the same Inferior Superior

10. Given a choice between a full-service hotel (e.g., Marriott, Hyatt, Westin, Hilton) and a limited-service hotel (e.g., Hampton Inn, Super 8, Red Roof Inn), which would you be more likely to choose when booking overnight accommodations for visitors?
____________________________________________
Why? ________________________________________
____________________________________________
____________________________________________

11. All-suite hotels (e.g., Residence Inn by Marriott, Embassy Suites) provide separate living and sleeping rooms within the same guest area. Typically, these accommodations are priced $10 to $15 more per room than comparable full-service hotels. Given the choice between a full-service hotel and an all-suite hotel, which would you be more likely to choose when booking overnight accommodations for visitors? ________________________________
Why? ________________________________________
____________________________________________
____________________________________________

12. Please rank the following hotel chains (eighteen are listed) in the order in which you would choose them when booking overnight hotel accommodations for visitors. Thank you for your cooperation.

| *Hotel Chain* | *Rank* | *Hotel Chain* | *Rank* |
|---|---|---|---|
| Marriott | _____ | Holiday Inn | _____ |
| Sheraton | _____ | Comfort Inn | _____ |
| Westin | _____ | Hampton Inn | _____ |
| Hyatt | _____ | La Quinta | _____ |
| Hilton | _____ | Days Inn | _____ |
| Four Seasons | _____ | Residence Inn | _____ |
| Doubletree | _____ | Hawthorn Suites | _____ |
| Loews | _____ | Embassy Suites | _____ |
| Radisson | _____ | | |

CHAPTER 10

# Analysis of Market Share, Occupancy, and Average Room Rates

## ¶ 10.01 INTRODUCTION

After the total current lodging demand in the subject market area is calculated and future projections for demand are made, the appraiser must identify the competitive positions of all of the area lodging facilities. This entails determining first the current market share, occupancy rates, and average room rates of the existing competitor facilities and then how these quantities would be affected by the addition of the proposed hotel. Once this information is generated, the appraiser can set about forecasting the average room rates for the market area facilities and for the subject property, so that a determination can be made about the economic feasibility of the proposed project.

Appraisers use one of two methods to analyze competitive positions: the market penetration method and the competitive index method. Both methods determine the market share captured by a lodging facility (market share is the percentage of the area's room-night demand actually supplied by the particular facility). By knowing the market share, a calculation can be made to determine the expected level of occupancy for the facility.

## ¶ 10.02 MARKET PENETRATION METHOD

The term penetration as it applies to the lodging industry refers to the percentage relationship between the actual market share and the fair market share of a lodging facility. The actual market share of a hotel is the number of rooms that are occupied per day in the hotel divided by the total number of occupied rooms in the market per day. The fair market share (also known as the average market share) of a hotel consists of its total number of rooms divided by the total of all the rooms in the market. The market penetration of a hotel is calculated by dividing its actual market share by its fair market share. It shows in percentages how well the hotel is attracting or capturing hotel room-night demand relative to a hypothetical "average" hotel in the market. Exhibits 10-1 and 10-2 illustrate the calculations that are used to determine the actual market share, the fair market share, and finally the market penetration of four hypothetical hotels.

The results of the penetration calculation show that Hotel *A* is achieving 12 percent more than its fair market share or 12 percent more than the average capture for the area; Hotel *B* is achieving 91 percent of its fair market share, so it is performing about 9 percent below the market; Hotel *C* is performing slightly above its fair market share; and Hotel *D* is achieving 2 percent less than its fair market share.

**Exhibit 10-1 Determining the Actual Market Share**

| Hotel | Number of Rooms | | Percentage of Occupancy | | Number of Occupied Rooms Per Day | Actual Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 80% | = | 80 | 13.2% |
| *B* | 200 | × | 65 | = | 130.0 | 21.4 |
| *C* | 250 | × | 75 | = | 187.5 | 30.9 |
| *D* | 300 | × | 70 | = | 210.0 | 34.5 |
| | 850 | | | | 607.5 | 100.0 |

**Exhibit 10-2 Determining Fair Market Share and Penetration**

| Hotel | Number of Rooms | Fair Market Share | Actual Market Share | | Fair Market Share | | Penetration |
|---|---|---|---|---|---|---|---|
| *A* | 100 | 11.8% | 13.2% | ÷ | 11.8% | = | 1.12 |
| *B* | 200 | 23.5 | 21.4 | ÷ | 23.5 | = | 0.91 |
| *C* | 250 | 29.4 | 30.9 | ÷ | 29.4 | = | 1.05 |
| *D* | 300 | 35.3 | 34.5 | ÷ | 35.3 | = | 0.98 |
| | 850 | 100.0% | 100.0% | | 100.0% | | |

## ¶ 10.03 COMPETITIVE INDEX METHOD

The competitive index of a hotel simply reflects the number of days per year for which one room in a hotel is occupied. In contrast to the penetration method, only one calculation is necessary; the competitive index is calculated by multiplying the percentage of occupancy by 365 days, as Exhibit 10-3 shows.

**Exhibit 10-3 Calculating Competitive Index**

| Hotel | Percentage of Occupancy | | Days per Year | | Competitive Index |
|---|---|---|---|---|---|
| *A* | 80% | × | 365 | = | 292.0 |
| *B* | 65 | × | 365 | = | 237.0 |
| *C* | 75 | × | 365 | = | 273.0 |
| *D* | 70 | × | 365 | = | 255.0 |

The competitive index and market penetration show the relative competitiveness (i.e., the relative occupancy ranking) of each hotel. For example, Hotel *A* is 23 percent more competitive than Hotel *B*, as demonstrated by the calculations in Exhibit 10-4.

**Exhibit 10-4 Calculating Relative Competitiveness**

| | Hotel *A* | | Hotel *B* | | Relative Competitiveness |
|---|---|---|---|---|---|
| Competitive Index | 292 | ÷ | 237 | = | 1.23 |
| Penetration | 1.12 | ÷ | 0.91 | = | 1.23 |

### [1] Advantages of Competitive Index Method

One advantage of the competitive index method over the penetration method is that the one calculation it requires is based on a single room and thus is easy to carry out. The penetration method, on the other hand, makes use of the entire room count of a property in two of the three calculations that it requires, which becomes complicated in dynamic market areas that have fluctuating room supplies. For example, assume an additional Hotel *E* were to enter our hypothetical market, and an appraiser wanted to determine the effect of the addition on the competitive relationship between Hotel *A* and Hotel *B*. Exhibit 10-5 shows the different calculations that would have to be done for each method.

As the exhibit shows, the competitive index method provides the same result as the penetration method, but requires less work.

Another advantage of the competitive index is that, as an analytical tool, it is generally easier for parties not familiar with hostelry terminology to grasp, particularly when market segmentation is being considered. For example, consider the competitive indexes for Hotels *A* and *B* for each individual market segment, as shown in Exhibit 10-6.

**Exhibit 10-5 Two Methods Compared**

**PENETRATION METHOD**

| Hotel | Number of Rooms | | Percentage of Occupancy | | Number of Occupied Rooms Per Day | Actual Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 80.0% | = | 80.0 | 10.4% |
| *B* | 200 | × | 65 | = | 130.0 | 16.9 |
| *C* | 250 | × | 75 | = | 187.5 | 24.4 |
| *D* | 300 | × | 70 | = | 210.0 | 27.3 |
| *E* | 225 | × | 72 | = | 162.0 | 21.1 |
| | 1,075 | | | | 769.5 | 100.0% |

**PENETRATION**

| Hotel | Number of Rooms | Fair Market Share | Actual Market Share | | Fair Market Share | | Penetration |
|---|---|---|---|---|---|---|---|
| *A* | 100 | 9.3% | 10.4% | ÷ | 9.3% | = | 1.12 |
| *B* | 200 | 18.6 | 16.9 | ÷ | 18.6 | = | 0.91 |
| *C* | 250 | 23.3 | 24.4 | ÷ | 23.3 | = | 1.05 |
| *D* | 300 | 27.9 | 27.3 | ÷ | 27.9 | = | 0.98 |
| *E* | 225 | 20.9 | 21.0 | ÷ | 20.9 | = | 1.01 |
| | 1,075 | 100.0% | 100.0% | | 100.0% | | |

**COMPETITIVE INDEX METHODS**

| Hotel | Percentage of Occupancy | | Days Per Year | | Competitive Index |
|---|---|---|---|---|---|
| *A* | 80% | × | 365 | = | 292 |
| *B* | 65 | × | 365 | = | 237 |
| *C* | 75 | × | 365 | = | 273 |
| *D* | 70 | × | 365 | = | 255 |
| *E* | 72 | × | 365 | = | 263 |

**COMPARISON OF METHODS**

| | Hotel *A* | | Hotel *B* | | Relative Competitiveness |
|---|---|---|---|---|---|
| Competitive Index | 292 | ÷ | 237 | = | 1.23 |
| Penetration | 1.12 | ÷ | 0.91 | = | 1.23 |

Using competitive indexes, the appraiser can state in simple terms that in Hotel *A*, one hotel room is occupied 175 nights per year by a commercial traveler, 29 nights per year by a meeting traveler, and 88 nights per year by a leisure traveler. Compared with Hotel *B*, Hotel *A* is almost 50% more competitive in the commercial market and 83% more competitive in the leisure market. Hotel *B* is, however, almost 150 percent more competitive than Hotel *A* in the group and meeting market.

**Exhibit 10-6 Market Segment Percentage and Market Segment Competitive Index**

| | Market Segment Percentage | | | Market Segment Competitive Index | | |
|---|---|---|---|---|---|---|
| Hotel | Commercial | Group & Meeting | Leisure | Commerical | Group & Meeting | Leisure |
| *A* | 60% | 10% | 30% | 175 | 29 | 88 |
| *B* | 50 | 30 | 20 | 118 | 71 | 48 |

## [2] Evaluation of Proposed Properties

The competitive index method is most often used to evaluate the relative competitiveness of proposed facilities and to forecast their stabilized occupancy.

This is accomplished by assigning competitive indexes to the subject's market segments based on how it is expected to compete with the other properties in the market. Once the relative competitiveness of each hotel is determined, an estimate of market share can be made. To accomplish this, the subject's projected market share is multiplied by the area's room-night demand, which yields an estimate of the room-nights captured; this figure is in turn converted into an occupancy percentage.

For example, assume that a market area comprises the five hotels (*A, B, C, D,* and *E*) discussed earlier. Another hotel, *F,* is a 150-room, commercially oriented facility that is planned for the area. It will have a minimal amount of meeting space and will be an average competitor in the leisure market. To estimate its stabilized occupancy, an appraiser would compile the data listed in Exhibit 10-7.

**Exhibit 10-7 Estimating Stabilized Occupancy**

| | | Estimated Market Segment | | | Market Segment Competitive Index | | |
|---|---|---|---|---|---|---|---|
| Hotel | Occupancy | Commerical | Group & Meeting | Leisure | Commerical | Group & Meeting | Leisure |
| *A* | 80% | 60% | 10% | 30% | 175 | 29 | 88 |
| *B* | 65 | 50 | 30 | 20 | 118 | 71 | 48 |
| *C* | 75 | 70 | 20 | 10 | 192 | 55 | 27 |
| *D* | 70 | 45 | 40 | 15 | 115 | 102 | 38 |
| *E* | 72 | 45 | 35 | 20 | 118 | 92 | 53 |

The proposed subject property might be expected to have the following competitive indexes:

| | Market Segment Competitive Index | | |
|---|---|---|---|
| | Commercial | Group and Meeting | Leisure |
| Hotel *F* | 190 | 30 | 50 |

The rationale for assigning these competitive indexes is as follows: Hotel *F* is planned to be oriented towards the commercial segment, so it is similar to Hotel *C*, which has a commercial competitive index of 192. In terms of meeting space, the proposed hotel is similar to Hotel *A*, which has a group and meeting competitive index of 29. The average leisure competitive index for the five existing hotels is 50, so it can be assumed that the proposed hotel will be similar in that regard.

The competitive indexes serve as a basis for calculating market share and percentage of occupancy estimates for the proposed hotel. However, the appraiser must first use the lodging activity build-up approach to determine room-night demand, market share, and occupancy for each hotel that is currently operating in the market (see ¶ 9.03 for a discussion of the lodging activity build-up approach).

### [a] Current Room-Night Demand

Using the lodging activity build-up approach, the current room-night demand (including both accommodated and latent demand) is shown in Exhibit 10-8.

**Exhibit 10-8 Estimating Stabilized Occupancy**

| Hotel | Commercial | Group and Meeting | Leisure |
|---|---|---|---|
| *A* | 17,520 | 2,920 | 8,760 |
| *B* | 23,725 | 14,235 | 9,490 |
| *C* | 47,907 | 13,688 | 6,844 |
| *D* | 34,492 | 30,660 | 11,498 |
| *E* | 26,609 | 20,695 | 11,826 |
| *Total Accomodated* | 150,253 | 82,198 | 48,418 |
| *Latent Demand* | 7,513 | 2,466 | 484 |
| *Total Demand* | 157,766 | 84,664 | 48,902 |

### [b] Projected Market Share

The projected market share for each property is determined by market segment by first multiplying the room count for each property by its appropriate competitive index, which results in a factor called the market share adjuster. The competitive index quantifies the competitiveness of only one room, so multiplying the competitive index by the property's room count adjusts the competitive index so that it reflects the entire property's competitiveness. The market share adjuster for one property is then divided by the total market share adjuster for all of the area's competitive hotels, which results in the market share for each property. Exhibit 10-9 shows the calculations for projected market share.

**Exhibit 10-9 Calculations for Projected Market Share**

**COMMERCIAL SEGMENT**

| Hotel | Number of Rooms | | Commercial Competitive Index | | Market Share Adjuster | Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 175 | = | 17,500 | 9.8% |
| *B* | 200 | × | 118 | = | 23,600 | 13.2 |
| *C* | 250 | × | 192 | = | 48,000 | 26.9 |
| *D* | 300 | × | 115 | = | 34,500 | 19.3 |
| *E* | 225 | × | 118 | = | 26,550 | 14.9 |
| *F* | 150 | × | 190 | = | 28,500 | 15.9 |
| Total | | | | | 178,650 | 100.0% |

**MEETING SEGMENT**

| Hotel | Number of Rooms | | Meeting Competitive Index | | Market Share Adjuster | Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 29 | = | 2,900 | 3.3% |
| *B* | 200 | × | 71 | = | 14,200 | 16.4 |
| *C* | 250 | × | 55 | = | 13,750 | 15.9 |
| *D* | 300 | × | 102 | = | 30,600 | 35.3 |
| *E* | 225 | × | 92 | = | 20,700 | 23.9 |
| *F* | 150 | × | 30 | = | 4,500 | 5.2 |
| Total | | | | | 86,650 | 100.0% |

**LEISURE SEGMENT**

| Hotel | Number of Rooms | | Leisure Competitive Index | | Market Share Adjuster | Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 88 | = | 8,800 | 15.7% |
| *B* | 200 | × | 48 | = | 9,600 | 17.2 |
| *C* | 250 | × | 27 | = | 6,750 | 12.1 |
| *D* | 300 | × | 38 | = | 11,400 | 20.3 |
| *E* | 225 | × | 53 | = | 11,925 | 21.3 |
| *F* | 150 | × | 50 | = | 7,500 | 13.4 |
| Total | | | | | 55,975 | 100.0% |

The percentage of occupancy for each hotel is calculated by first multiplying the market share percentage by the total room-night demand for the corresponding segment to arrive at the room-nights captured for the corresponding segment. Then the subject property's combined total room-nights captured is divided by the number of available rooms per year at the subject property (i.e., the subject property's room count multiplied by 365).

### [c] Projected Occupancy

Exhibit 10-9 shows the projected occupancy of Hotel *F*, as well as the effect it would have on the occupancies of the existing hotels in the market area. Note the difference in the number of room-nights captured as compared to the data for the market before the introduction of Hotel *F* (see ¶ 10.03[2][a]).

**Exhibit 10-10 Room-Nights Captured**

| Hotel | Commercial | Group & Meeting | Leisure | Total | Occupancy[1] |
|---|---|---|---|---|---|
| *A* | 15,461 | 2,794 | 7,678 | 25,933 | 71% |
| *B* | 20,825 | 13,885 | 8,411 | 43,121 | 59 |
| *C* | 42,439 | 13,462 | 5,917 | 61,818 | 68 |
| *D* | 30,449 | 29,886 | 9,927 | 70,262 | 64 |
| *E* | 23,507 | 20,235 | 10,416 | 54,158 | 66 |
| *F* | 25,084 | 4,403 | 6,553 | 36,040 | 66 |

[1] Occupancy = Total room-nights captured ÷ (Room Count × 365)

In addition to the introduction of a new hotel, other factors that can change the competitive indexes of hotels include:

- A major renovation or an addition to an existing hotel.
- A change in management of a hotel franchise.
- A change in market orientation for a particular property.
- The physical or functional obsolescence of a facility.

Any of these factors can make the evaluation of the relative competitiveness of a new lodging facility more difficult. However, competitive indexes are useful tools in that they help to portray the competitive dynamics of a market area.

## ¶ 10.04 STABILIZED OCCUPANCY

Stabilized occupancy figures represent the anticipated levels of occupancy for lodging facilities over their economic life, including any stages of build-up, plateau, or decline in their life cycles. Stabilized occupancy calculations exclude any abnormal relations of supply and demand, as well as any transitory or nonrecurring conditions (favorable or unfavorable) that may result in unusually high or low levels of occupancy. While it is likely that a hotel will operate at occupancies above its stabilized level for a period of time, it is equally possible for new competition and temporary downturns in the economy to force the actual occupancy below this standard. Essentially, stabilized occupancy is the typical occupancy experienced by a hotel over its economic life.

For new hotels, an assumed two- to five-year build-up in occupancy is generally included in the projection; a stabilized occupancy level starting with the first year is not expected. The initial years often see operating losses, so the inclusion of the build-up period in the projection is necessary to properly account for the actual start-up cash requirements.

Many factors influence the projection of a stabilized level of occupancy. The following are some of the key *market-specific* considerations:

- Historical occupancy cycles
- Composition of demand
- Supply and demand trends
- Trends in competitive properties
- Significant area development

These are some of the important *property-specific* considerations:

- Age
- Degree of obsolescence
- Location
- Market share
- Management and image

The nature of the local hotel demand is probably the best indicator for establishing a stabilized level of occupancy. Different types of travelers have different travel patterns (i.e., days of travel, length of stay and seasonality), and the particular mixture of these visitors within a given market will influence the area's overall level of occupancy.

For example, assume that the demand in a market has a very strong business base that generates a significant room-night demand Monday through Thursday nights. However, the local area has no leisure attractions, so very few people use the market area's lodging facilities on Friday and Saturday nights. There is, however, some commercial demand on Sunday nights from business travelers planning an early start on the work week. This occupancy pattern adds up to an average areawide level of occupancy of approximately 72 percent, assuming the daily occupancies listed in Exhibit 10-11.

**Exhibit 10-11 Occupancy Statistics**

| Weekday | Percent of Occupancy |
|---|---|
| Monday | 100% |
| Tuesday | 100 |
| Wednesday | 100 |
| Thursday | 100 |
| Friday | 30 |
| Saturday | 35 |
| Sunday | 40 |
| Weekly Average | 72% |

Under the market conditions given in the exhibit, and given the nature of the existing lodging demand, there would be little justification for using a stabilized occupancy factor of more than 72 percent for a proposed facility in this market unless the property had significant competitive attributes that would enable it to capture a larger than average share of the limited weekend demand. Furthermore, because it is highly unusual for a hotel to consistently achieve 100 percent occupancy levels 52 weeks a year with the normal commercial drop off on three-day weekend holidays, Christmas week, and the summer months, it would be difficult to maintain a 72 percent level on a year-round basis in any event, so a good case can be made for establishing the stabilized level in this example at a more reasonable 68 percent level.

Historical occupancy cycles for a market area provide an indication of the level at which stabilized occupancy should be set. Exhibit 10-12 provides the twenty-year occupancy cycle, with related statistical data, for three different cities:

**Exhibit 10-12 Twenty-Year Occupancy Cycle for Three Cities**

| Year | City *A* | City *B* | City *C* |
|---|---|---|---|
| 1 | 71.0% | 72.0% | 57.0% |
| 2 | 66.0 | 74.0 | 68.0 |
| 3 | 63.0 | 76.0 | 62.0 |
| 4 | 69.0 | 75.0 | 56.0 |
| 5 | 60.0 | 69.0 | 50.0 |
| 6 | 61.0 | 68.0 | 47.0 |
| 7 | 63.0 | 69.0 | 49.0 |
| 8 | 66.0 | 70.0 | 51.0 |
| 9 | 64.0 | 69.0 | 46.0 |
| 10 | 66.0 | 64.0 | 57.0 |
| 11 | 68.0 | 71.0 | 59.0 |
| 12 | 69.0 | 71.0 | 61.0 |
| 13 | 72.0 | 77.0 | 63.0 |
| 14 | 72.0 | 78.0 | 60.0 |
| 15 | 69.0 | 76.0 | 63.0 |
| 16 | 66.0 | 72.0 | 62.0 |
| 17 | 59.0 | 68.0 | 61.0 |
| 18 | 65.0 | 68.0 | 61.0 |
| 19 | 69.0 | 70.0 | 57.0 |
| 20 | 70.0 | 69.0 | 60.0 |

| | City *A* | City *B* | City *C* |
|---|---|---|---|
| Average Occupancy | 66.4% | 71.3% | 57.5% |
| Highest Occupancy | 72 | 78 | 68 |
| Lowest Occupancy | 59 | 64 | 46 |
| Difference | | | |

The stabilized occupancy for each of these three cities should approximate their average occupancy, which is generally close to the midpoint between the highest and lowest recorded occupancy level during the twenty-year period.

## ¶ 10.05 AVERAGE RATE PER OCCUPIED ROOM

The average rate per occupied room is among the most important variables in a forecast of the income and expense of a hotel because it directly affects both financial feasibility and market value. Professionals who conduct market studies should understand how average rates are calculated and be familiar with the various factors that affect their future movement.

To be fully documented, an economic market study and appraisal for a lodging facility should include a detailed analysis that explains the derivation of its forecasted average rates as well as a comparison of the subject property's rates with those of competitive hotels. An estimate of average rate depends on the evaluation of many factors, including:

- Supply and demand conditions in the local hostelry market
- Management's marketing expertise and ability to create a positive price/value relationship in the eyes of the consumer
- Current room rates of competitive hotels
- The quality, class, and other attributes of the subject property
- The market orientation of the subject property, including the rate-sensitivity characteristics and double occupancy percentages of each individual market segment

A hotel's average rate per occupied room is calculated by dividing the net rooms revenue derived from guestrooms by the number of paid rooms occupied. The result is the weighted average of the various rate categories used by the hotel during the period.

The equation used to calculate the average rate per occupied room is as follows:

Overall Average Rate Per Occupied Room =
Net Rooms Revenue/Number of Paid Rooms Occupied

The *Uniform System of Accounts for Hotels* (8th ed., Hotel Association of New York City, Inc., (1986)) defines the components of this formula as follows:

- *Net rooms revenue:* Total rooms revenue less allowances.
- *Allowances:* Rebates and overcharges or revenue not known at the time of sale but adjusted at a subsequent date. Allowances may also include revenue forgone as a result of hotel promotions or complimentary services.
- *Paid rooms occupied:* Rooms occupied by hotel guests on a paid basis. The overall average rate per occupied room does not include any occupancy derived from complimentary rooms.

## ¶ 10.06 FORECASTING AVERAGE RATE PER OCCUPIED ROOM

The procedure used to forecast average rates per occupied room for lodging facilities varies depending on whether the property is an existing or proposed hotel. An existing hotel's established room rate level and competitive position may change slightly, but they provide the appraiser with a benchmark from which to forecast future trends in average rates. Because proposed hotels have no operating history, an average rate must be derived from an analysis of the competitive rates of local lodging facilities, both current and forecasted, based on anticipated changes in supply, demand, and competitive factors.

## [1] Procedure for Existing Hotels

The first step for the appraiser in this procedure is to compile the property's overall average rates by month for the previous three to five years. The appraiser must verify that the average rates do not contain complimentary rooms. The next step is an analysis of the historical trends in average room rates for the subject property—to determine what the compounded growth rate has been over the past several years. If the data is available, the average room rate should be examined by individual market segments. Lastly, average room rates should be examined to determine if there are any seasonal effects on demand. If so, the average rate by season and month should be elevated to determine the compounded growth trends by season.

After the data regarding historical average room rates has been compiled and analyzed, the historical relationships between occupancy and average rate fluctuations should be investigated. Average room rates are often affected by changes in occupancies. For example, average rates usually soften or even decline as occupancies trend downward, and the reverse takes place as occupancies increase. The reason for this relationship lies both in the local market and in the individual property. On a marketwide basis, hotel occupancies decrease when there is either an increase in the supply of hotel rooms or a decrease in the demand for transient accommodations. Both situations typically increase the competition among area hotels, which often leads to rate sensitivity. While not all hotels feeling the impact of greater competition will immediately institute a price-cutting program, they will be more conscious of the negative effect of raising room rates or of holding a hard rate policy when negotiating new business with groups and contracts. As area occupancies decrease, hotels feel pressured to cut rates in order to hold on to their market share. In a declining market, therefore, appraisers should look for the real possibility that average rates may remain flat or even decline.

Notwithstanding local market conditions, average room rates usually increase as a property's occupancy rises. This can be attributed to the fact that when a hotel approaches 100-percent occupancy, it is able to sell more of its high-priced rooms. In addition, management's bargaining position is enhanced, so it does not have to offer discounts or other inducements to attract patronage. For example, a customer making a reservation at a hotel with one room remaining will probably pay rack or full rate. By selling out the higher-priced rooms, a hotel's average room rate will generally increase faster than either inflation or local market conditions would dictate.

### [a] Average Rates of Competitors

The next step for the appraiser is to compile a list of average room rates for the subject property's primary and secondary competitors. One year's worth of historical data is adequate, but a trend analysis can be made if data from additional years can be gathered. The appraiser must be certain that the information represents average room rates and not other types of hotel room rate statistics, of which there are many. The following is a list of some of the terms used in the industry to describe different types of hotel room rates:

- *Rack rate:* An undiscounted room rate. The term is taken from the front desk's room rack which contains information about each room's rate including the highest rate that can be charged for that accommodation. When a hotel is operating full or when someone comes in without a reservation, the rack rate is generally the only rate available. The average rate is always less than the rack rate.

- *Published rate:* The rate found in directories and other publications. This rate is usually quoted in ranges (i.e., single: $70–$100) and represents the range of rack rates for specific types of accommodations. Published room rates typically set the upper limits of average rates. Average room rates tend to be closer to the published rates for single rooms than for doubles.
- *Commercial rate:* A special discounted rate available to certain commercial accounts. Some hotels allow almost any commercial traveler to use a commercial rate, while others apply this rate only for specific accounts.
- *Contract rate:* A discounted rate available to specific users, such as an airline, convention group, or bus tour. Arrangements for this rate are negotiated individually by the user, and payment is often billed directly to the firm or organization using the room. Depending on the amount and timing of the usage, a contract rate can be heavily discounted and significantly lower than either the average rate or the commercial rate.

### [b] Comparison of Subject Property With Competitive Properties

The next step for the appraiser is to compare the subject property's average rate with that of the competition to determine the reasons for any differences in average rates. Generally, rate variances can be attributed to several factors, including location, physical facilities, management, image, quality, and market segments served. In addition, if there have been any trends in average rate movement over time, these factors should be quantified and evaluated.

### [c] Future Changes in Market Area Economy and Competitive Supply

Once the historical competitive data has been analyzed, the appraiser must forecast any changes in the local economy or competitive supply that may affect average rates in the future. The appraiser must also forecast a yearly percentage change in average room rates over a projection period. The key factors that influence future trends in room rates are:

- *Supply and demand relationship.* As discussed in Chapters 9 and 10, the balance between the market area's supply of transient lodging facilities and the local demand generally has a significant impact on future trends in average room rates, because hotel room rates tend to mirror changes in area occupancies.
- *Inflationary trends.* When an appraiser forecasts the income and expense of a hotel over a projection period, the occupancy usually levels off at a point in time known as the stabilized year. Until this hypothetical point of equilibrium, room rates are usually affected more by local conditions and the increased (or decreased) occupancy of the subject property than by inflationary pressures. After the level of occupancy has reached this stabilized point, and all external market conditions are assumed to be in equilibrium, the average room rate is typically projected to increase at the rate of inflation.
- *New construction.* Newly constructed lodging facilities must typically achieve room rates that are higher than the going market rate in order to cover development costs.

In addition to improving the neighborhood in which it is built, a new hotel often allows existing hotels to push average room rates up so that they are competitively below the new property's rates but significantly above the current levels. However, this type of rate movement takes place only in markets that are not overbuilt. If too many new rooms open at once, the rates of every hotel in the market area will suffer.

### [d] Average Rate Projection for Subject Property

Once all the previously described data has been accumulated and evaluated, the appraiser forecasts the subject's average rate over the projection period.

## [2] Procedure for Proposed Hotels

The procedure for forecasting average rates for a proposed hotel is similar to that used for an existing facility except that the appraiser does not have the benefit of operating history to provide a starting point for the projection. The appraiser must therefore rely upon room-rate data for competitive properties, particularly average rates by market segment. The relative competitiveness of each property must also be carefully evaluated in order to determine the room-rate differentials necessary to maximize the subject's competitive position.

Appraisers use four basic methods to project average room rates for proposed hotels: competitive positioning, the bottom-up method, the rule of thumb approach, and the market segmentation approach. Each method has advantages and disadvantages that the appraiser must consider in light of the particular circumstances surrounding a proposed hotel. In some instances a combination of methods is used when the strengths of one can counterbalance the weaknesses of another. Each method is analyzed in the following sections.

### [a] Competitive Positioning Method

The competitive positioning method forecasts the room rates of a proposed hotel by using the rates currently achieved by competitive lodging facilities. The range of average room rates established by competitive hotels is considered to set the general limits for the rates that can be achieved by the proposed hotel. The rate for the proposed hotel is then determined by the actual average room rate of the competitive property that it most closely resembles in quality, size, facilities, market orientation, and location.

Exhibit 10-13 provides the average room rates of the primary competition in a hypothetical market area.

An analysis of the attributes of these hotels reveals Hotel *F* to be the most similar of the group to the proposed property. On the basis of this conclusion, the appraiser should give the room rate achieved by Hotel *F* the most weight when setting the average rate for the proposed property. Further analysis reveals that Hotel *F*'s rate of $88.00 should be scaled slightly upward for the following reasons:

- The subject property will be new when it opens. Hotel *F* will be six years old.
- Hotel *F* derives a larger percentage of its business from the meeting and convention market segment, which tends to receive greater discounts than the commercial segment.
- The subject property will have a more visible location with better access than Hotel *F*.

**Exhibit 10-13 Hypothetical Market Area's Average Room Rates**

| Property | Estimated Average Room Rate |
|---|---|
| *A* | $68.00 |
| *B* | 82.00 |
| *C* | 77.00 |
| *D* | 80.00 |
| *E* | 87.00 |
| *F* | 88.00 |
| *G* | 78.00 |
| Average | $81.00 |

It appears that an average room rate of between $89.00 and $90.00 would be justified and reasonable for the subject property.

Advantages of the competitive positioning method are as follows:

- The dynamics of the surrounding market area are taken into account by the consideration of actual average room rates achieved by competitive properties.
- The price sensitivities of local demand are reflected in the data used in the process.
- The method is based on other local hotels, so it inherently considers area operating costs.

The disadvantages of the competitive positioning method are as follows:

- It depends on accurate average room rate information from competitive hotels, which is sometimes difficult to obtain.
- It relies on the assumption that a property, similar in almost all respects to the subject, exists in the marketplace. If such a property does not exist, subjective adjustments must be made to compensate for the differences in the subject property. The appropriateness of the ultimate result depends on the skill and experience of the appraiser. The competitive positioning method is a good way to verify that the average room rate achieved by an existing lodging facility actually reflects its competitive position in the local market.

### [b] Bottom-Up Method

The bottom-up method (also known as the Hubbart Formula) assumes that a proposed hotel should charge room rates that will cover all the costs of its operation, including a predetermined net income level, debt service, and development costs. To use this method, an appraiser first determines the development and financing costs of the project. The process continues by working upward from the bottom of an income and expense statement which is tailored to the anticipated operating characteristics of the subject property, until the required room rate is derived. The required room rate, as determined by this method, directly reflects all of the predetermined development and operational considerations specific to the subject property.

Exhibit 10-14 is an abridged version of an income and expense statement for a hypothetical proposed property.

**Exhibit 10-14 Abridged Income and Expense Statement**

| | |
|---|---|
| Required Net Income* | 2,883,000.00 |
| Total Fixed Charges | 878,000.00 |
| Undistributed Operating Expenses | 3,207,000.00 |
| Required House Profit | 6,968,000.00 |
| Estimated Departmental Profits (non-rooms) | 1,519,000.00 |
| Required Rooms Profit | 5,449,000.00 |
| Estimated Rooms Expense (22.6%) | 1,591,000.00 |
| Required Rooms Revenue | 7,040,000.00 |
| Total Occupied Rooms (300 × 72% × 365) | 78,840.00 |
| Estimated Average Room Rate | $89.29 |

*Net income to cover debt service and rate of return on invested equity

Using the bottom-up method, it was determined, on the basis of the total project cost, the amount of the mortgage, and the resulting debt service and equity return requirements, that a net income before debt service of $2,883,000 would be required. Taking into consideration local market conditions and expense factors, estimates were made for expenses such as fixed charges, undistributed operating expenses, and rooms expense as well as several miscellaneous profits such as departmental profit. Assuming an occupancy of 72 percent, the resulting calculation indicates that an average rate of $89.29 would be necessary to generate the required net income.

While the bottom-up method can be used to estimate an average room rate, it does not take into account any local market conditions or competitive factors, which means that many marketplace factors are ignored. Thus, the bottom-up method is more appropriate for justifying project feasibility than for setting actual average room rates. For example, the foregoing computation might be better used to conclude that if the market cannot support an average room rate for the subject property of at least $89.29, then the net income before debt service of $2,883,000 would probably not be achieved, resulting in a lower than contemplated return to the invested capital components (debt and equity).

The bottom-up method of establishing an average room rate has the following advantages:

- Several property-specific factors are accounted for, including return requirements of invested capital, the property's fixed costs and operating expenses, and the contemplated level of occupancy.
- This method does not require information pertaining to the average room rates of competitive lodging facilities.

The bottom-up method has the following disadvantages:

- It does not use a market basis to evaluate the reasonableness of the average room rate estimate. This method may, therefore, result in an average room rate that is unobtainable in the local marketplace.
- This method is relatively complicated to use and is overly dependent on assumptions, such as cost and expense levels.
- It requires an estimate of occupancy for the subject property, which would probably necessitate some fieldwork to compile data on occupancy percentages of competitive lodging facilities.

## [c] Rule of Thumb Method

The rule of thumb method relies on the time-honored theory that every dollar of average room rate should support approximately $1,000 of total hotel value (i.e., land, improvements, and FF&E) on a per room basis. Exhibit 10-15 illustrates this theory.

**Exhibit 10-15 Rule of Thumb Calculations**

| | |
|---|---|
| Total Hotel Property Value | $26,780,000.00 |
| Number of Available Rooms | ÷ 300 |
| Value Per Room | $89,267.00 |
| Required Average Room Rate | $89.27 |
| or | |
| Estimated Average Room Rate (market) | $89.27 |
| Value Per Room | $89,267.00 |
| Number of Available Rooms | × 300 |
| Total Property Value | $26,780,000.00 |

These calculations show that the rule of thumb method can be used in two directions. The first calculation starts with the local property value and determines the average room rate necessary to justify this amount of investment. This procedure and its conclusion are similar to the bottom-up method in that the average room rate is not market-justified but rather illustrates economic feasibility. The second calculation starts with the average room rate, which is derived from the market, and calculates the maximum amount of total property value this room rate would be able to support.

The rule of thumb method relies on a number of assumptions, including the subject's occupancy, ratio of food and beverage revenue to rooms revenue, operating costs, fixed expenses, and capital costs. Properties that do not fit the national norms for these assumptions are apt to require more or less than $1.00 of average rate to justify $1,000 of per room value. For example, assume that this rule of thumb works for hotels with an assumed occupancy level of 72 percent. If the subject property was projected to achieve only a 68 percent stabilized occupancy then it would take more than $1.00 of average room rate to equate to $1,000 of per room value.

The advantages of the rule of thumb method are:

- It is simple to calculate and easy to use.
- It may be used to determine either an average rate based on total value, or the total value based on an achievable average rate.

The disadvantage of the rule of thumb method is that it relies upon a number of inherent assumptions that are not explicitly accounted for. For this reason, it should only be used to establish broad parameters for room rates and project value.

## [d] Market Segmentation Method

The market segmentation method uses a forecasted market breakdown (i.e., commercial, meeting and group, or leisure) for the subject property as a basis for calculating a weighted average room rate. This method involves multiplying the average room rate per market segment by the anticipated number of occupied room nights for each respective market segment that produces revenue for the hotel. The overall average room rate is then calculated by dividing the total rooms revenue by the total number of occupied rooms. The result is a weighted average room rate that reflects the price sensitivity of each segment of lodging demand.

Most hotel market studies and appraisals use the competitive positioning or market segmentation methods for estimating average room rates. Each method works well for all types of existing and proposed lodging facilities. However, neither of the methods are purely objective; they both rely heavily on the experience and judgment of the appraiser who conducts them.

CHAPTER 11

# Revenue Forecast



## ¶ 11.01 INTRODUCTION

Forecasting the revenue of a lodging facility is best accomplished in a step-by-step fashion that follows the format set forth in the *Uniform System of Accounts for Hotels* (Hotel Association of New York City, Inc., 8th ed. HANYC Inc., 1986). In this system, sources of income are categorized and estimated separately before they are combined in one complete statement of both revenue and expense. Most hotels follow this uniform procedure; it has become the standard format for forecasting.

The major categories of revenue in this system are room, food service, beverage, and telephone. A miscellaneous category of other income—in which smaller amounts of revenue from sources such as rentals, forfeited advance deposits, and vending machines are combined—is also usually forecasted.

The build-up cover approach and the fixed and variable component approach are the two most commonly used methods for projecting food and beverage revenue. While the build-up cover approach is used only to forecast food and beverage revenue, the fixed and variable component approach is also used to estimate other types of revenue. Where possible, appraisers use both methods as a means of verifying the accuracy of a forecasted estimate.

The build-up approach forecasts food and beverage revenue by developing estimates of individual revenue components such as patronage, number of meals served, and average price per meal. The fixed and variable component approach is based on the anticipated relationship of food revenue to rooms revenue and beverage revenue to food revenue. The build-up approach requires knowledge of local market conditions, and it takes into account the specific facilities offered by the subject property. The fixed and variable component approach depends on data from a directly comparable hotel, but can easily be adjusted to reflect differences in occupancy levels.

This chapter explains the theory behind the fixed and variable component approach and demonstrates its application in revenue forecasts. Chapter 12 shows how it is used to make expense projections. The procedure used in the fixed and variable component approach is identical for both revenues and expenses.

## ¶ 11.02 ROOMS REVENUE

The estimated total rooms revenue is the most important component of the overall revenue forecast because it is the major source of profit for any lodging facility. It is also important because it sets the benchmark from which other revenues are projected. The procedure for forecasting rooms revenue is relatively straightforward. The appraiser multiplies the projected occupancy rate for the subject property as determined by the room-night analysis conducted earlier in the market study (see Chapter 9) by the forecasted average room rate (see Chapter 10). The result is then multiplied by the room count of the property, which is in turn multiplied by 365 days. These computations yield the total rooms revenue.

## ¶ 11.03 FOOD AND BEVERAGE REVENUE

Most full-service lodging facilities provide both food and beverage outlets for the use of their guests as well as local residents. The primary outlets found within most lodging facilities are restaurants, lounges, bars, banquet rooms, and room service. These outlets generate two kinds of income: food revenue and beverage revenue.

Food revenue is defined as revenue derived from the sale of food, including coffee, milk, tea, and soft drinks. Food sales do not include employee meals charged on hotel employees' checks, which are usually an adjustment to food cost. Beverage revenue is defined in the *Uniform System of Accounts for Hotels* as revenue derived from the sale of alcoholic beverages. In addition to the revenue generated by the sale of food and beverages, hotels generally produce related income from meeting room rental, cover charges, service charges, and miscellaneous banquet revenue.

### [1] Food Revenue

Exhibit 11-1 lists the various revenue categories included in the food department of a hotel. The table also shows whether the category is relatively fixed, occupancy sensitive, rate sensitive, or food sensitive. This information is useful when food revenue is projected through use of a fixed and variable component approach.

Food revenue varies greatly, depending on the number of outlets, the management expertise, and the market orientation of each outlet. External factors such as the competitive environment, proximity to demand generators, and the market segmentation of a hotel also influence the revenue-generating potential of a food outlet.

**Exhibit 11-1 Food Revenue**

*Source: Uniform System of Accounts for Hotels*

| Category | Percent of Sales | Fixed Revenue | Variable Revenue: Occupancy-Sensitive | Variable Revenue: Rate-Sensitive | Variable Revenue: Food- and Beverage-Sensitive |
|---|---|---|---|---|---|
| Food | 60–85 | — | Moderately | — | Highly |
| Beverage | 15–40 | — | Moderately | — | Highly |
| Other income | | | | | |
| Public Room Rentals | 0–2 | — | Moderately | — | Slightly |
| Cover and Minimum Charges | 0–2 | — | Moderately | — | Highly |
| Sundry Banquet Income | 0–2 | — | Slightly | — | Highly |

Food revenue is calculated by multiplying factors for demand and average check. The unit of demand used to quantify food volume is the cover, which represents one meal served to one person. This term originates from the cover plate in each place setting that is removed just prior to the appetizer course. The number of patrons served during each meal period is simply determined by counting the cover plates that were used. The average check is similar in concept to average room rate and is calculated by dividing the total food revenue for a period of time by the number of covers served. (Generally, the average check is calculated separately for food revenues and beverage revenues.)

## [a] Build-Up Cover Approach

The build-up cover approach is a means of forecasting demand for food service by estimating the total number of covers a property is expected to sell. The forecast of food revenue is then determined by multiplying the total number of covers by the estimated average check. The appraiser can project demand (i.e., number of covers) by analyzing either restaurant activity or lodging activity.

The analysis of restaurant activity also involves multiplying turnover—the number of times a seat is occupied during a given meal period—by the number of seats available per meal period. By totaling the number of covers for each meal period for all of the food services of a property during the projection period, the appraiser can approximate total food demand.

Eating- and drinking-place sales statistics are used to formulate two restaurant market indexes for approximately 300 U.S. metropolitan areas. Since 1968, Market Statistics, a division of Bill Communications, Inc., has published restaurant data and statistics in *Restaurant Business* magazine. This information is summarized in two indexes.

1. Restaurant Activity Index (RAI)
2. Restaurant Growth Index (RGI)

The restaurant activity index (RAI) measures an area's eating-place sales activity relative to its food store sales and compares this ratio with the national average. More specifically, it is the ratio of an area's eating-place sales (expressed as a percentage of total U.S. eating-place sales) to the area's food store sales (expressed as a percentage of total U.S. food store sales). Eating-place sales include retail sales of restaurants and lunch rooms, cafeterias, fast-food sales, banquets, and sales of specialty foods such as those found in ice cream and frozen yogurt stands. Drinking-place sales are excluded.

The national average is the index base, expressed as 100, and a specific area is compared with the national average by the following formula.

RAI = Percentage of U.S. Eating-Place Sales Located in the Market/
Percent of U.S. Food Store Sales Located in the Market

If the resulting number is larger than 100, it indicates a greater than average propensity to eat away from home. Some of the reasons why a restaurant activity index may be greater than 100 include the fact that local citizens dine out more than the national average or that local restaurants receive non-local patronage from sources such as transient vehicular traffic, hotel guests, conventioneers, vacationers, or residents of nearby communities.

An index lower than 100 indicates that an area's percentage of dining out sales is lower than that of the nation as a whole. This may be attributed to an insufficient number of restaurants, which forces residents to dine out in neighboring metropolitan areas, and restaurants situated in neighboring metropolitan areas that draw patronage away from local outlets.

The purpose of the restaurant activity index is to indicate the current level of dining-out activity, and further analysis must be made to identify the reasons for this level.

The restaurant growth index (RGI) presents the relationship between restaurant supply and demand in the form of an index. When supply equals demand, the index is 100. The mathematical equation used to calculate RGI is as follows.

RGI = Demand/Market's Percentage of U.S. Total Eating Place Sales × 100

In the foregoing equation, demand is an average of the market's share of the following five variables: the number of working women (this figure is multiplied by two to give it extra weight), U.S. households with effective buying incomes of $25,000 or more, U.S. eating-place sales, U.S. hotel and motel receipts, and the U.S. population under the age of 14 and between the ages of 25 and 44. Multiplying by 100 ensures that the final figure will be in an index form.

The amount by which the RGI exceeds 100 indicates the growth potential that is present. For example, an RGI of 120 indicates that the current market area is underdeveloped and could support an approximate 20% increase in the number of food and beverage facilities. When the market is saturated, the index will drop below 100. The lower the number, the more saturated the market.

Both the RAI and RGI should be evaluated concurrently in order to make a proper determination of an area's future restaurant potential.

Turnover is generally estimated by determining the actual past turnover experienced by the subject property if it has an operating history; if not, by that of similar facilities in the market area.

If the appraiser has no operating history to refer to, data for similar outlets can be used. The necessary information can usually be obtained through discussions with the management of the hotels in which the outlets are operated or by actually surveying and counting the number of patrons served during specific meal periods in such outlets. Once the turnover has been estimated for each of the food outlets, it is multiplied by the number of seats, meal periods, and business days to arrive at a forecast of the total number of covers the property will sell.

There are, however, two drawbacks to the analysis of restaurant activity. The first is that it can be difficult to obtain accurate turnover ratios from competitive facilities. The second is that adjustments must be made to the data that are needed to reflect the attributes of the subject property. This procedure requires a number of subjective decisions on the part of the appraiser and can become quite complicated.

Projecting food demand by the analysis of lodging activity is justified by the fact that the number of covers sold by a hotel is directly related to guestroom usage (room-night demand) and market segmentation. Through statistical analysis and knowledge of the frequency with which each market segment makes use of a hotel's facilities, the total in-house demand can be estimated. The appraiser then combines the in-house forecast with a factor for demand created outside the hotel (i.e., meeting and banquet business) to forecast the total number of covers the property will sell.

The analysis of lodging activity takes into account the total house count (number of people occupying the guestrooms) and the patronage patterns of the different market segments into which the guests fall. Since in-house demand typically accounts for 60 percent to 80 percent of the food and beverage sales for a hotel (depending on hotel type, location, and proximity to alternative dining facilities), the analysis of lodging activity generally produces a more supportable estimate of food demand than does the analysis of restaurant activity.

To project future total food revenue using an analysis of lodging activity, the appraiser must take the following steps:

1. Calculate the total house count by market segment using the projected occupancy and double occupancy estimates derived during the room-night analysis and the average room rate analysis.
2. Apply the percentage of each market segment that patronizes each of the proposed subject's food outlets by meal period to the total house count to yield the approximate future in-house food service demand in each of the market segments.
3. Estimate the out-of-house demand generated from non-hotel guests using a hotel's restaurant facilities either on a per-cover basis or as a percentage of total demand to yield out-of-house restaurant demand.
4. Estimate total banquet covers served to non-hotel guests based on the product of the average number of banquets per week and the average number of covers per banquet or the average number of banquet covers per day.
5. Determine total food service demand by adding together in-house food service demand, out-of-house restaurant demand, and non-hotel guest banquet demand.
6. Estimate the average check for each meal period based on the operating history of either the subject property or similar competitive food facilities in the marketplace.
7. Multiply the average check for each meal period by the estimated total number of covers (per year) for that meal period to yield the total food revenue.

[i] **House count.** The term "house count" refers to the number of guests that stay at a hotel over a specific period of time (usually one year). This quantity is used to determine the rate of double occupancy, which is the average number of guests occupying one guestroom. The double occupancy rate is calculated by dividing the house count for the year by the number of occupied rooms for the same period of time, as in the following example:

$$\text{House Count/Occupied Rooms} = 85{,}252/64{,}659 = 1.32$$

Thus, every guestroom sold within this hotel had an average of 1.32 occupants. The commercial market segment is typically composed of individual business travelers; as a whole, therefore, it has a low rate of double occupancy (1 to 1.4). Meeting and convention demand generally has a higher rate. Commercial groups (i.e., business meeting attendees) typically have a lower double occupancy rate (1.35 to 1.50) than social groups, which are sometimes more price sensitive and thus produce a range of double occupancy of 1.5 to 2.0. Leisure travelers are typically families, for which the double occupancy rate is 1.7 to 2.5.

[ii] **In-house capture.** In-house capture is based on the propensity of each hotel guest to use the property's food outlets. Capture differs depending upon the market segment, meal period, and type of food facility available.

For example, commercial travelers exhibit a higher than average propensity to take breakfast at the property's facilities, especially from room service. The meeting and convention segment exhibits mixed propensities to dine at the subject's facilities, depending on whether the meeting or convention is held within the hotel, and whether a planned breakfast is provided to the group. Similarly, leisure travelers also show a mixed propensity to use in-house facilities. This segment tends to forgo breakfast on weekdays, but has a high tendency to order breakfast or brunch on the weekends.

In-house capture also varies by meal period. In most hotels there is a fairly strong breakfast demand from guests, especially on the weekends if the restaurant offers brunch. Typically, the lunch meal period captures little in-house traffic. Because few guests are in the hotel at midday, lunch demand is predominantly from local business people and shoppers, depending on the hotel's location and proximity to office buildings and retail outlets. The hotel's dinner demand usually depends on the dining alternatives in the local area. If suitable alternatives exist, commercial and leisure travelers do not usually dine at the hotel's food outlets. Meeting and convention guests often have planned functions at night and will therefore create little dinner demand.

[iii] **Out-of-house restaurant demand.** Food service patronage from local clientele (outside capture) includes demand generated by nearby residents, business people, and transients passing through the area. Out-of-house restaurant demand can be calculated as a percentage of total food service demand excluding banquet patronage. Typical ranges of out-of-house demand percentages are listed in Exhibit 11-2.

**Exhibit 11-2 Out-of-House Demand Percentages**

| Meal Period | Percentage of total food demand excluding banquet patronage |
|---|---|
| Breakfast | 5%–15% |
| Lunch | 30%–70% |
| Dinner | 20%–60% |

Out-of-house restaurant demand is generally lowest during breakfast and highest at lunch. Dinner demand is variable, depending on the quality of the facilities of the subject property and the local dining alternatives.

Most new hotels typically experience a high out-of-house restaurant demand during the initial year or two as local residents and business people try out the new food outlets. As the appeal of the hotel's novelty subsides, out-of-house usage generally declines. Overall, the percentage of total food demand (excluding banquet patronage) remains constant albeit minimal for breakfast, but generally declines for lunch and dinner.

[iv] **Banquet demand.** Banquet covers are estimated separately and are based on the product of the average number of banquets per week multiplied by the average number of covers per banquet. Banquet covers are assumed to be out-of-house patronage. Use of banquet facilities by in-house meeting and convention patronage is included in estimates of overall food service use.

## [b] Fixed and Variable Component Approach

The second approach that may be used to forecast food revenue is the fixed and variable component approach. The forecasting procedures used in this approach represent one of the most accurate models of hotel financial performance. With proper input, it can produce reliable forecasts of every category of hotel revenue and expense. The fixed and variable component approach forms the basis for most computerized hotel forecasting models employed by hotel appraisal and consulting firms as well as by a number of hotel companies, investors, lenders, and developers.

This approach is based on the concept that most items of revenue and expense within a hotel have a fixed component, which does not vary with a hotel's occupancy or other volume measure, and a variable component, which changes in direct relationship with occupancy or another measure of volume (e.g., total revenue). By estimating the food revenue for a specific level of occupancy and knowing what portion of the revenue is fixed and what portion is variable, the appraiser can calculate the revenue for other different levels of occupancy.

For an existing hotel, the estimate of food revenue at the specific occupancy level is based on past operating history. For a proposed facility, the food revenue estimate is derived from either the actual sales volume of a similar facility or the percentage relationship of food revenue to rooms revenue and beverage revenue to food revenue of a similar facility.

This same procedure can be used to project all categories of revenues and expenses found in a hotel's operating statement. It should be noted, however, that not all categories vary directly with occupancy. For example, food departmental expense varies with food revenue, telephone expense varies with telephone revenue, administrative and general expense varies with total revenue, and energy cost varies with total revenue.

To use the fixed and variable component approach to make financial forecasts, the appraiser must complete the following steps:

1. Obtain actual income and expense data from the subject property for an existing hotel, or from similar properties for a proposed hotel.
2. Make any necessary adjustments to this data so it reflects as closely as possible the individual characteristics of the subject property. These adjustments may include changing the average room rate, modifying income and expense ratios, and altering fixed charges. The end result of these changes should be a one-year profit-and-loss statement that expresses the undiscounted first year average room rate for the subject in current dollars, and income and expense ratios at a level appropriate for the given occupancy percentage. This profit and loss statement is called the base and will serve as the basis for calculating the fixed and variable component relationships.

3. Inflate (or deflate) the revenue and expense numbers in the base to a level that reflects current dollars for the forecast year. The average room rate used in the base comes from the average rate projection. Any discounting of the average rate is disregarded in developing the base for each projected year.
4. Estimate the fixed and variable percentages for each revenue and expense category. Exhibit 11-3 lists typical ranges of fixed and variable percentages along with the index used to measure variable changes.

**Exhibit 11-3 Fixed and Variable Percentages for Revenues and Expenses**

| Revenues and Expense Category | Percent Fixed | Percent Variable | Index of Variability |
|---|---|---|---|
| **Revenues** | | | |
| Food | 25–50 | 50–75 | Occupancy |
| Beverage | 0–30 | 70–100 | Food Revenue |
| Telephone | 10–40 | 60–90 | Occupancy |
| Other Income | 30–60 | 40–70 | Occupancy |
| **Departmental Expenses** | | | |
| Rooms | 50–70 | 30–50 | Occupancy |
| Food and Beverage | 35–60 | 40–65 | Food and Beverage Revenue |
| Telephone | 55–75 | 25–45 | Telephone Revenue |
| Other Income | 40–60 | 40–60 | Other Income |
| **Undistributed Operating Expenses** | | | |
| Administrative and General | 65–85 | 15–35 | Total Revenue |
| Management Fee | 0 | 100 | Total Revenue |
| Marketing | 65–85 | 15–35 | Total Revenue |
| Franchise Fees | 0 | 100 | Rooms Revenue |
| Repairs and Maintenance | 55–75 | 25–45 | Total Revenue |
| Energy | 80–95 | 5–20 | Total Revenue |
| **Fixed Expenses** | | | |
| Property Taxes | 100 | 0 | Total Revenue |
| Insurance | 100 | 0 | Total Revenue |
| Reserve for Replacement | 0 | 100 | Total Revenue |

5. Calculate the fixed component by multiplying the appropriate base revenue or expense category for the projected year by the fixed percentage estimated in Step 4.
6. Calculate the variable percentage change. Variable revenues or expenses are assumed to vary directly with some index of variability. Exhibit 11-2 shows the appropriate index of variability for each revenue and expense category. The variable expense change is calculated by dividing the projected index of variability by the base index of variability for the projected year.

7. Calculate the unadjusted variable component by multiplying the appropriate base revenue or expense category for the projected year by the variable percentage estimated in Step 4.
8. Adjust the unadjusted variable component for variability by multiplying it by the variable percentage change calculated in Step 6. The resulting product is the adjusted variable component.
9. Total the forecasted revenue or expense for that specific category, in the projected year, by adding the fixed component calculated in Step 5 to the adjusted variable component calculated in Step 8.

#### [c] Test for Reasonableness

After making a financial projection, the appraiser should evaluate the result for reasonableness. The appraiser must determine whether the result is sensible (i.e., whether it is supported by the results achieved by similar hotels), whether it is likely that the subject property can actually achieve the projected figures, and finally, whether the individual projection is in line with all of the other projections.

To evaluate financial operating information, the appraiser generally uses various categories of data—for example, percentage of total revenue, percentage of rooms revenues, dollars per available room, and dollars per occupied room. These units of comparison put the financial data on a common base (e.g., amount per room) so that the operating results of many hotels can be compared and contrasted.

Each unit of comparison is better suited to certain revenue or expense categories than others. The applicability of certain units is due to specific relationships that cause various revenues and expenses to react differently to changes in occupancy, average room rate, and food and beverage volume. For example, if a revenue or expense category is primarily fixed, then greater emphasis should be placed on the dollars per available room as a unit of comparison, since it remains fixed even when revenues change. If the category varies in relation to changing occupancy levels or average room rates, the appropriate unit of comparison would be percentage of rooms or total revenue data, which will change in accordance with changes in revenues. Exhibit 11-4 shows the primary units of comparison used in the analysis of hotel financial data along with the factors that affect the sensitivity of these units. Listed next to each unit of comparison are the revenue and expense categories best suited for the particular form of comparison.

### [2] Beverage Revenue

Beverage revenue is derived through the sale of beverages (generally alcoholic) from a hotel's restaurants, lounges, banquet rooms, and room service. In accordance with the *Uniform System of Accounts for Hotels,* beverage revenue should be given a category separate from food revenue (although it should share the same expense category).

Beverage revenue can be forecasted in a manner similar to food revenue by using either a build-up cover approach or a fixed and variable component approach. The main difficulty in preparing forecasts of beverage revenue is estimating the future success of an in-house bar or lounge. Becasue the bulk of beverage revenue generally comes from a lounge outlet, the appraiser should have a clear understanding of the various dynamics that create success or failure in this type of business. Lounge customers tend to be fickle, so one year's "in" spot may be unpopular the next. Much of the success has to be attributed to the skills and expertise of management, which means there is a high degree of business risk (and opportunity) in operating a hotel lounge.

**Exhibit 11-4 Primary Units of Comparison**

| Unit of Comparison | Sensitivity Factors | Revenue and Expense Categories Analyzed |
|---|---|---|
| Percentage of total revenue | Occupancy<br>Average room rate<br>Food and beverage revenue | Administrative and general<br>Management Fee<br>Marketing<br>Property Operations and maintenance |
| Percentage of rooms revenue | Occupancy<br>Average room rate | Food revenue<br>Telephone revenue<br>Other income<br>Rooms expense |
| Percentage of food and beverage revenue | Food and beverage revenue | Food and beverage revenue |
| Per available room | Fixed categories | Administrative and general<br>Marketing<br>Property operations and maintenance<br>Energy<br>Insurance<br>Property taxes |
| Per occupied room | Occupancy | Food revenue<br>Beverage revenue<br>Telephone revenue<br>Other income<br>Rooms expense<br>Energy |

### [a] Build-Up Cover Approach

The build-up cover approach for forecasting beverage revenue is handled in a manner similar to that for projecting food revenue. The appraiser first looks at the percentage of the business that will be generated by in-house guests and the percentage that will originate outside the property. If the hotel lounge has any degree of success, a substantial portion of the beverage revenue will come from patrons who are not hotel guests. In addition to the demand generated from the beverage outlets, a certain amount of beverage revenue originates from liquor consumption by in-house restaurant-goers.

### [b] Fixed and Variable Component Approach

As with food revenue, the fixed and variable component approach is generally the preferred procedure for forecasting this category of income. Exhibit 11-2 shows that beverage revenue is typically 70 percent to 100 percent variable and 0 percent to 30 percent fixed. Because of this high variability, which is attributable to the direct relationship between food and beverage revenues, an assumed 100 percent variable component is normally used.

## ¶ 11.04 TELEPHONE REVENUE

Telephone revenue is derived from fees paid by hotel guests for local and long distance calls and from out-of-house patrons' use of public telephones. As part of the deregulation of the telephone industry, hotels are now permitted to resell telephone services to their guests at a reasonable profit. Prior to deregulation, hotels could collect only a 15 percent commission on long distance telephone calls, which was usually inadequate compensation, and many hotels suffered losses as a result of providing telephone service. At present, hotels have highly sophisticated telephone systems that incorporate automatic billing and posting to guest accounts, least-cost routing, and use of various providers of long distance services (e.g., AT&T, MCI, and US SPRINT). Hotel telephone departments are now more likely to show some profit, although revenues depend largely on the usage characteristics of the guests.

In recent years, long distance telephone charges billed by hotels to individual guests have decreased significantly because many long distance carrier services can be accessed by either a toll-free local call or an 800 number. Callers are generally charged merely an access fee rather than the normal long distance tariff. As a result, profits from telephone service have not grown as rapidly as the hotel industry had expected with telephone deregulation.

As a rule, telephone revenue varies directly with changes in occupancy. A small portion is fixed, representing pay station revenue generated by out-of-house patronage of food and beverage outlets and meeting rooms. The appropriate units of comparison are a percentage of rooms revenue or an amount per occupied room. Exhibit 11-5 lists the various categories of telephone revenue and describes their individual characteristics.

**Exhibit 11-5 Telephone Revenue**

*Source: Uniform System of Accounts for Hotels*

| | | | Variable Revenue | | |
|---|---|---|---|---|---|
| Category | Percent of Sales | Fixed Revenue | Occupancy-Sensitive | Rate-Sensitive | Food- and Beverage-Sensitive |
| Local | 25–60 | — | Highly | — | — |
| Long distance | 35–60 | — | Highly | — | — |
| Service charge | 0–20 | — | Highly | — | — |
| Pay station | 0–20 | Somewhat | — | — | Somewhat |

Telephone revenue is normally projected through the fixed and variable component approach, with 10 percent to 40 percent of the revenue being fixed and 60 percent to 90 percent occupancy-variable. The fixed component represents the out-of-house use of pay phones as well as telephone service for meetings and conferences.

## ¶ 11.05 OTHER INCOME

Other income is revenue derived from sources other than guestroom, food and beverage, or telephone sales. The following is a list of the most common categories of other income with examples of specific sources:

- Rentals: Stores, office space, concession space, showcases, clubs, and storage.
- Commission: Auto rental, photography, telegram, and vending services.

- Concessions: Gift shops, barber shops, and beauty salons.
- Cash discounts earned: Discounts from creditors' accounts for payment within the discount period (does not include trade discounts, which count as a deduction from cost of goods sold).
- Electronic games and pinball machines.
- Forfeited advance deposits and guaranteed no-shows.
- Service charges: Charges added to customer's account for service.
- Interest income: Interest from moneys invested.
- Salvage: Revenue from the sale of old and obsolete items.
- Vending machines.

Other income is highly occupancy sensitive and slightly food-and-beverage sensitive, which means that the appropriate units of comparison are a percentage of rooms revenue adjusted for any unusual food-and-beverage volume and other income per occupied room. Care must be taken when projecting other income to evaluate all the potential sources of revenue. Hotels with extensive retail space or recreational amenities should divide other income into several categories so as to recognize and properly account for significant revenue generators.

## ¶ 11.06 TOTAL REVENUE

Total revenue is the sum of the rooms revenue, food revenue, beverage revenue, telephone revenue, and other income for the subject property. Projected total revenue is an important data point because it will serve as a unit of comparison and an index of variability for several expense categories.

CHAPTER 12

# Expense Forecast



## ¶ 12.01 INTRODUCTION

After the forecasted revenue for a proposed property has been determined, the next task for the appraiser is to project the expenses that the property would be likely to incur. Expenses for lodging facilities should be categorized according to the standardized system outlined in *Uniform System of Accounts for Hotels* (Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.), HANYC, Inc., 1986). The accounts in this system include rooms, food and beverage, telephone, other, administrative and general, management fees, marketing, property operations and maintenance, energy, property taxes, insurance, and reserve for replacement.

Each expense account should be analyzed separately and projected independently of any other, because each account has unique fixed and variable characteristics. As part of this process, the appraiser divides each major account into its component categories. Each category should then be evaluated on the basis of whether it is fixed or varies with differing levels of occupancy, room rate, or food and beverage volume. The fixed and variable method of forecasting expenses, which can also be used to forecast revenues, is discussed in Chapter 11.

The fixed and variable approach to forecasting hotel revenues and expenses involves the following steps:

1. The financial statements of comparable hotels form the basis for forecasting revenue and expense items. If the subject property is an existing hotel, its historical operating performance is considered in formulating projections. For proposed hotels, the appraiser must rely on the operating results of comparable properties.
2. The comparable financial statements are adjusted to reflect the unique characteristics of the subject property, so as to create a one-year financial statement using the subject property's undiscounted first-year's average income and expense ratios representing the occupancy level actually experienced by either the subject or comparable hotels. This procedure yields a base-year profit-and-loss statement that can be used to determine the relationship between the fixed and variable components.
3. The base-year revenue and expense amounts are inflated or deflated to reflect current dollars for each projection year. The rate of inflation reflects the anticipated price change for the individual line item in the income and expense statement. This step is performed to adjust the comparable financial data that constitutes the base to the inflated dollars anticipated for that particular year.
4. The fixed and variable percentages of each income and expense item are estimated. Exhibit 12-1 illustrates typical fixed and variable percentages and the index used to measure change in the variable component.

The index of variability refers to a factor that controls the movement of the variable component. For example, the variable component of food revenue changes with occupancy; beverage revenue is tied directly to food revenue; and food and beverage expense is largely dependent on food and beverage revenue. The variable component of undistributed operating expenses and fixed expenses is correlated with revenue.

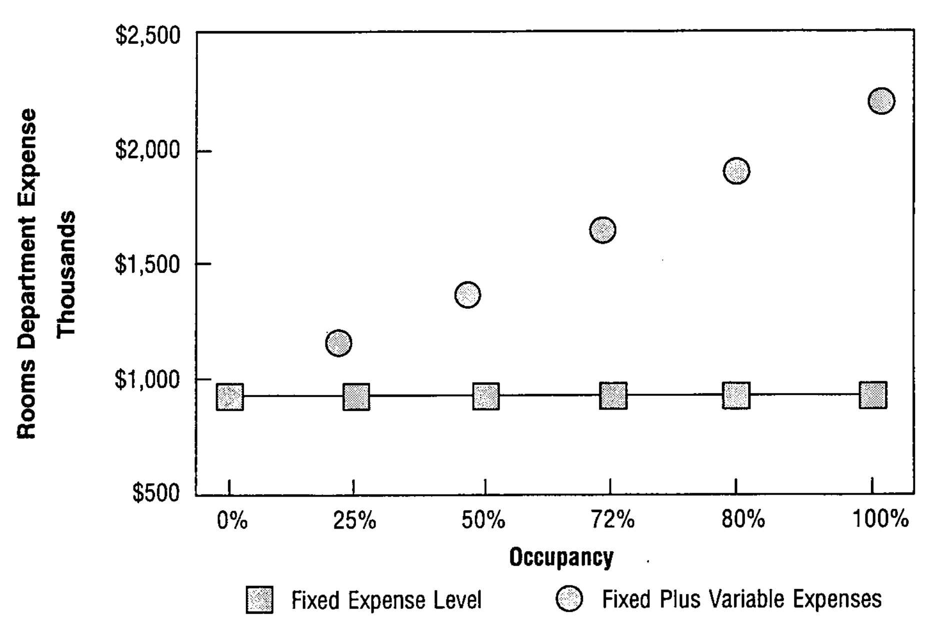
5. Each individual line item is projected separately. The fixed component is estimated by multiplying the appropriate fixed percentage by the inflated base-year revenue or expense for the corresponding projection year.
6. The variable components are assumed to be in accordance with the index of variability set forth in Step 4. The amount of change is quantified by dividing the appropriate projected index of variability by the index of variability for the base year.
7. The unadjusted variable component is calculated by multiplying the appropriate base revenue or expense category for the projection year by the variable percentage estimated in Step 4.
8. The unadjusted variable component is adjusted for variability by multiplying the results of Step 7 by the variable percentage change calculated in Step 6. The resulting product is known as the adjusted variable component.
9. The forecasted revenue or expense is the total of the fixed component calculated in Step 5 and the adjusted variable component calculated in Step 8.

The fixed and variable approach can be illustrated graphically. Exhibit 12-2 shows the subject's rooms department expense as of the stabilized year.

**Exhibit 12-1 Range of Fixed and Variable Expenses**

| Revenue and Expense Category | Percent Fixed | Percent Variable | Index of Variability |
|---|---|---|---|
| Food | 25–50 | 50–75 | Occupancy |
| Beverage | 0–30 | 70-100 | Food Revenue |
| Telephone | 10–40 | 60–90 | Occupancy |
| Other Income | 30–60 | 40–70 | Occupancy |
| **Departmental Expenses** | | | |
| Rooms | 50–70 | 30–50 | Occupancy |
| Food and Beverage | 35–0 | 40–65 | Food and Beverage Revenue |
| Telephone | 55–75 | 25–45 | Telephone Revenue |
| Other Income | 40–60 | 40–60 | Other Income |
| **Undistributed Operating Expenses** | | | |
| Administrative and General | 65–85 | 15–35 | Total Revenue |
| Management Fee | 0 | 100 | Total Revenue |
| Marketing | 65–85 | 15–35 | Total Revenue |
| Franchise Fees | 0 | 100 | Rooms Revenue |
| Repairs and Maintenance | 55–75 | 25–45 | Total Revenue |
| Energy | 80–95 | 5–20 | Total Revenue |
| **Fixed Expenses** | | | |
| Property Taxes | 100 | 0 | Total Revenue |
| Insurance | 100 | 0 | Total Revenue |
| Reserve for Replacement | 0 | 100 | Total Revenue |

**Exhibit 12-2 Illustration of Fixed and Variable Relationship of Rooms Expense**



## ¶ 12.02 ROOMS EXPENSE

Rooms expense consists of all the costs involved in the sale and upkeep of guestrooms and public space. The individual categories of rooms expense are moderately occupancy-sensitive and slightly rate-sensitive, which means that a portion of the overall expense is fixed and the remainder is occupancy-variable.

Salaries, wages, and employee benefits represent a substantial portion of rooms expense. Although part of the payroll cost is occupancy-variable, because management can schedule maids, bell personnel, and house cleaners to work on an as-needed basis when occupancy requires, much of the rooms payroll is actually fixed. Many positions, including front desk personnel, public area cleaners, and the housekeeper and other supervisory staff, must be maintained at all levels of occupancy. As a result, salaries, wages, and employee benefits are only moderately occupancy-sensitive.

Commissions represent remuneration to travel agents for booking rooms business. Because these charges are usually based on a percentage of rooms revenue, they are very sensitive to occupancy and average room rate. Reservations incur a similar expense that reflects the cost of a franchise reservation system, which is typically a certain percentage of rooms revenue. Other rooms expense categories such as laundry, linen, supplies, and uniforms are also somewhat affected by volume and are therefore slightly occupancy-sensitive.

Rooms expense is strongly influenced by changes in occupancy and average room rates, so the appropriate units of comparison that the appraiser should use to project rooms expense are a percentage of rooms revenue and an amount per occupied room. The projection derived from these quantities is then compared with a similar hotel's rooms expense.

The ratio of rooms expense to rooms revenue, the "rooms expense ratio," is an important statistic that often is a key indicator of the skill and effectiveness of management. Unless a hotel suffers from an extremely low level of occupancy or an unusually depressed average room rate, rooms expense should not exceed 25 percent of rooms revenue. If rooms expense is greater than this amount, problems may exist that warrant ownership investigation.

Rooms expense projections are usually made using the fixed and variable component approach, with 50 percent to 70 percent of the expense being fixed and 30 percent to 50 percent occupancy-variable. For example, it is estimated in Exhibit 12-3 that 60 percent of rooms expense is fixed and 40 percent varies with occupancy.

## ¶ 12.03 FOOD AND BEVERAGE EXPENSE

Food and beverage expense consists of the expenditures that must be made to operate the food, beverage, and banquet facilities of a hotel. Although food revenue and beverage revenue are normally projected individually and entered separately in an income and expense statement, the expenses for these two revenue sources are combined into a single entry.

The majority of food and beverage expense is made up of the cost of sales, salaries, and wages. These components are moderately to highly food-and-beverage–sensitive in that they vary directly with changes in food and beverage volume. The other associated costs (e.g., laundry and dry cleaning, operating supplies, and uniforms) tend to be either slightly food-and-beverage–sensitive or moderately fixed (i.e., they vary only slightly with changes in occupancy or room rates, or food and beverage volume). Given the nature of the components of food and beverage expense,

**Exhibit 12-3 Forecast of Rooms Department Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stablized |
|---|---|---|---|---|
| Base Rooms Expense | $1,400 | $1,456 | $1,514 | $1,575 |
| Percent Fixed | 60% | 60% | 60% | 60% |
| Rooms Expense Fixed Component | $840 | $873 | $908 | $945 |
| Base Rooms Expense | $1,400 | $1,456 | $1,514 | $1,575 |
| Percent Variable | 40% | 40% | 40% | 40% |
| Unadjusted Variable Component | $560 | $582 | $606 | $630 |
| Unadjusted Variable Component | $560 | $582 | $606 | $630 |
| Variable Percentage Change | 0.9854 | 1.0157 | 1.0612 | 1.0915 |
| Adjusted Variable Component | $552 | $591 | $643 | $687 |
| Fixed Component | $840 | $873 | $908 | $945 |
| Adjusted Variable Component | $552 | $591 | $643 | $687 |
| Total Rooms Expense | $1,392 | $1,465 | $1,551 | $1,632 |
| Percent of Rooms Revenue | 23.5% | 23.1% | 21.7% | 20.5% |
| Amount Per Available Room | $5,352 | $5,634 | $5,966 | $6,278 |
| Amount Per Occupied Room | $22.57 | $23.04 | $23.35 | $23.88 |

the appropriate unit of comparison is a percentage of food and beverage revenue. When this unit of comparison is used, the appraiser should select comparable hotels with similar ratios of beverage to food. The profit margin from the sale of beverages is considerably higher than that from the sale of food, so a hotel with a higher ratio of beverage to food should have a lower food and beverage expense ratio. The reverse is true as the ratio of beverage to food sales declines.

As with rooms expense, the ratio of food and beverage expense to food and beverage revenue is a benchmark that can be used to evaluate the skill and effectiveness of a hotel's management. Many hotel operators run a highly efficient rooms department but lose thousands of dollars through poorly managed food and beverage service. Unless a hotel has an extremely low volume of food and beverage revenue or suffers from an unusually high cost of labor, food and beverage expense should not exceed 80 to 83 percent of food and beverage revenue. Food and beverage expense in excess of this amount may indicate poor management.

Food and beverage expense is normally projected through the fixed and variable component approach, with 35 percent to 55 percent of the expense being fixed and 45 percent to 65 percent variable. The appropriate index of variability for food and beverage expense is food and beverage revenue. This means that the variable portion of the food and beverage expense category will vary directly with changes in food and beverage revenue.

Exhibit 12-4 assumes that 55 percent of food and beverage revenue is fixed and that 45 percent varies with food and beverage revenue in its calculation of the subject property's food and beverage expense.

**Exhibit 12-4 Forecast of Food and Beverage (F&B) Department Expense ($ thousands)**

| | 1994 | 1995 | 1996 | Stabilized |
|---|---|---|---|---|
| Base F&B Expense | $1,221 | $1,270 | $1,321 | $1,374 |
| Percent Fixed | 55% | 55% | 55% | 55% |
| F&B Expense Fixed Component | $672 | $699 | $726 | $756 |
| Base F&B Expense | $1,221 | $1,270 | $1,321 | $1,374 |
| Percent Variable | 45% | 45% | 45% | 45% |
| Unadjusted Variable Component | $550 | $572 | $594 | $618 |
| Unadjusted Variable Component | $550 | $572 | $594 | $618 |
| Variable Percentage Change | 0.9890 | 1.0116 | 1.0464 | 1.0690 |
| Adjusted Variable Component | $543 | $578 | $622 | $661 |
| Fixed Component | $672 | $699 | $726 | $756 |
| Adjusted Variable Component | $543 | $578 | $622 | $661 |
| Total F&B Expense | $1,215 | $1,277 | $1,348 | $1,416 |
| Percent of Food and Beverage Revenue | 93.3% | 92.2% | 90.5% | 89.5% |
| Amount Per Available Room | $4,674 | $4,910 | $5,186 | $5,447 |
| Amount Per Occupied Room | $19.70 | $20.08 | $20.29 | $20.72 |

## ¶ 12.04 TELEPHONE EXPENSE

Telephone expense consists of all of the costs associated with the operation of a hotel telephone department. For smaller hotels with automated phone systems, the telephone department may be as simple as an additional responsibility for the front desk personnel; in large properties, the telephone department usually has one or more full-time telephone operators to provide the necessary service to the guests.

The bulk of telephone expense is the cost of local and long distance calls that are billed by the telephone companies that service the hotel. Because most of these calls originate from in-house guests, these expenses are moderately occupancy sensitive. Unless a particular department has unusually heavy telephone usage, the normal use of telephone services by hotel employees is charged to the telephone expense account. The remaining costs, such as salaries and wages, miscellaneous expenses, and printing, are all moderately fixed. In light of a recent modification of accounting categories in the *Uniform System of Accounts for Hotels* that reallocates equipment rental expense from the telephone expense account to that of rent, taxes, and insurance, the appraiser should take careful note of the accounting for telephone equipment rental or lease expense.

Given the nature of the components of total telephone expense and in view of the fact that the cost of telephone service is largely driven by the in-house usage that generates telephone revenue, the appropriate unit of comparison is a percentage of telephone revenue.

Telephone expense is normally projected through the fixed and variable component approach, with the expense being 55 percent to 75 percent fixed and 25 percent to 45 percent directly variable with telephone revenue. The fixed component is the operational usage of telephone services by hotel employees along with the normal fixed line charges from the telephone companies. The variable expense is the actual usage by hotel guests, which corresponds directly with telephone revenue.

In Exhibit 12-5, telephone expense is estimated to be approximately 60 percent fixed and 40 percent variable.

**Exhibit 12-5 Forecast of Telephone Department Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stablized |
|---|---|---|---|---|
| Base Telephone Expense | $149 | $155 | $162 | $168 |
| Percent Fixed | 60% | 60% | 60% | 60% |
| Telephone Expense Fixed Component | $90 | $93 | $97 | $101 |
| Base Telephone Expense | $149 | $155 | $162 | $168 |
| Percent Variable | 40% | 40% | 40% | 40% |
| Unadjusted Variable Component | $60 | $62 | $65 | $67 |
| Unadjusted Variable Component | $60 | $62 | $65 | $67 |
| Variable Percentage Change | 0.9881 | 1.0124 | 1.0532 | 1.0818 |
| Adjusted Variable Component | $59 | $63 | $68 | $73 |
| Fixed Component | $90 | $93 | $97 | $101 |
| Adjusted Variable Component | $59 | $63 | $68 | $73 |
| Total Telephone Expense | $149 | $156 | $165 | $173 |
| Percent of Telephone Revenue | 64.9% | 64.0% | 62.5% | 61.5% |
| Amount Per Available Room | $572 | $600 | $635 | $667 |
| Amount Per Occupied Room | $2.42 | $2.45 | $2.48 | $2.53 |

## ¶ 12.05 OTHER INCOME EXPENSE

Other income expense includes all of the costs that are associated with the corresponding other income revenue, such as rentals, forfeited advance deposits, and vending machine revenues. The extent of these expenses depends on the nature of the revenue. For example, if a hotel leases a gift shop in its lobby, the cost to the hotel would be minimal, consisting of such items as rental fees and commissions. If, on the other hand, the hotel operated the gift shop, both the revenue and expenses would be higher; revenue would include the proceeds from products sold, and expenses would include the cost to purchase products to sell, payroll, and so forth.

On the basis of an analysis of the components that constitute other income expense, the appropriate unit of comparison is a percentage of other income revenue.

Other income expense is normally projected by the fixed and variable component approach, with 40 percent to 60 percent of the expense being fixed and 40 percent to 60 percent varying directly with other income revenue.

Exhibit 12-6 presents the calculation of the subject property's Other Income expense. Income expense is estimated to be 70 percent fixed, with 30 percent varying directly with other income.

**Exhibit 12-6 Forecast of Other Income Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Other Income Expense | $81 | $85 | $88 | $82 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Other Income Expense Fixed Component | $57 | $59 | $62 | $64 |
| Base Other Income Expense | $81 | $85 | $88 | $92 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $24 | $25 | $26 | $27 |
| Unadjusted Variable Component | $24 | $25 | $26 | $27 |
| Variable Percentage Change | 0.9943 | 1.0066 | 1.0166 | 1.0295 |
| Adjusted Variable Component | $24 | $26 | $27 | $28 |
| Fixed Component | $57 | $59 | $62 | $64 |
| Adjusted Variable Component | $24 | $26 | $27 | $28 |
| Total Other Income Expense | $81 | $85 | $88 | $92 |
| Percent of Other Income Revenue | 47.8% | 47.4% | 47.0% | 46.6% |
| Amount per Available Room | $312 | $326 | $340 | $355 |
| Amount per Occupied Room | $1.31 | $1.34 | $1.32 | $1.35 |

## ¶ 12.06 ADMINISTRATIVE AND GENERAL EXPENSE

The administrative and general expense of a hotel is made up of all of the managerial and operational expenses that cannot be attributed to a particular department. For example, the general manager might work part of one day solving a problem in the rooms department and devote the remainder of the day to booking an important food and beverage function. It is too difficult to continually keep track of the manager's activities and allocate his or her salary to individual departments, so the category of administrative and general is used to account for it.

Most administrative and general expenses are relatively fixed. The exceptions are commissions on credit card charges, which are highly dependent on occupancy; cash overages and shortages and provisions for doubtful accounts, all of which are affected moderately by the quantity of transactions or total revenue; and salaries and wages, benefits, and security, which are influenced slightly by volume.

In recent years, several new categories have been added to administrative and general expenses. One example is human resources, which includes the cost of recruiting, relocating, and training. Another example is security, which encompasses the cost of contract security for the property and other related expenses.

The category called "insurance/general." comprises the premiums for policies that cover liability, fidelity, life insurance, theft coverage, and business interruption insurance. Fire and extended coverage insurance on the building and its contents is a separate insurance expense category.

Liability coverage encompasses third-party actions involving bodily injury and personal property and is typically based on rooms receipts, meeting and banquet revenue, and food and beverage revenue. Some of the factors that affect liability insurance expense are the size of meeting, banquet, or restaurant facilities; the amount of alcohol served as a percentage of total food and beverage sales; and the existence of a lounge dance floor. Factors that can increase liability insurance expense include building design (such as a high-rise structure), swimming pools, lack of life safety support systems (fire and smoke alarms), and any transportation services provided to guests.

Given the nature of the components of administrative and general expense, the appropriate unit of comparison to test for reasonableness is an amount per available room. The result of this test can be verified by using a percentage of total revenue.

Projections of administrative and general expense are normally made using the fixed and variable component approach, with 65 percent to 85 percent of the expense being fixed and 15 percent to 35 percent varying directly with total revenue.

In the example in Exhibit 12-7, it is assumed that approximately 70% of administrative and general expenses is fixed and 30 percent vary in relation to total revenue.

**Exhibit 12-7 Forecast of Administrative and General Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stablized |
|---|---|---|---|---|
| Base Administrative and General Expense | $675 | $702 | $730 | $759 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Administrative and General Expense Fixed Component | $472 | $491 | $511 | $531 |
| Base Administrative and General Expense | $675 | $702 | $730 | $759 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $202 | $210 | $219 | $228 |
| Unadjusted Variable Component | $202 | $210 | $219 | $228 |
| Variable Percentage Change | 0.9863 | 1.0147 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $200 | $214 | $231 | $247 |
| Fixed Component | $472 | $491 | $511 | $531 |
| Adjusted Variable Component | $200 | $214 | $231 | $247 |
| Total Administrative and General Expense | $672 | $705 | $742 | $779 |
| Percentage of Total Revenue | 8.8% | 8.6% | 8.2% | 7.8% |
| Amount per Available Room | $2,585 | $2,712 | $2,854 | $2,996 |
| Amount per Occupied Room | $10.89 | $11.08 | $11.17 | $11.39 |

## ¶ 12.07 MANAGEMENT FEE EXPENSE

The management fee expense category accounts for the basic fee paid to the management company that will operate the subject property. Management fees differ depending on whether the management company is a first- or second-tier operator. The appraiser should use the actual fee structure negotiated for the management company, if it has been selected, or a fee based on market analysis in the event the operator is not known. The estimate for the incentive portion of the management fee is generally found at the point in the income and expense statement that forms the basis for the incentive fee calculation. For example, if the incentive management fee is based on a percentage of income before fixed charges, then the incentive fee is located just after this point in the statement.

Basic hotel management fees are almost always based on a percentage of total revenue, which means that they are 100 percent variable. The proper unit of comparison is a percentage of total revenue.

In Exhibit 12-8, the management company is operating the subject property for a basic management fee of 3 percent, which is considered reasonable for this type of company.

**Exhibit 12-8 Forecast of Management Fee ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Projected Total Revenue | $7,620 | $8,153 | $9,101 | $10,016 |
| Management Fee Percentage | 3.0% | 3.0% | 3.0% | 3.0% |
| Management Fee Expense | $229 | $245 | $273 | $300 |

## ¶ 12.08 MARKETING EXPENSE

Marketing expense includes all of the expenses associated with advertising, sales, and promotion of a lodging facility. These marketing activities are designed to attract new customers and retain existing ones through efforts aimed at creating an image for the hotel, developing customer awareness, and stimulating patronage to the property and its various facilities. Unlike most expense categories, marketing is almost totally controlled by management. Hotel operators typically develop annual marketing plans that detail future expenditures. If such budgets are followed, total marketing expenses can be projected accurately.

The hotel operator must consider many factors when compiling a marketing budget. One of the most significant is that the results of marketing expenditures are not always immediately realized. Depending on the type of advertising and promotion, increased patronage may not be seen for months or even years. Over time, however, this lag period tends to be offset, because the benefits of a successful marketing campaign generally continue after the program has ended.

Hotels have unique operating characteristics that must be considered either when developing a marketing plan or when reviewing the effectiveness of an established marketing effort. For an appraiser to forecast hotel revenues, the marketing programs of the past several years (along with anticipated future plans) should be evaluated to determine their potential effect on the income and expenses of the hotel. Some of the unique characteristics that should be addressed are as follows:

- New hotels, especially those catering to the meeting and convention segment, should have a marketing plan that commences before the hotel opens. Organizers of business meetings and conferences typically plan their meeting accommodations three to six months in advance, while large national associations choose their convention sites as far as five years in advance. If a meeting-oriented hotel is not in the marketplace in time to obtain advance business, it will be passed over in favor of the established competition and suffer low occupancy levels during the initial years of its operation.

- Because the effect of marketing tends to be cumulative, the initial marketing efforts for a new hotel may require greater expenditures than those for an established facility in order to achieve the desired results.
- Marketing expenditures are similar to a hotel maintenance program. If an existing property has neglected its marketing efforts for several years, the appraiser may have to allow for a higher than normal marketing budget either to maintain or to increase current revenues. However, if an aggressive marketing program has been in effect, a reduction in marketing expenses may be justified, because revenues will not be adversely affected.
- The marketing budget should be designed for the specific property as well as for the nature of local lodging supply and demand. Characteristics such as location, visibility, chain affiliation, and class and types of market segments serviced can affect the type and amount of marketing expenditures required.

Marketing expense is divided into seven categories: salaries and wages, benefits, sales, advertising and merchandising, reservations, other marketing activities, and fees and commissions. Together they form the entire marketing effort of the property, incorporating both the internal staff and outside agencies. All categories are budgeted, fixed expenses, except for reservations and fees and commissions, which are occupancy and rate sensitive because they are generally based on a percentage of rooms revenue.

Costs related to the marketing of guestrooms, such as reservations and travel agency fees and commissions, have traditionally been charged to rooms expense. However, there is a growing recognition that these costs are elements of the overall marketing activity, and hotels that recognize these functions as marketing responsibilities should charge these expenses to marketing.

The appropriate unit of comparison for marketing expenses is an amount per available room. Sometimes it is helpful to remove the franchise fee cost and make a separate calculation for it because it is generally 100 percent variable, depending on the rooms revenue.

Marketing expense is normally projected through the fixed and variable component approach, with 65 percent to 85 percent of the expense being fixed and 15 percent to 35 percent varying directly with total revenue. The fixed and variable component approach must sometimes be adjusted to account for unique marketing considerations, such as the costs incurred by fees and commissions paid to travel agencies.

Exhibit 12-9 presents a marketing forecast based on a fixed and variable component model in which 70 percent of this expense is considered fixed and 30 percent varies with total revenue. This relationship takes into account the location of the subject property, the local market for transient accommodations, the competitive environment, and the hotel's anticipated market segmentation.

## ¶ 12.09 PROPERTY OPERATIONS AND MAINTENANCE EXPENSE

Property operations and maintenance (PO&M), which is also known as repair and maintenance, is another expense that is largely controlled by management (see Exhibit 12-10). Except for repairs necessary to keep the facility open and precautions against damage, most maintenance items can be deferred for various lengths of time. However, maintenance is an accumulating expense. If a needed repair is merely postponed, it is neither eliminated nor does it go away of its own accord. Rather it becomes what is known as deferred maintenance that must ultimately be attended to at some later date. When an appraiser projects income and expense for an existing lodging facility, the property operations and maintenance expenses over the past several years should be investigated to determine whether adequate expenditures were made to keep the facility in good condition. This should be done in conjunction with a physical inspection of the property to determine whether the funds that were expended were sufficient for the repairs required.

**Exhibit 12-9 Forecast of Marketing Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Marketing Expense | $540 | $561 | $584 | $607 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Marketing Expense Fixed Component | $378 | $393 | $409 | $425 |
| Base Marketing Expense | $540 | $561 | $584 | $607 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $162 | $168 | $175 | $182 |
| Unadjusted Variable Component | $162 | $168 | $175 | $182 |
| Variable Percentage Change | 0.9863 | 1.0147 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $160 | $171 | $185 | $198 |
| Fixed Component | $378 | $393 | $409 | $425 |
| Adjusted Variable Component | $160 | $171 | $185 | $198 |
| Total Marketing Expense | $538 | $564 | $594 | $623 |
| Percentage of Total Revenue | 7.1% | 6.9% | 6.5% | 6.2% |
| Amount per Available Room | $2,067 | $2,168 | $2,284 | $2,396 |
| Amount per Occupied Room | $8.71 | $8.87 | $8.94 | $9.12 |

The following factors influence the required level of maintenance for lodging facilities:

- *Age of the hotel.* New hotels are typically protected for several years by new equipment and manufacturer's warranties, so PO&M costs during the initial years of operation are reduced. As hotels become older, maintenance costs tend to escalate rapidly.
- *Use of a preventive maintenance system.* Some hotel operators conduct preventive maintenance programs that consist of periodic checks and maintenance of all the important components of a lodging facility. The purpose of preventive maintenance is to anticipate possible maintenance problems early enough so that only minor repairs, rather than major overhauls, are necessary.
- *Quality of initial facilities.* The quality and type of the initial construction can have a direct effect on future maintenance requirements. The use of high-quality building materials and construction methods will generally reduce the need for maintenance expenditures over the long term. During the physical inspection, the appraiser should investigate the condition and quality of the original construction.

Property operations and maintenance is considered an operating expense and, as such, under IRS regulations, it can contain only items that can be expensed rather than capitalized. For example, if a table leg breaks, the repair of the leg would be considered an expense and chargeable to property operations and maintenance. If the table was instead replaced, it would become a capital expenditure that would not appear under the property operations and maintenance category. Appraisers account for capital replacements of items such as furniture, fixtures, and equipment reserve for replacement expense.

The items in property operations and maintenance are either fixed or very slightly influenced by changes in occupancy and food and beverage usage. The fact that PO&M is mostly fixed means that the appropriate unit of comparison for this expense category is an amount per available room that is verified by a percentage of total revenue.

Property operations and maintenance is normally projected by the fixed and variable component approach with 55 percent to 75 percent of the expense being fixed and 40 percent to 60 percent varying directly with total revenue. In Exhibit 12-10, it is assumed that 70 percent of the category is fixed to project operations and maintenance expense.

**Exhibit 12-10 Forecast of Property Operations and Maintenance Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Property Oper. & Maint. Expense | $338 | $351 | $365 | $380 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Property Oper. & Maint. Expense Fixed Component | $236 | $246 | $256 | $266 |
| Base Property Oper. & Maint. Expense | $338 | $351 | $365 | $380 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $101 | $105 | $110 | $114 |
| Unadjusted Variable Component | $101 | $105 | $110 | $114 |
| Variable Percentage Change | 0.9863 | 1.1047 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $100 | $107 | $116 | $124 |
| Fixed Component | $236 | $246 | $256 | $266 |
| Adjusted Variable Component | 100 | 107 | 116 | 124 |
| Total Property Oper. & Maint. Expense | $336 | $353 | $372 | $390 |
| Percentage of Total Revenue | 4.4% | 4.3% | 4.1% | 3.9% |
| Amount per Available Room | $1,294 | $1,357 | $1,430 | $1,499 |
| Amount per Occupied Room | $5.45 | $5.55 | $5.60 | $5.71 |

## ¶ 12.10 ENERGY EXPENSE

Energy consumption within a lodging facility typically takes several forms: water and space heating, air conditioning, lighting, cooking fuel, and other miscellaneous power requirements. The most common sources of energy are electricity, natural gas, fuel oil, and steam. In addition to these energy uses, energy expense also includes the cost of water service. The total cost of energy varies with the source and quantity of fuel used. Electricity tends to be the most expensive source, followed by oil and gas.

The cost of electrical energy is a function of the amount of energy consumed and the size of the peak demand. The unit of electrical consumption is the kilowatt-hour, which is measured by a watt-hour meter. To calculate the monthly electric bill, the utility company reads the electric meter and determines the number of kilowatt-hours of electricity consumed since the last reading. This amount is multiplied by the appropriate scheduled rate to determine the usage charge. The demand charge reflects the peak number of kilowatts required by the property during a specific, short-term time period. The demand is also read monthly from the utility meter, with the additional charge added to the electric bill on the basis of a demand rate schedule.

Utility charges for other sources of energy, such as gas and oil, are generally based entirely on usage, with no additional expense for demand. The unit of gas consumption is the therm, which is measured by a gas meter. Oil is delivered to the property and stored in tanks. Bills are rendered upon delivery and the unit charge is the gallon.

A large portion of energy consumption is relatively fixed and varies little with changes in occupancy. Restaurants, kitchens, public areas, and corridors must be continually lighted and heated or air conditioned, whether the hotel is full or nearly empty. The energy costs of an additional occupied room (i.e., a few hours of light, television, heat, or air conditioning) are minimal.

To forecast the energy cost for a hotel or motel, estimates must be made for total energy consumption, sources of energy, and utility rates.

The amount of energy consumed in the process of heating, air conditioning, and operating a lodging facility is measured in terms of British thermal units (BTUs). By estimating the number of BTUs a hotel or motel will use over a twelve-month period and multiplying this amount by a cost factor based on local utility charges, an energy cost forecast can be developed.

In order to estimate the amount of energy consumed by a facility, it is necessary to know the conversion factor that relates the unit of consumption (kilowatt-hours, therms, and gallons) to the specific number of BTUs produced. The following table shows the conversion factors for electricity, gas, and oil.

A portion of the energy consumed by hotels and motels is always in the form of electricity. This source is generally supplemented by either gas or oil when these alternatives are available and cost effective. Electrical energy accounts for approximately 40 percent to 60 percent of the total BTU energy consumption for a typical lodging facility, with the supplemental fuels representing the remainder.

Once the total units of consumption have been calculated, the appraiser contacts the local utility company and fuel oil dealer to determine rates and costs. In most instances, utility companies are extremely helpful in providing the necessary data, information, and costs to estimate the energy costs for a lodging facility.

Once the base year energy expense has been estimated, a projection is made using the fixed and variable component approach, with 80 percent to 95 percent of the expense being fixed and 5 percent to 20 percent varying directly with total revenue. In Exhibit 12-11, it is assumed that 90 percent of this category is fixed and 10 percent varies directly with total revenue.

## ¶ 12.11 PROPERTY TAX EXPENSE

Property tax expense includes the taxes paid to local municipalities for governmental services such as highways, schools, parks, sanitation, and other services and facilities. The purpose of property taxes is the allocation of the municipal tax burden on the basis of value. The weight of the tax burden the owner will assume increases proportionally with the value of the property. The legal term for property tax is "ad valorem" tax, or tax "in proportion to value."

Depending on the policy of the municipality, property taxes can be based on the value of the real property alone (real estate tax) or the value of the personal property in its entirety (personal property tax).

**Exhibit 12-11 Forecast of Energy Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Energy Expense | $318 | $331 | $344 | $358 |
| Percent Fixed | 90% | 90% | 90% | 90% |
| Energy Expense Fixed Component | $286 | $298 | $310 | $322 |
| Base Energy Expense | $318 | $331 | $344 | $358 |
| Percent Variable | 10% | 10% | 10% | 10% |
| Unadjusted Variable Component | $32 | $33 | $34 | $36 |
| Unadjusted Variable Component | $32 | $33 | $34 | $36 |
| Variable Percentage Change | 0.9862 | 1.0147 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $31 | $34 | $36 | $39 |
| Fixed Component | $286 | $298 | $310 | $322 |
| Adjusted Variable Component | $31 | $34 | $36 | $39 |
| Total Energy Expense | $318 | $331 | $346 | $361 |
| Percentage of Total Revenue | 4.2% | 4.1% | 3.8% | 3.6% |
| Amount per Available Room | $1,222 | $1,275 | $1,322 | $1,389 |
| Amount per Occupied Room | $5.15 | $5.21 | $5.21 | $5.28 |

To establish the proper allocation of the tax burden, municipalities employ assessors to assess, or valuate, all the taxable real estate within their jurisdictions. Theoretically, the assessment bears a definite relationship to market value, so that properties of equal market values will have similar assessments, and properties of higher and lower values will have proportionately larger and smaller assessments.

Because the objective of assessed value is to maintain a specific value relationship among all properties in a taxing jurisdiction, comparable hotel assessments should be evaluated to determine whether the subject property's assessed value is equitable.

Some municipalities assess properties at 100 percent of market, while others use a certain percentage of market value. In any case, the allocation of the tax burden to each property will not change if the relationshp between the assessed value and market value is altered. If additional properties are developed within a tax jurisdiction, the tax base increases while the tax rate decreases, assuming that the municipal budget remains constant. Although the assessed value of the properties does not change, the individual tax burden decreases because the additional properties generate tax revenue. If the municipal budget increases, however, the tax rate will increase proportionately.

Projecting property tax expense for an existing hotel is relatively simple. The assessed value is normally on public record and can be found in the appropriate municipal office. Multiplying the assessed value by the anticipated rate yields the estimated property tax burden. The appraiser must determine, however, whether the assessed value might escalate at some future time, as the result either of improving trends in local real estate market values or of a new valuation of the subject property triggered by a recent sales transaction.

Projecting property tax expense for a proposed lodging facility is generally more difficult. Local assessors are often reluctant to provide initial estimates of assessed values until the hotel is complete and operational. They are apt to use a cost approach and say that the assessed value will be based on total project cost. Because the assessor has no incentive to provide an accurate projection of assessed value, there is always a tendency to overstate these initial estimates; consequently, when the final value is placed on the property, a reduced amount is looked upon favorably. The appraiser should, nonetheless, contact the assessor and attempt to obtain an indication of what the assessed value will be, although this estimate should be tempered by the results of research into comparable assessments.

The objective of assessed value is to maintain a specific value relationship among all of the properties in a tax jurisdiction, so that the best way to make an estimate of the assessed value of a proposed hotel is to base it on the actual values of similar hotels. The acumen of the appraiser comes into play in this process when the indicated assessed values must be adjusted to reflect any differences between them and the subject property.

## [1] Real Property Assessment

Because tax jurisdictions provide separate assessed values for real property (i.e., land and improvements), it is advisable to compare the assessed values of only the improvements, not the combined land and improvement values. The combination of the two equals the total property value and forms the basis for calculating the real estate tax burden of an individual property. The assessed value of the land is developed from actual land sales within the jurisdiction. On the basis of these known land sales, the assessor can determine the relative desirability of the parcels; as value declines, so does desirability. Each parcel is assessed on the basis of its desirability relative to the surrounding parcels, which means that assessors are often reluctant to change one land assessment because doing so could alter the assessment grid for all the other parcels in the jurisdiction. As a result, when developing an assessed value estimate of a proposed hotel, the actual assessed value of the land should be considered unchangeable (because any locational advantages or disadvantages have theoretically been accounted for), and only the improvement value should be compared and adjusted. Improvement value does not include such factors as decor, management, franchise, or business value.

## [2] Personal Property Assessment

If a tax jurisdiction imposes a personal property assessment, the appraiser must estimate the value of the furniture and equipment in addition to land and improvements. Because personal property assessment procedures differ widely, guidance from the local assessor is often helpful. In many instances, the assessed value of furniture and equipment is based on actual cost less a mandated depreciation schedule. The key factor for an appraiser working with this type of assessment is a clear definition of what is considered personal property and what is considered real property.

## ¶ 12.12 INSURANCE EXPENSE

Insurance expense consists of the cost of insuring the hotel and its contents against damage or destruction from fire, weather, sprinkler leakage, boiler explosion, and so forth. It does not include liability coverage, which is charged to administrative and general expense. Insurance expenses are generally 100 percent fixed and do not vary with a hotel's volume.

Insurance rates are based on many factors, including building design and construction, fire detection and extinguishing equipment, fire district, distance from firehouse, and the history of fires in the area. Sometimes it is possible to obtain an estimate of insurance cost from a local insurance agent who is familiar with the project and area insurance rates. If this is not possible, the appraiser should use the insurance costs incurred by similar lodging facilities expressed on a per available room basis.

## ¶ 12.13 RESERVE FOR REPLACEMENT EXPENSE

Furniture, fixtures, and equipment are essential to the operation of a lodging facility, and their quality often determines the overall quality of a facility. All non–real estate items that are normally capitalized rather than expensed are included in this category.

The furniture, fixtures, and equipment in a hotel are exposed to heavy use and must be replaced at regular intervals. The useful life of these items is determined by the quality and durability of their construction and the amount of guest traffic and use to which they are subjected.

Periodic replacement of furniture, fixtures, and equipment is essential to maintain the quality, image, and income of a lodging facility. Capitalized expenditures are not included in the operating statement but nevertheless affect an owner's cash flow; consequently, an appraisal should reflect these expenses in the form of an appropriate reserve for replacement. As a general rule, a reserve of 3 percent to 5 percent of total revenue is usually sufficient to provide for timely replacement of furniture, fixtures, and equipment. The reserve for replacement is based on a percentage of total revenue, so it is 100 percent variable. The unit of comparison is a percentage of total revenue.

## ¶ 12.14 OVERALL STATEMENT OF INCOME AND EXPENSE

From the room-night analysis that produces an estimate of occupancy to the reserve for replacement calculation, the overall forecast must be combined into an overall statement of income and expense covering the appropriate forecasted years. This should be organized in accordance with the *Uniform System of Accounts for Hotels* and contain ratios of total and departmental revenues and amounts per available room.

The appraiser should examine the reasonableness of all the numbers and ratios in the overall statement. Among the numerical relationships that should be verified are the following:

- As occupancy increases, most operating ratios tend to decrease, with the exception of property operations and maintenance expense, which generally increases for a new property.
- As occupancy increases, the increase in the average rate per occupied room generally outpaces inflation.

Hotels with a high food and beverage volume (i.e., ratio of food and beverage revenue to rooms revenue) will tend to have lower profit ratios (i.e., net income to total revenue). However, if the food and beverage departments are operated at a profit, these properties will bring in more revenue. The optimum profit percentage for a lodging facility depends upon the food and beverage volume produced by the hotel (i.e., ratio of food and beverage to rooms). A well-run hotel will make a departmental profit of $.80 for each dollar of rooms revenue and only $.30 for each dollar of food and beverage revenue, so the volume of each department will dramatically impact the overall bottom line percentage. For example, a rooms-only lodging facility may have a net income ratio of 40 percent compared to a 20 percent bottom line for a property with a high food and beverage volume. However, the property with the high food and beverage volume will often generate a greater dollar profit on a per room basis.

CHAPTER 13

# Property Valuation



## ¶ 13.01 INTRODUCTION

Hotel owners, lenders, and operators frequently require appraisals to establish the value of properties in which they have an interest. In performing a market study and appraisal, a valuation is essential in order to determine whether the subject property is economically feasible. Simply put, a project is considered feasible when its economic value is greater than the cost that was incurred in its development; if the project's value upon completion is less than the cost of its development, then it is considered not feasible. Appraisals are also used to establish prices for sales and transfer, to determine the security for mortgage debt, and to verify assessed value for property taxes.

Professional appraisers use a combination of three approaches in appraising real estate for market value: (1) the cost approach, (2) the sales comparison approach, and (3) the income capitalization approach. Usually, all three are employed in an appraisal, and the appraiser takes into account the inherent strengths of each as well as the nature of the subject property when making the final estimate of market value.

The cost approach is based on a determination of the cost of replacing a property, with adjustments for various forms of depreciation and obsolescence. The sales comparison approach compares the known sales prices of hotels that are similar to the subject hotel. The income capitalization approach capitalizes the anticipated earnings of the property in order to estimate its total value.

In theory, all three approaches result in the same value estimate. In practice, however, the value indicated by the income capitalization approach most closely reflects the type of analysis generally performed by typical buyers and sellers. The results from the cost and sales comparison approaches are generally used to support and verify the results of the income approach.

## ¶ 13.02 COST APPROACH

The cost approach yields an estimate of market value by totaling the current cost of replacing a property. This is accomplished by determining the value of the land when vacant and available and combining it with the estimated cost to construct the improvements. For an existing hotel, depreciation, in the form of physical deterioration or functional or economic obsolescence, must be quantified and deducted from the replacement cost to estimate market value. For proposed hotels, the cost approach is compared with the market value conclusion by means of the income approach to determine project feasibility.

The cost approach may provide a reliable estimate of value for newly constructed properties not suffering from external obsolescence; as buildings and other forms of improvements age and depreciate, however, the resultant loss in value becomes increasingly difficult to quantify.

Knowledgeable buyers of lodging facilities generally base their purchase decisions on such economic factors as forecasted net income and return on investment. Since the cost approach does not reflect any of these income-related considerations but rather requires a number of subjective and unsubstantiated depreciation estimates, it is not commonly used as the primary process in a hotel valuation.

### [1] Replacement Cost

Replacement cost is simply the cost of developing a property similar to the subject property. The replacement cost of several elements must be combined to determine the total replacement cost for the subject property. These elements are: land value; building construction cost; furniture, fixtures, and equipment (FF&E) cost; soft costs; opening costs; and developer's costs.

The replacement cost for property improvements, which includes buildings, parking facilities, landscaping, and signage can be estimated with information provided by one of several construction cost services, such as Marshall Stevens, Boecke, or Dow. Other sources of replacement data include local building contractors and developers, architects, engineers, and professional cost estimators. Cost may be estimated by an amount per square foot of improvements (calculator method), as an amount per room, or as an amount per each building component (segregated method).

A developer will typically provide the appraiser with the budgeted development cost of a proposed hotel. As of the writing of this book, the construction of new limited-service and extended-stay hotels has resumed. The development of full-service hotels is not yet feasible in most markets throughout the United States. The valuation of a proposed extended-stay hotel is used as a case study throughout this chapter.

The main element of the replacement cost for property improvements is physical replacement construction cost. Exhibit 13-1 sets forth the estimated construction cost of a proposed extended-stay product, as provided by the developer.

**Exhibit 13-1 Estimated Construction Cost of Proposed Extended-Stay Product**

**Development Budget**

| Cost Category | Amount | |
|---|---|---|
| **Land** | | $1,235,000 |
| **Building** | | |
| Construction Contract | | 6,800,000 |
| Architectural and Engineering | | 180,000 |
| Real Estate Taxes | | 30,000 |
| Insurance | | 38,000 |
| Permits | | 620,000 |
| Contingency | | 340,000 |
| **Furniture, Fixtures, and Equipment (FF&E)** | | 1,755,000 |
| **Soft Costs** | | |
| Legal and Clearing Costs | | 110,000 |
| Feasibility and Appraisal | | 40,000 |
| Financing Fees | | 50,000 |
| Construction Interest | | 352,000 |
| Pre-opening and Startup Costs | | 225,000 |
| Working Capital | | 100,000 |
| Operating Reserve | | 325,000 |
| Development Fees | | 600,000 |
| | | 1,802,000 |
| | | $12,800,000 |

A cost analysis performed by the appraiser through the use of Marshall Stevens indicates a basic improvement cost of $68.20 per square feet for the 99,483 square feet of the proposed improvements, yielding an estimated basic structure cost of $6,784,740, supporting the basic building cost estimate provided by the developer.

The replacement cost of the FF&E can be estimated through the use of a cost service or design company or by surveying hotel companies for their typical FF&E expenditure. The Uniform Franchise Offering Circulars (UFOCs) of hotel franchise companies also provide a good source for a range of FF&E costs of different lodging products. For a proposed project the replacement cost for FF&E can be determined by multiplying the amount of money budgeted per room for the proposed project by the final number of rooms in the facility. The FF&E cost for this proposed extended-stay hotel is $12,500 per room or a total of $1,755,000 for the 130 units of the project.

Soft costs include legal and closing expenses, fees for financing and other professionals, as well as construction interest. Pre-opening costs consist of the funds necessary to hire and train personnel prior to the hotel's opening, pre-market the property, and equip the hotel with inventories. Estimates of working capital and funds for an operating reserve to cover any operational or debt service shortfalls during the initial years of operation can be based on the profile and total cost of the development.

If the project is to be franchised, the initial franchise fee must be included in the cost estimates. In addition, the developer's cost—the fee that must be paid to a developer for providing project administration—must be considered.

A developer's profit of 10 percent to 20 percent of total project cost inclusive or exclusive of land value has historically been included in the cost approach estimate developed by appraisers. In practice, many developers made little or no profit during the last construction cycle. There are differing theories regarding developer's profit, but it is generally accepted that developers require profit in order to do their job. The reality is that development opportunities are often scarce, and a reasonable developer's fee is considered adequate to compensate a developer. Often the development arm of a hotel management or ownership company is motivated by the profits it will garner through its on-going involvement with the property. The earning of management fees or the upside of return on owner's equity can be considered a developer's profit for the entity undertaking the project.

## [2] Land Value

The traditional method of estimating land value, through the review and analysis of comparable land sales, is generally the most accurate method of estimating land value for a particular site, but it is applicable only if enough relevant and recent data is available. Sales of land slated for hotel development are best analyzed in terms of price per room of the project proposed for the site. Comparably located and zoned sites can also be adjusted to the subject site to determine land value.

Because of the real estate depression of the early 1990s, few transactions of land purchased for hotel development occurred between 1990 through 1995. Land sales from the mid- to late-1980s are likely irrelevant in estimating land value today because of the dramatic change in market conditions since that time. The fact that land is worth something to someone only when it can be put to use explains why land values generally decline by a greater proportion than values of improved properties during a real estate downturn. Many markets in the United States are now experiencing the development of limited-service and extended-stay hotels, so land transactions for these projects are providing an indication of market value. However, because full-service hotel development is not yet feasible in many markets, land transactions are scarce for such projects. In the absence of land sales, two alternative approaches are useful in evaluating what a hotel site is worth.

### [a] Ground Lease Approach

When the existing or proposed hotel improvements represent the highest and best use of the property, the ground lease approach is an accurate method for estimating land value because it is readily supported by numerous self-adjusting comparables (e.g., hotels that are constructed on expensive land tend to generate higher rooms revenue), as well as the overall economics of the individual project.

During the past twenty-five years, hotels have been routinely constructed on leased land. Lease terms differ somewhat from hotel to hotel, but the basis for the rental calculation is usually tied to a percentage of the revenue generated by the hotel. By using the forecasted stabilized revenues for the subject property and applying a typical hotel ground lease rental formula, the appraiser determines the hotel's economic rental, or what can be termed the income attributed to the land. The land value is then estimated by dividing the economic rental by an appropriate capitalization rate.

One advantage of this method is that rental formulas are tied directly to a percentage of revenue that inherently reflects both the locational attributes of the site (occupancy and rate) and the allowable density of development, so the resulting economic ground rental justly represents the greatest net return to land over a given period of time. This self-adjusting aspect is one of the main reasons for the reliability of the ground lease approach.

Recalculating a data base of lease formulas as a percentage of only rooms revenue results in a range of 3 percent to 4 percent for areas in the United States outside of California and Hawaii, and 4 percent to 7 percent within desirable areas of these two states. Some local submarkets will fall outside of these norms because of specific market conditions. Applying the ground rental percentage to an estimate of rooms revenue results in the net income attributable to the land. Applying an overall capitalization rate of 7 percent to 11 percent, depending on the market and location, results in a land value estimate.

Assume, for example, that the proposed hotel, were it open and stabilized today, could be expected to achieve a $92 average rate. Exhibit 13-2 sets forth a land estimate using the ground lease approach, a 1996 average rate of $92, a 3.5 percent ground rental percentage and a 9 percent capitalization rate.

**Exhibit 13-2 Ground Lease Approach**

| | |
|---|---|
| Stabilized Average Rate ($ '96) | $92 |
| Days in the Year | 365 |
| Stabilized Occupancy | 80% |
| Projected Rooms Revenue Per Room | $26,864 |
| Ground Rent % | 3.5% |
| Projected Income Attributable to Land | $940 |
| Capitalization Rate | 9% |
| Estimated Land Value Per Room | $10,447 |

## [b] Land Residual Approach

An alternative method of estimating a hotel site's value is the land residual approach. This method, if used with accurate variables, is the most appropriate for determining what the developer can afford to pay for the land for a specific project. A market feasibility study is performed to estimate what the economic value of the hotel will be once it is open and operational. The development costs of the hotel, including all soft costs (e.g., interest and pre-opening expenses, as well as a developer's fee) are estimated. A developer's profit may or may not be generated, depending on the project's profile and market conditions.

The amount by which the economic value of the hotel, based on projected future cash flow, exceeds the hotel's estimated development cost is what determines the net residual value to the land. In our example, the developer's consultants have estimated that the hotel will be worth $105,000 per room once it is open and operational in 1998. The developer estimates that the total development cost of the hotel, exclusive of land costs and a developer's profit, will be $89,000 per room. The residual value of the land and developer's profit is equal to the value of the total project upon completion of $105,000 per room less the project's development cost of $89,000 per room, or $16,000 per room. Assuming a developer's profit of 10 percent of the project cost exclusive of land value raises the total project cost to $98,000, leaving a residual to the land of $105,000 less $98,000 or $7,000 per room. Reducing the developer's profit to 5 percent raises the residual value of the land to $11,500.

Applying these two approaches to our example results in an estimate of land value ranging from $7,000 to $11,500, or 7.1 percent to 11.7 percent of total project cost. For this case study, we will conclude at the value derived by means of the ground lease approach, $10,500 per room or a total of $1,235,000. Once the hotel has been developed, the value of the land component may rise to represent a greater proportion of total value. However, the challenging economics of hotel development will likely reduce land values to below the traditional range of 10 percent to 20 percent of total project cost for the near term. While the choice of variables used in such an analysis is subjective, a careful consideration of the attributes of the market, the proposed project, and the site can lead to a prudent analysis and conclusion. Developers attempting to build new hotels should be careful not to pay too much for the land component in this current economic environment of low inflation and slim developer profits.

## ¶ 13.03 SALES COMPARISON APPROACH

The sales comparison approach is used to estimate the value of a property by comparing it with similar properties recently sold in the open market. To obtain an accurate estimate of value, the sales price of a similar property must be adjusted to reflect any differences between it and the subject property.

During the early 1990s, hotel sales transactions were scarce. The lack of data made this approach difficult to apply in the valuation process. In 1994 the market was revitalized, and sales activity picked up considerably. Today, hotel investors and developers keep current on hotel sales transactions, looking for the dollar amount per room for which a hotel has transacted and the capitalization rate at which the hotel has sold. Historical fiscal year, trailing twelve-month or first forecasted year net income before depreciation and income taxes but after deducting management fee and a reserve for replacement, is divided by the sales price to derive the capitalization rate. While these indicators are of interest to participants in the hotel industry, they do not serve as a basis for their own valuation conclusions regarding a specific project because of inherent limitations in the sales comparison approach.

The sales comparison approach can provide a usable value estimate for simple forms of real estate, such as vacant land and single-family homes, where the properties are homogeneous and adjustments are few in number and relatively simple to compute. However, for larger and more complex investments such as shopping centers, office buildings, and hotels, where the adjustments are numerous and difficult to quantify, the sales comparison approach becomes considerably less reliable.

As with the cost approach, hotel investors typically do not use the sales comparison approach to reach final purchase decisions. Various factors, such as the lack of timely hostelry data, the number of insupportable adjustments, and the difficulty involved in determining the true financial terms and human motivations of comparable transactions, usually render the results of the sales comparison approach somewhat questionable. The sales comparison is best used as a means of providing a range of values that bracket and support the income capitalization approach. Any reliance on its results, however, beyond the establishment of broad generalizations, is not normally justified by the quality of data.

The market-derived capitalization rates used by some appraisers (which rely on data derived from the sales comparison approach) are susceptible to the same shortcomings inherent in the sales comparison approach itself. To substantially reduce the reliability of the income capitalization approach by employing capitalization rates obtained from unsupported market data not only weakens the final estimate of value but also ignores the normal investment analysis procedures employed by typical hotel purchasers.

## ¶ 13.04 INCOME CAPITALIZATION APPROACH

Appraisers and participants in the hotel industry use the income capitalization approach to value property by analyzing the local market for transient accommodations, examining existing and proposed competition and developing a forecast of income and expense that reflects current and future anticipated income trends and area cost components up through a stabilized year of operation or for a specific holding period.

The forecast of income and expense is expressed in current dollars as of the date of each forecasted year. The stabilized year reflects the anticipated operating results of the property over its remaining economic life, including the normal stages of build-up, plateau, and decline. A stabilized year level of occupancy and average rate should inherently take into consideration normal economic fluctuations that cause cyclical increases and decreases in the net income of a hotel investment. Any abnormal transitory or nonrecurring conditions that result in unusual revenue or expenses for the property are excluded from consideration in the selection of a stabilized year of operation.

The forecast of income and expense is then converted into a value through an income capitalization process that reflects the rate of return required by market participants. One of the considerable benefits of real estate ownership is that the investment may be leveraged (i.e., the buyer may finance a major portion of the purchase price and therefore significantly increase the yield on the equity invested in the project. One year of forecasted net income may be capitalized into an estimate of market value if the hotel's upside potential and downside risks can be adequately reflected through a single-year forecast. The overall capitalization rate applied to the net income may be derived from the market (i.e., calculated by dividing the historical or forecasted net income of a hotel that has recently been sold by the sales price). Since such a method is rarely reliable because of the numerous conditions affecting net income and transaction prices, an alternative method—the band of investment method—is often used. The band of investment is a calculation of the weighted cost of capital. The debt component, typically representing 50 percent to 75 percent of an investment, and the equity component, representing the remainder of the purchase price, are weighted at their respective rates of return. The resultant capitalization rate is divided into the forecasted net income to derive an estimate of market value.

Hotels, because of their large business and personal property components, are typically in some form of transition. Buyers generally look to enhance the value of the hotel they are acquiring by physically improving or changing the management of the property. Hotel markets are also often in flux because of additions to supply and changes in the make-up of existing supply. For these reasons, a multi-year forecast of income and expense is generally preferred to reflect future fluctuations in occupancy, average rate, and net income. Ten-year forecasts have become the norm for real estate valuations, because they represent typical holding periods and are used to analyze and value other real estate investments that require complete lease rollovers to accurately reflect market rents. A multi-year forecast of net income may be converted into an estimate of market value through a discounted cash flow analysis whereby the net income forecasted for the ten-year holding period plus the net sales proceeds at the end of the holding period are discounted back to the date of value by an appropriate discount rate. One overall discount rate that considers the varying costs of capital used in the market may be derived through surveys of market participants or through an analysis of actual sales. This simple discounted cash flow model may be further refined through the use of a mortgage-equity technique that considers the different cost of capital required by the debt and equity components.

Because of the compounding inherent in rates of return required over multi-year holding periods, the simple weighted cost of capital utilized in the band of investment is mathematically inaccurate for the development of an overall discount rate that accurately reflects the debt and equity components of an investment.

To estimate the value of the subject property, we have used a ten-year discounted cash flow analysis in which the cash flow to equity and the equity reversion are discounted to the present value at the equity yield rate, and the income to the mortgagee is discounted at a mortgage interest rate. The sum of the equity and mortgage values is the total property value. To convert the forecasted income stream into an estimate of value, the anticipated net income (before debt service and depreciation) is allocated to the mortgage and equity components on the basis of market rates of return and loan-to-value ratios. The sum of the mortgage component and the equity component equals the value of the property. The process of estimating the value of the mortgage and equity components is as follows.

1. The terms of typical hotel financing are set forth, including interest rate, amortization term, and loan-to-value ratio.
2. An equity yield rate of return is established. Numerous hotel buyers base their equity investments on a ten-year equity yield rate projection that takes into account ownership benefits such as periodic cash flow distributions, residual sale or refinancing distributions that return any property appreciation and mortgage amortization, income tax benefits, and various nonfinancial considerations (e.g., status and prestige). The equity yield rate is also known as the internal rate of return on equity.
3. The value of the equity component is calculated by first deducting the annual debt service from the forecasted net income before debt service, leaving the net income to equity for each projection year. The net income as of the eleventh year is capitalized into a reversionary value. After deducting the mortgage balance at the end of the tenth year and the typical brokerage and legal costs, the equity residual is discounted back to the date of value at the equity yield rate. The net income to equity for each of the ten projection years is also discounted to the present value. The sum of these discounted values is the value of the equity component. Adding the equity component to the initial mortgage balance yields the overall property value.

   Because the mortgage and the debt service amounts are unknown but the loan-to-value ratio was determined in step 1, the preceding calculation can be solved through an iterative process or by use of a linear algebraic equation that computes the total property value.
4. The value is proven by allocating the total property value between the mortgage and equity components and verifying that the rates of return set forth in steps 1 and 2 can be met from the forecasted net income.

## [1] Mortgage Component

Data for the mortgage component is generally developed from statistics pertaining to actual hotel mortgages made by long-term permanent lenders. The American Council of Life Insurance, which represents twenty large life insurance companies, publishes quarterly information pertaining to the hotel mortgages issued by its member companies. Exhibit 13-3 summarizes the average mortgage interest rate of the hotel loans made by these lenders. The AA utility bond yield as reported by Moody's Bond Record is shown for purpose of comparison.

**Exhibit 13-3 Typical Hotel and Motel Mortgage Rates**

*Source: American Council of Life Insurance; Moody's Bond Record*

| Year | Average Interest Rate | Average AA Utility Bonds |
|---|---|---|
| 1995 | 8.94 | 7.77 |
| 1994 | 9.50 | 8.22 |
| 1993 | 9.13 | 7.44 |
| 1992 | 9.73 | 8.55 |
| 1991 | 10.42 | 9.09 |
| 1990 | 10.53 | 9.65 |
| 1989 | 10.11 | 9.56 |
| 1988 | 10.27 | 10.31 |
| 1987 | 9.94 | 9.77 |
| 1986 | 9.83 | 9.30 |

(Data not shown for limited number of loans.)

The average interest rate of a hotel mortgage and the concurrent yield on an AA utility bond have a close mathematical relationship. Through regression analysis, this relationship is expressed as follows:

$$Y = 2.9040 + 0.77650X$$

where Y = Estimated hotel/motel mortgage interest rate
X = Current average AA utility bond yield (coefficient of correlation is 95.5%).

If, for example, the current yield on AA utility bonds, as reported by Moody's Bond Record, is 7.68 percent, the equation produces an estimated hotel/motel interest rate (Y) of 8.9 percent.

In addition to the mortgage interest rate estimate derived from this regression analysis, the terms of hotel mortgage loans made by institutional lending clients are constantly monitored. There has been a significant increase in the availability of debt financing since 1994, though one would not yet characterize capital as "free flowing" for hotel investments, particularly for new construction. Projects are able to secure mortgage financing at interest rates ranging from 8 percent to 11 percent, depending on the location, affiliation, and operator, and loan-to-value ratio. Underwriting is much stricter than it was during the 1980s, and lenders are looking for minimum debt coverage ratios of 1.4, and loan-to-value ratios rarely exceed 65 percent. Amortization schedules have also decreased from the thirty-year norm prevalent during the 1980s to anywhere from ten to twenty-five years, with twenty years being the most prevalent. Lenders are now more aware of the short life cycles and high risks associated with hotel investments and thus are requiring that debt be retired more rapidly than in the past.

For the proposed extended stay property, we have assumed that a 9.00 percent interest, twenty-year amortization mortgage with a 0.109769 constant, and a 65 percent loan-to-value ratio is appropriate.

## [2] Equity Component

Additional capital required for a hotel investment is generally supplied by an equity investor. The rate of return that an equity investor expects over a ten-year holding period is known as equity yield. Unlike the equity dividend, which is a short-term rate of return, an equity yield specifically considers a long-term holding period (generally ten years), annual inflation-adjusted cash flows, property appreciation, mortgage amortization, and proceeds from a sale at the end of the holding period.

It is difficult to quantify the rate of return required by equity investors seeking to purchase hotel properties. To establish an appropriate equity yield rate, two important sources of data are past appraisals and investor interviews.

### [a] Past Appraisals

Appraisers can derive equity yield rates from the market when they appraise hotels that sell on or about the time at which they are appraised. In the case of hotels that were actually sold after appraisal, it is possible to determine an appropriate equity yield rate by inserting the projection into a valuation model and adjusting the appraised value to reflect the actual sales price by modifying the return assumptions. Exhibit 13-4 shows a representative sample of hotels that were sold shortly after they were appraised, along with the imputed equity dividend and equity yield returns based on the valuation approach.

**Exhibit 13-4 Summary of Derived Rates and Yields**

| Hotel | City and State | Date of Sale | Overall Rate (%) | Total Property Yield (%) | Equity Yield (%) |
|---|---|---|---|---|---|
| Warner Center Marriott | Woodland Hills, CA | 12/95 | 9.1 | 11.7 | 14.8 |
| Westin Bonaventure | Los Angeles, CA | 12/95 | 1.9 | 17.8 | 24.2 |
| Hilton at the Club | Pleasanton, CA | 12/95 | 10.5 | 13.4 | 17.0 |
| The Plaza | New York, NY | 6/95 | 7.0 | 11.0 | 14.0 |
| Residence Inn | Baton Rouge, LA | 6/95 | 12.7 | 14.8 | 21.2 |
| Residence Inn | Overland Park, KS | 6/95 | 8.9 | 14.7 | 20.8 |
| Residence Inn | Des Moines, IA | 6/95 | 9.8 | 14.1 | 19.6 |
| Residence Inn | Hunt Valley, MD | 6/95 | 12.3 | 13.6 | 18.3 |
| Residence Inn | Kansas City, MO | 6/95 | 10.4 | 13.2 | 19.8 |
| Residence Inn | Lincoln, NE | 6/95 | 10.0 | 13.7 | 18.5 |
| Fullerton Suites | Fullerton, CA | 5/95 | 12.9 | 18.7 | 28.5 |
| Savoy Hotel | San Francisco, CA | 3/95 | 5.8 | 14.4 | 19.6 |
| Marriott Fisherman's Wharf | San Francisco, CA | 12/94 | 10.8 | 13.4 | 19.4 |
| Sheraton Inn | Napa, CA | 12/94 | 8.9 | 13.7 | 19.8 |

**Exhibit 13-4 Summary of Derived Rates and Yields *(cont.)***

| Hotel | City and State | Date of Sale | Overall Rate (%) | Total Property Yield (%) | Equity Yield (%) |
|---|---|---|---|---|---|
| Marriott Hotel | Portland, OR | 12/94 | 12.9 | 17.4 | 30.0 |
| Radisson Inn | Springfield, MO | 12/94 | 8.2 | 10.1 | 11.3 |
| Williamsburg Hilton | Williamsburg, VA | 12/94 | 15.4 | 19.0 | 32.0 |
| Marriott Tech Center | Denver, CO | 12/94 | 13.7 | 16.4 | 27.1 |
| Holiday Inn Sunspree | Singer Island, FL | 12/94 | 8.6 | 10.6 | |
| Sheraton Hotel | Hasbrouck Heights, NJ | 11/94 | 18.3 | 21.1 | 30.7 |
| Marriott East Side | New York, NY | 10/94 | 8.5 | 9.7 | 11.1 |
| Marriott Resort | Vail, CO | 10/94 | 14.2 | 18.9 | 30.5 |
| Radisson Mark Resort | Vail, CO | 9/94 | 8.9 | 15.8 | 24.1 |
| Marriott SFO | Burlingame, CA | 8/94 | 10.2 | 13.2 | 19.0 |
| Best Western Otay Valley Inn | Chula Vista, CA | 7/94 | 13.2 | 21.1 | 31.8 |
| Sheraton Hotel | Cypress Creek, FL | 7/94 | 9.0 | 13.3 | 19.4 |
| Hampton Inn | Islandia, NY | 7/94 | 12.6 | 16.6 | 28.2 |
| Hampton Inn | Willow Grove, PA | 7/94 | 11.0 | 14.3 | 23.0 |
| Hampton Inn | West Palm Beach, FL | 7/94 | 10.8 | 10.8 | 14.3 |
| Hampton Inn | Naples, FL | 7/94 | 11.4 | 11.5 | 24.9 |
| Hampton Inn | Albany, NY | 7/94 | 9.3 | 11.5 | 24.9 |
| Westin Kauai | Lihue Kauai, HI | 6/94 | (1.9) | 8.1 | 7.2 |
| Residence Inn | Binghamton, NY | 6/94 | 10.8 | 13.9 | 21.9 |
| Hotel Millenium | New York, NY | 6/94 | 9.5 | 14.1 | 23.0 |
| Radisson Inn | Orlando, FL | 5/94 | 12.9 | 18.0 | 28.2 |
| Newark-Fremont Hilton | Newark, CA | 5/94 | 8.8 | 14.9 | 20.7 |
| Best Western Fireside Inn | Cambria, CA | 4/94 | 11.7 | 15.8 | 24.3 |
| Checkers Hotel Kempinski | Los Angeles, CA | 4/94 | 3.0 | 18.3 | 27.0 |
| Phoenician Resort | Phoenix, AZ | 4/94 | 6.6 | 9.3 | 8.9 |
| Crescent Hotel | Phoenix, AZ | 3/94 | 6.5 | 7.2 | 2.2 |
| Holiday Inn | Edison, NJ | 3/94 | 6.5 | 7.2 | 2.2 |
| Ritz-Carlton | Phoenix, AZ | 2/94 | 11.0 | 14.6 | 21.7 |
| Sir Francis Drake | San Francisco, CA | 12/93 | 7.7 | 16.9 | 25.6 |
| Omni Chicago | Chicago, IL | 9/93 | 8.5 | 14.3 | 20.4 |
| Seven Peaks Excelsior Hotel | Provo, UT | 8/93 | 8.7 | 15.3 | 20.7 |
| Airport Marriott | Long Beach, CA | 7/93 | 14.7 | 18.5 | 30.1 |
| Doubletree Hotel | Salt Lake City, UT | 7/93 | 10.4 | 16.5 | 26.5 |
| Radisson Pan American | Miami, FL | 5/93 | 8.3 | 12.0 | 17.1 |
| Hyatt Hotel Airport | Atlanta, GA | 4/93 | 8.0 | 10.7 | 11.7 |

### [b] Investor Interviews

Institutional and individual hotel investors, as sources of equity funds, have definite return requirements that can be expressed as an equity yield rate based on a ten-year projection of net income before incentive management fees but after debt service. Based on surveys and investor interviews, Exhibit 13-5 is an illustration of the equity yield requirements of a cross-section of hotel investors.

**Exhibit 13-5 Surveys and Investor Interviews**

| Source of Equity | Equity Yield Requirements |
|---|---|
| Private Placement | 20%–24% |
| Institutional | 18%–22% |

Upward adjustments are indicated where expense and/or revenue projections substantially deviate from historical data, proposed properties, properties located in seasonal markets (which increase cash flow volatility), leasehold interests, properties located in very small markets, older hotels, properties that rely on only a few demand generators or cyclical demand generators, properties in areas that lack economic diversification, properties or markets that are particularly dependent on one demand segment, and properties located in areas characterized by a declining population and employment base. An upward adjustment is also indicated when a property has the potential to lose its franchise, when rooms revenue constitutes a small portion of total revenue, and when the penetration rate is high, to reflect its vulnerability.

Downward adjustment of the yield rate is indicated in primary market areas or hotels located in markets that have strong barriers to entry (making new supply unlikely beyond the stabilized year). Factors considered indicative of new competition include strong areawide occupancy and average rate levels and the availability of vacant land with favorable zoning and pricing.

Given an assumed 65 percent loan-to-value ratio, which is the risk inherent in achieving the projected income stream and anticipated market position of the subject property, it is likely that an equity investor would require an equity yield rate of 20 percent before payment of incentive management fees. This estimate is well supported by the equity yield requirements presented previously.

## [3] Terminal Capitalization Rate

Inherent in the valuation process is the assumption of a sale at the end of the assumed ten-year holding period. The estimated reversionary sales price at that time is calculated by capitalizing the projected eleventh year's net income by an overall terminal capitalization rate. From this sales price, a percentage is deducted for the seller's brokerage and legal fees. The net proceeds to the equity interest (also known as the equity residual) are calculated by deducting the outstanding mortgage balance from the reversion.

In estimating the residual value of a property, the appraiser must select a terminal capitalization rate and an allocation for brokerage and legal fees. The terminal capitalization rate is an overall rate applied to one stabilized year; it thus incorporates the cost of debt and equity capital. The terminal capitalization rate can be derived through a mortgage equity band of investment technique, which calculates the weighted average cost of the capital used in a hotel investment. Exhibit 13-6 combines the previously derived mortgage financing terms (a 65 percent loan-to-value ratio and a 0.109797 debt service constant) with a cash-on-cash equity dividend rate of 9 percent to calculate an overall capitalization rate.

**Exhibit 13-6 Calculating an Overall Capitalization Rate**

| | Percent of Value | | Rate of Return | | Weighted Average |
|---|---|---|---|---|---|
| Mortgage | 0.65 | × | 0.1070797 | = | 0.07018 |
| Equity | 0.35 | × | 0.09000 | = | 0.03150 |
| Overall Capitalization Rate | | | | | 0.10168 |

Because the overall rate will be used to capitalize net income ten years from the date of value, an upward adjustment is appropriate to reflect the uncertainty inherent in this extended time period. For the purpose of this valuation, an 11 percent terminal capitalization rate will be used.

As a point of reference, the terminal capitalization rate may be compared with the going-in rate implied by the value estimated for the subject property. The going-in rate reflects the capitalization rate that would be applicable if a hotel were operating at a stabilized level as of the date of value. This rate is calculated by dividing the stabilized net income, expressed in current dollars as of the date of value, by the value indicated by the income capitalization approach. Generally, the terminal capitalization rate is approximately 100 to 200 basis points above the going-in rate.

## [4] Valuation of Mortgage and Equity Components

Up to this point in the analysis, a number of objective decisions and some subjective evaluations of market data have been made; the remainder of the valuation analysis is purely mathematical. An algebraic formula equation calculates the amount of debt and equity that the hotel will be able to support given the anticipated cash flow derived from the forecast of income and expense and the specific return requirements of the mortgage lender (interest) and the equity investor (equity yield). As an alternative to an algebraic formula, the value (based on the previously defined terms) may be calculated on an iterative basis, as described in the proof of value that follows.

The process of solving for the value of the mortgage and equity components begins by deducting the annual debt service from the projected income before debt service, leaving the net income to equity for each year. The net income as of the eleventh year is capitalized into a reversionary value using the terminal capitalization rate. The equity residual, which is the total reversionary value less the mortgage balance at that point in time and less any brokerage and legal costs associated with the sale, is discounted to the date of value at the equity yield rate. The net income to equity for each projection year is also discounted back to the date of value. The sum of these discounted values equals the value of the equity component.

The amount of the mortgage and the debt service are unknown; however, the terms and loan-to-value ratio of current financing applicable to the subject property have been derived. The annual debt service and resultant net income to equity cannot be calculated without knowing the property's total value, the very unknown that we are attempting to calculate. In essence, the property's value must be determined by forecasting the net income available for debt service, and by calculating, through an iterative or algebraic process, the mortgage amount that the net income is capable of supporting at the assumed interest rate and a specified loan-to-value ratio. This process computes total property value on the basis of market-derived mortgage and equity return requirements.

A proof of value is established by allocating the total property value between the mortgage and equity components and verifying that the rates of return set forth can be met from the projected net income. Using a computerized mortgage/equity model to perform the necessary iterative calculations results in the following estimate of value.

The value is proven by calculating the yields to the mortgage and equity components during the projection period. If the mortgage achieves its 9 percent yield and the equity yield is 20 percent, then $13,695,000 is the correct value by the income capitalization approach. Using the assumed financial structure set forth in the previous calculations, market value can be allocated between the debt and equity as follows:

| | |
|---|---|
| Mortgage Component (65%) | $8,902,000 |
| + Equity Component (35%) | $4,793,000 |
| Total | $13,695,000 |

The annual debt service is calculated by multiplying the mortgage component by the mortgage constant:

Mortgage Component ($8,902,000) × Mortgage Constant (0.107967) = $961,123

The cash flow to equity is calculated by deducting the debt service from the projected net income before debt service, as shown in Exhibit 13-7.

**Exhibit 13-7 Cash Flow to Equity Calculation**

| Year | Net Income Available for Debt Service | | Total Annual Debt Service | | Net Income to Equity |
|---|---|---|---|---|---|
| 1997 | $1,124,000 | – | $961,000 | = | $163,000 |
| 1998 | 1,418,000 | – | 961,000 | = | 457,000 |
| 1999 | 1,663,000 | – | 961,000 | = | 692,000 |
| 2000 | 1,709,000 | – | 961,000 | = | 748,000 |
| 2001 | 1,769,000 | – | 961,000 | = | 808,000 |
| 2002 | 1,833,000 | – | 961,000 | = | 872,000 |
| 2003 | 1,898,000 | – | 961,000 | = | 937,000 |
| 2004 | 1,962,000 | – | 961,000 | = | 1,001,000 |
| 2005 | 2,032,000 | – | 961,000 | = | 1,071,000 |
| 2006 | 2,103,000 | – | 961,000 | = | 1,142,000 |

The equity residual at the end of the tenth year is calculated as follows:

Reversionary Value ($2,175,000/0.1100) = $19,773,000 – (Brokerage and Legal Fees (593,000) + Mortgage Balance (6,323,000)) = $12,857,000

Exhibits 13-8, 13-9, and 13-10 demonstrate that each of the components actually received their anticipated yields, providing that the $30,493,000 value is correct given the assumptions used in this approach.

**Exhibit 13-8 Total Property Value**

| Year | Net Income before Debt Service | | Present Worth of $1 Factor @ 14.1% | | Discounted Cash Flow |
|---|---|---|---|---|---|
| 1997 | $1,124,000 | x | 0.876490 | = | $985,000 |
| 1998 | 1,418,000 | x | 0.768234 | = | 1,089,000 |
| 1999 | 1,653,000 | x | 0.673349 | = | 1,113,000 |
| 2000 | 1,709,000 | x | 0.590184 | = | 1,009,000 |
| 2001 | 1,769,000 | x | 0.517290 | = | 915,000 |
| 2002 | 1,833,000 | x | 0.453399 | = | 831,000 |
| 2003 | 1,898,000 | x | 0.397400 | = | 754,000 |
| 2004 | 1,962,000 | x | 0.348317 | = | 683,000 |
| 2005 | 2,032,000 | x | 0.305296 | = | 620,000 |
| 2006 | 21,283,000* | x | 0.267589 | = | 5,695,000 |
| Total Property Value | | | | = | $13,694,000 |

*10th year net income of $2,103,000 plus net sales proceeds of $19,180,000

**Exhibit 13-9 Mortgage Component**

| Year | Total Annual Debt Service | | Present Worth of $1 Factor @ 8.9% | | Discounted Cash Flow |
|---|---|---|---|---|---|
| 1997 | $961,000 | x | 0.918465 | = | $883,000 |
| 1998 | 961,000 | x | 0.843578 | = | 811,000 |
| 1999 | 961,000 | x | 0.774798 | = | 745,000 |
| 2000 | 961,000 | x | 0.711625 | = | 684,000 |
| 2001 | 961,000 | x | 0.653603 | = | 628,000 |
| 2002 | 961,000 | x | 0.600311 | = | 577,000 |
| 2003 | 961,000 | x | 0.551365 | = | 530,000 |
| 2004 | 961,000 | x | 0.506410 | = | 487,000 |
| 2005 | 961,000 | x | 0.465120 | = | 447,000 |
| 2006 | 7,284,000* | x | 0.427196 | = | 3,112,000 |
| Value of Mortgage Component | | | | | $8,904,000 |

*10th year debt service of $961,000 plus outstanding mortgage balance of $6,323,000

**Exhibit 13-10 Equity Component**

| Year | Net Income to Equity | | Present Worth of $1 Factor @ 20.0% | | Discounted Cash Flow |
|---|---|---|---|---|---|
| 1997 | $163,000 | x | 0.833322 | = | $136,000 |
| 1998 | 457,000 | x | 0.694426 | = | 317,000 |
| 1999 | 692,000 | x | 0.578681 | = | 400,000 |
| 2000 | 748,000 | x | 0.482227 | = | 361,000 |
| 2001 | 808,000 | x | 0.401851 | = | 325,000 |
| 2002 | 872,000 | x | 0.334871 | = | 292,000 |
| 2003 | 937,000 | x | 0.279056 | = | 261,000 |
| 2004 | 1,001,000 | x | 0.232543 | = | 233,000 |
| 2005 | 1,071,000 | x | 0.193784 | = | 208,000 |
| 2006 | 13,999,000* | x | 0.161484 | = | 2,261,000 |
| Value of Equity Component | | | | | $4,794,000 |

*10th year net income to equity of $1,142,000 plus sales proceeds of 12,857,000

## ¶ 13.05 BREAK-EVEN ANALYSIS

A break-even analysis identifies the point at which the level of sales for a lodging facility produces neither a profit nor a loss from operations. Basically, for hotels and motels the break-even point is the occupancy level at which all cash outlays necessary for the operation can be met. The break-even point can be established either before or after debt service, although most lenders require a calculation of the break-even point after debt service to determine the security of their loan.

The break-even occupancy level can be estimated by using a computerized analysis of the fixed and variable components of revenue and expense items. Programs have been written that are able to take an achievable occupancy percentage (and the corresponding operating ratios) established by an appraiser for a subject property and, through a series of steps, drop the occupancy level and automatically adjust the operating ratios to reflect the lower revenues that would be achieved. The calculations continue until the break-even point for occupancy, before and after debt service, is attained. The appraiser then compares the break-even figures with those for the projected stabilized year for the subject property in order to determine whether there is enough leeway to cover debt service during low points in the occupancy cycle.

## ¶ 13.06 FEASIBILITY

The key to determining the economic feasibility of a lodging facility is the value estimate derived from the income capitalization approach. A new hotel is feasible if the economic value of the hotel as determined by the income capitalization approach exceeds the total replacement cost for the facility by a wide enough margin so as to provide the developer and the investors in the project with a satisfactory profit.

The same type of feasibility analysis is carried out each time a hotel is bought or sold. Essentially, the buyer performs an analysis based on the income capitalization approach and establishes a maximum price that he or she is willing to pay. If the selling price demanded by the seller is less than the value set by the buyer's analysis, the deal is made.

## ¶ 13.07 PROPERTY TAX ASSESSMENTS FOR HOTELS AND MOTELS

Among the significant expenses incurred by hotels are the property taxes paid to local municipalities. Because hotel owners may pay as much as 8 percent of their total revenue in real estate taxes, hotel owners and operators should constantly monitor their hotels' tax assessments to ensure that their property tax burden is kept to a minimum.

Property taxes are levied by municipalities to generate revenues to pay for essential government services. The purpose of real estate taxes is to allocate the municipal tax burden on the basis of real estate value. The higher the value of the real estate owned by a taxpayer, the larger the proportion of the tax burden the individual must assume. The concept underlying this tax is known as ad valorem, or in proportion to value. To establish the proper distribution of the tax burden, municipalities employ tax assessors to value all the taxable property within their jurisdiction. Theoretically, the assessed value of a property should bear a definite relationship to market value, so that properties of equal market value have similar assessments and properties of higher or lower value have proportionally larger or smaller assessments.

### [1] Estimation of Market Value

The goal of the entire property tax assessment process is the accurate estimation of market value. This goal is fairly easy to achieve for real estate such as vacant land and single-family homes. However, the issues involved in developing a supportable estimate of value for more complex properties become highly complex. Leading the list of property types that are difficult to value for assessment purposes are hotels and motels. Assessors must understand that lodging facilities comprise more than the traditional property components of land, bricks, and mortar; they are retail-oriented, labor-intensive businesses necessitating a high level of managerial expertise. In addition, hotels require a significant investment in personal property (furniture, fixtures, and equipment) that has a relatively short useful life and is subject to rapid depreciation and obsolescence. Characteristics specific to lodging facilities must be taken into consideration during the hotel assessment process in order for an accurate value assessment to be determined.

### [2] Improvement Value Evaluation

Hotel owners should monitor their property assessments on an ongoing basis to ensure that a favorable assessment relationship with other hotels in the taxing jurisdiction is maintained. This can be accomplished by evaluating the assessed values of all comparable hotels within the local market area. Assessors generally provide separate values for land and improvements. Since it is usually difficult to successfully appeal the land portion of the assessment, only the improvement value portion of the property assessment must be evaluated.

The first step in the evaluation process is equalizing the improvement assessment by using a common unit of comparison, which for a hotel is the assessed value per available room (i.e., the improvement assessment divided by the room count). The assessed values (per room) of all the comparable hotels are then compared with the owner's to determine whether the properties have been fairly assessed relative to each other. Adjustments related to differences such as quality of facilities, number and types of amenities, product class, and markets served should be considered. At this point in the analysis, owners should be looking for glaring discrepancies between the assessed value of their property and that of other hotels in the market area.

Comparing the assessed values of hotels within a taxing jurisdiction by means of this technique only pinpoints inequities between hotel assessments; it does not verify that the assessed value placed on a property is fair relative to its market value or the value of other types of real estate.

To evaluate the relationship between a property's market value and its assessed value, hotel owners should use the income capitalization approach, as previously set forth in this section, to aid in determining a fair assessment of the value of their lodging facility.

# CHAPTER 14

# Investment Strategies



## ¶ 14.01 REASONS FOR INVESTING

The following is a list of reasons to invest in hotel real estate:

1. Hotel real estate is typically countercyclical to stocks and bonds and provides portfolio diversification.
2. Hotels are an inflation hedge because hotel rates can be adjusted daily, within the constraints of market conditions.
3. Hotel real estate provides a refinancing opportunity that can generate tax-free return of capital from appreciating assets. Mortgage amortization also creates equity.
4. Hotel investing can be tax efficient because of associated depreciation and amortization write-offs.

5. Hotel real estate provides a competitive total return, and includes a current income component.
6. Hotel real estate is less volatile than equities.
7. Real estate is the single largest asset class available for investment.
8. Travel and tourism is the world's largest employer and industry. According to the Wharton Economic Forecasting Associates Group (WEFA), travel and tourism accounts for 10.2 percent of global gross domestic product, or $2.6 trillion; 183 million employees or one in every ten workers; 11.2 percent of capital investment (US $613 billion) and 11.0 percent of consumer spending worldwide. Travel and tourism is expected to increase over the next ten years.

## ¶ 14.02 HISTORICAL PERSPECTIVE

Rarely can an investor or company succeed through imitation or cost cutting. Creativity is necessary. However, creativity usually does not mean a truly new or revolutionary idea. What is generally needed is a new combination of ideas, an extrapolation of what is already known. This chapter reviews the recent history of the hotel industry from the perspective of hotel investment, describes the investment objectives that hotel real estate is most suited to achieve, and, finally, develops a series of investment guidelines.

The various participants in a typical hotel investment do not usually have the same goals or interests. Most participants, with the exception of the owner, are geared toward up-front fees, short-term benefits, and maximizing annual fees based on total revenue rather than toward profitability of the asset. The following sections consider the goals of some of the participants in the traditional hotel investment.

### [1] Hotel Chains and Management Companies

In the early 1960s, companies such as Hilton and Sheraton created management contracts as a means of expanding into overseas markets. Once the viability of management contracts as an expansion vehicle was demonstrated, most US hotel groups emulated this strategy during the 1970s and the 1980s to capitalize on the advantages of third-party ownership. These management contracts featured up-front pre-opening fees and annual base management fees, generally ranging from 3 percent to 4 percent of total revenue. While many of these contracts included provisions for an incentive management fee, some management companies had no expectations of ever realizing them. The 3 percent to 4 percent base management fee, in many cases, was sufficient to allow management companies to realize a 50 percent net operating income after all operating and fixed charges.

The revenue-based (as opposed to profit-based) fees led to a continual upgrading of a chain's amenities and services, which increased revenue (and the fees) but not necessarily profits for the owner. Most of these management contracts lasted for long periods of time (more than twenty years) and did not provide any performance clauses or mechanisms for replacing inappropriate or incompetent operators.

As the real estate industry expanded in the 1980s, both foreign and US hotel groups were pursued by investors and owners in what was generally regarded as a "sellers' market" for management companies. Today, however, there is much competition between and among hotel groups and other management companies, and the market has turned in favor of the buyer of management services.

## [2] Developers, Syndicators, and Architects

The short-term goal of developers during the 1960s and 1970s was to earn an up-front development fee or profit. Limited partners, brought into a deal by a fee-taking syndicator, were motivated primarily by tax write-offs. Their short-term goal was to shelter personal income with accelerated depreciation write-offs. Architects, frequently unburdened by such tedious concerns as economic budgets, designed properties that satisfied the egos of developers and provided syndicators with a salable image. Property amenities, room sizes, and construction quality increased (only partly as a result of a more competitive environment), whereas consumers' willingness to pay for these improvements did not rise at the same rate.

## [3] Lenders

The desire of savings and loans to compete with commercial banks, their new authority to lend money to nonresidential borrowers, and their desire to increase volume and achieve higher levels of fee income resulted in excessive financing during the 1980s. Many savings and loans made a profit with up-front points and fees, in addition to high interest rates on near 100 percent loan-to-value financing. Other underwriting deficiencies included the failure to obtain accurate independent and timely appraisals, and lenders operating with incomplete or nonexistent "in-substance" foreclosure rules. In-substance foreclosure occurs when the debtor has little or no equity remaining and loan repayment is doubtful but the mortgagee has not taken possession of the asset.

## [4] Highs and Lows

During the past nineteen years, occupancies peaked in 1979 at 72 percent and declined to 61 percent in 1987 and 1991. The average occupancy for the nineteen-year period from 1976 to 1994 was 65.7 percent. The average occupancy in 1995 was 65.5 percent. With the exception of the five-year period from 1988 to 1992, room rate growth has exceeded inflation for the twenty-year period from 1976 to 1995, demonstrating that hotel investments, unlike stocks and bonds, are a good inflation hedge (countercyclical), and a good investment for inflationary economies. In 1970, only 35 percent of US hotels were chain affiliated. By 1995, roughly 75 percent of US hotels were chain affiliated.

Hotels are retail–oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. The hotel industry is cyclical, event sensitive, and volatile. Hotels can be high-risk investments, especially if the management company, developer, syndicator, architect, and lender do not have congruent interests and goals. As a result of divergent interests among these participants, many hotels have been built in markets that did not need additional hotel capacity, and at escalated costs resulting from up-front fees, which meant that while many hotels were not profitable, many of the participants in hotel deals made money, at the expense of the hotel owner.

The US lodging industry during the 1980s was characterized by a massive building boom (product segmentation), favorable tax laws (syndication), strong economy, a rising stock market, extremely strong capital markets with declining interest rates, significant increase in hotel debt levels, and foreign participation (globalization), which drove up purchase prices. Net interest payments increased from less than 7 percent of total revenue during the late 1970s and early 1980s to more than 14 percent by 1991.

From mid-1990 to late-1993, the US lodging industry suffered through a worldwide recession and was further hurt by the junk-bond market collapse in late 1990, the Persian Gulf war in early 1991, illiquidity in the capital markets, and overbuilding. Overseas lenders and investors substantially reduced their activity in the US, and the Financial Institution, Recovery, Reform and Enforcement Act of 1989 (FIRREA) required more stringent capital standards for thrift institutions.

In addition to the changes in lending policies mandated by FIRREA, many newly conservative institutions reduced new real estate funding levels as a response to large increases in their nonperforming real estate loans. Because banks and savings and loan associations had historically been the source for roughly half the financing for commercial properties, a material reduction in loan activity significantly affected real estate markets. The shortage of debt financing occurred at a time when many 1980s bullet loans and mini-perms were approaching maturity. According to a national accounting firm, more than $2 billion in hotel loans was delinquent or in the process of foreclosure as of September 1990. More than 40 percent of the mini-perms and construction loans held by US banks were scheduled to mature by the end of 1992.

Hotel values eroded considerably during the recession, and capable buyers typically dictated price and terms of a hotel sale. Sales of foreclosed hotel assets by the Resolution Trust Corporation and the Federal Deposit Insurance Corporation during the early 1990s, regardless of the poor condition of the capital markets, resulted in liquidation pricing. In short, the market favored hotel buyers.

The industry returned to profitability in 1993 through a reduction in interest (lender write-offs), payroll (downsizing), property taxes (lower values), and food and beverage expenses and reductions in management fees. In 1993, for the first time in five years, average rate increased at a rate greater than inflation. By late 1993, a flurry of activity in the market began as investors slowly realized that hotel values had hit the bottom of the cycle. It appears that in 1996 the greatest inflow of capital into the hotel industry in more than a decade will have occurred. From 1994 to today, a rising US stock market, favorable interest rates, an expanding economy, and a lack of new hotel supply (particularly in the full–service segment) have helped the hotel industry.

## [5] Current Environment

New full-service hotel construction in the US is currently inhibited because (1) development costs exceed value; (2) there is limited capital availability for new full-service construction, and (3) many projects require multi–year development lead times. Most industry sources do not expect significant new, full–service hotel construction in the US between now and 1999. Nationally, room starts have already increased 250 percent from 1993 (excluding Las Vegas casino starts—see Chapter 23) to 1995. Currently there is a shortage of decent hotels available for sale. At the same time, large pools of qualified potential buyers are seeking new acquisitions.

## ¶ 14.03 VALUE DRIVERS: INDUSTRY FUNDAMENTALS VS. CAPITAL MARKETS

Capital availability is a prime determinant of values in the hospitality industry. Liquidity facilitates transactions and provides for price discovery. Without liquidity, small capital flows can move pricing.

While occupancy figures receive a lot of publicity, other factors, such as changes in average rate, investor psychology, financial liquidity, and profitability ratios are also very important. Capital availability and cost affect returns more than industry fundamentals such as occupancy and average rate. Capital availability drives capitalization rates and new construction feasibility and therefore new supply. Supply changes have a higher correlation with capital availability than with demand. Unfortunately, supply growth does not necessarily correlate with demand growth. In the early 1980s, room starts nearly doubled, while occupancy was steadily declining from its 1979 high. The early 1990s crash was a result of a capital crash more than it was a result of a demand crash or overbuilding.

Real estate assets typically exhibit lower volatility (and consequently lower returns) than stocks or bond investments; however, in the short-term, a hotel's performance may vary more than other types of real estate with long-term leases. This variability dictates either longer potential holding periods to smooth out industry cycles or a market cycle timing approach, with the end result of potentially greater equity returns for hotel investments as compared to other real estate.

Hotels, perhaps more than any other type of real estate, display cyclical occupancy trends over the long term. New hotels are built either because of an abundance of capital or because growth in demand causes an increase in area-wide occupancy levels and attracts the attention of developers, lenders, hotel chains, and management companies. When the rate of new property construction outpaces growth in demand, overall occupancy levels decline while demand "catches up" and/or the least competitive facilities drop out of the market.

## ¶ 14.04 INVESTMENT STRATEGIES

### [1] Timing the Market

Unlike stock investing, the best strategy for investing in hotel real estate is market cycle timing, not dollar-cost-averaging or holding for long time periods. Hotel real estate market cycles take years to change, while equities can change in a day. The Tax Reform Act of 1986 removed many of the tax benefits associated with real estate ownership that had assumed greater importance than sound economic underwriting. That the industry remained relatively strong for three to four years after the Act was passed demonstrates how easy it is for an astute investor to time the hotel real estate market.

The hotel real estate cycle historically is eight to twelve years long. The building boom of the early 1920s came to an end with the depression of the early 1930s. The REIT-induced real estate slump of the early 1970s was forgotten by the time of the peak of 1979 and the early 1980s. That peak ended in the early 1990s. Many investors that purchased hotels at or near the bottom of the 1970s cycle and sold in the early and mid-1980s realized large returns. Those investors that purchased hotel property in the early 1990s will earn huge returns when as they sell in 1996 and beyond.

The most prudent time for hotel acquisition, as demonstrated by the 1970s and 1990s real estate cycle, is not when the market is achieving strong occupancies and many new properties are under development, but rather when new construction has peaked and occupancies and average rates are improving.

### [2] Risk Avoidance

An approach that not only analyzes investment opportunities prospectively but also assesses potential risk complements this market cycle timing strategy. Controlling downside risk maximizes portfolio yields, in the same way that the baseball batter that consistently hits doubles and triples will outperform the "home-run or strikeout" hitter. Risk is managed with adequate cash reserves, intelligent renovation plans, low property break-even levels, and an asset diversification strategy.

The selection of hotel properties may be the most important aspect of a combined market cycle timing/risk avoidance strategy. Recognizing current and future value, buying "right," enhancing value with effective asset management, negotiating well-structured property management and franchise agreements, and selling at or near the peak in the real estate cycle is a strategy that has proven successful.

## [3] Appreciation Maximization

It is a good idea to focus on appreciation and seek to maximize total return and not just current yield, because yield can be more than offset by capital losses. Current income is not always a true indicator of underlying asset value. A high current dividend strategy favors premium-priced performing hotels in strong markets. These properties often have minimal upside, if they have any at all. Because at the time of acquisition these assets are maximally productive, they sometimes have only one direction in which they can move—downward—and are therefore higher-risk investments than they appear. The reliance of the pension fund community on this investment strategy is a significant reason for its poor performance in hotel investments. Strong hotels in strong markets sell at premium and may be at the peak of their life cycle. Appreciation maximization strategy seeks strong market positions with defensible niches. High penetration rates or profit margins are indicative of a dominant competitive position. However, when the market is very strong, it can attract competition.

Secondary markets are sometimes better markets in which to execute this strategy because they sometimes attract less notice, and therefore less new competition.

Performing hotels in recovering markets are hard to value, because market changes are beyond the hotel owner's control. The greater the percentage value attributable to future market behavior, the greater the likelihood that value will vary over time. However, market recovery bets can be very profitable—hotel investors that bought well-located, strong property in the oil-producing, depressed areas of Texas and parts of Colorado in the late 1980s have demonstrated this with huge earned appreciations since that time.

Some hotels are underperforming and are located in weak markets. Weak hotels in weak markets face two questions: will the asset improve and will the market improve? Such hotels are too risky.

## [4] "Fixer Uppers"

The most consistent way to maximize returns and minimize risk is to find hotels that have a problem that can be fixed. The fixable requirement generally excludes locational problems. Buying underperforming hotels in sound markets is less risky because the investor is not dependent on factors out of his control. If the market is sound or even strong, he does not have to wait for the market to turn around—he needs only to turn the property around. Five basic strategies for purchasing hotels include:

1. Look for properties that are receiving their fair share of revenue but have high expenses that can be reduced with competent management. Increases in cash flow from expense reductions are generally less risky than forecasted

revenue increases. Historical statements should be recast to provide an example of potential cost savings and the effect on value. Roughly 40 percent of all the expenses at a hotel are labor. An expense reduction strategy should focus on the number of employees currently at the hotel, their wages and benefits, and labor productivity based on sales. Characteristics of underperforming properties may include rising expenses, expanded accounts payable, accelerated staff and management turnover, erosion of guest services, sales and marketing cutbacks, and deferred maintenance.

2. Properties that need capital expenditures are good acquisition candidates. One strategy is to buy well-located property in poor condition, and completely renovate and reposition. Pressure to sell is often strongest when the immediate need for property refurbishment clashes with owner illiquidity, loss of confidence, disinterest, and pressure from bankers.

A variation of this strategy is to purchase run-down, de-franchised hotels at the end of their economic life cycle for little more than land value, say $10,000 to $20,000 per room. In many cases these old properties have the best locations in a market, and after renovation the investor is left with a franchisable mid- or upper-level hotel in a strong location at one-half the cost basis of its competitors. One of the challenges with this variation is that many municipalities require that a property, upon a major renovation, be brought back into compliance with current codes. Compliance-type improvements rarely provide an adequate financial return.

3. Reposition properties at a lower level, if it will increase net operating income.
4. Buy hotels with excess development capacity or excess land in markets in which additional development is warranted. This provides immediate cash dividends from the existing asset and future development potential upside.
5. Buy hotels with clearly definable and divisible wings and replace with multiple brands at different price points.

## [5] Buying Below Replacement Cost

The principle of substitution—essentially, that the buyer will evaluate available purchase options with equivalent utility and select the property with the lowest price—is the driving force behind hotel real estate values. In the income approach, it is embodied as the concept that a prudent purchaser would not accept a return on a property that would be below an alternative investment of similar risk. In the sales comparison approach, the principle of substitution means not paying more for a property than the cost of acquiring an equally desirable substitute. In the cost approach, the principle of substitution is expressed as not paying more for a property than the amount for which a site can be acquired and improvements that have equal desirability and utility constructed.

In most markets, supply and demand conditions eventually generate investment returns that justify new construction. When this occurs, existing buildings that are of comparable quality to new construction command similar rents (RevPAR), and thereby generate greater returns to the extent that the asset was originally purchased below replacement cost. The critical variables determining profitability include the duration of time for market supply and demand balances to change, capital adequacy, and the quality and life cycle position of the facilities.

A secondary advantage to buying below replacement cost is the fact that the feasibility of new construction is limited, which protects current yields.

Hotels are often mispriced because of limited data and inefficient capital markets. Often, too, value distortions are psychologically based. Common psychological distortions include overpaying for investments that appear secure (pension funds, for instance, are mistakenly drawn to assets with high dividend yields), overestimating risks, and overcompensating others for those risks.

A good way to separate value from emotion is to emphasize fundamental research, disciplined valuation techniques, and strict buy-and-sell rules when making a buying decision. While it is important to be able to identify unrecognized opportunity, one must avoid the tendency to overestimate the likelihood of a favorable but unlikely occurrence.

Financial projections should not automatically project that each year will be better than the preceding one. Recessions do occur. Real estate is a depreciating asset with a finite economic life that includes not only a growth phase, but also maturity and decline. Few operating histories trend steadily upward. Most properties move upward and downward.

Stabilization is an important concept in this regard. A stabilized occupancy and average rate is the average performance for the property *over its remaining economic life,* and not a point reflecting the hotel's current life cycle position. The danger occurs when a property is incorrectly stabilized at a peak level during the acquisition analysis, but the holding period is for a longer term. The buyer often ends up trying to exit the investment at a performance level below the level at acquisition, resulting in a loss. It is important to realize that most projection periods are longer than the ability to project new supply. Consequently, it is a good idea to have short holding periods, as well as an exit strategy developed prior to acquisition.

## [6] Short-Term Holding Periods

Hotels have a definite functional life. Because exterior architectural styles change regularly, many lodging facility exteriors appear dated after seven to ten years. Major exterior renovations are usually required after twenty years.

Asset values decline exponentially after the mid-life point of a hotel. However, major renovation and repositioning can postpone a hotel's mid-life for many years, depending on the strength of its location and market.

The industry uses a standard 4 percent replacement reserve, which some claim is less than half what it should be. The naysayers, however, demonstrate an incomplete understanding of hotel valuation. First, the 4 percent replacement reserve is meant to cover only the costs of replacing the furniture and equipment. It specifically excludes so-called short-lived building components. Short-lived building components are building systems such as a roof, parking lot, or boiler that will need to be replaced before the end of the asset's useful life. Real estate theory holds that if short-lived building component replacements are not, by industry convention, deducted from cash flow, then those costs are considered by the market in its selection of an equity yield. In this respect, short-lived building components are not unlike the asset management function and incentive fees. All three of these items are costs implicitly considered in the selection of an equity yield rate. If short-lived building components are to be deducted from cash flow, then equity yield rates must be adjusted to reflect this new assumption.

Over the long term, all investment returns trend toward the mean. Short-term holding periods accomplish the following:

- Mitigate illiquidity because of increased stability in the forecast horizon. Short-term cash flows are more reliably projected, resulting in lower risk.

- Force a full evaluation of the exit strategy before committing to the investment.
- Reduce the potential for negative event volatility.
- Reduce the likelihood of short-lived building component (e.g., roof, boiler) replacements, which rarely result in increased profitability.

Beyond the stabilization period, value increases occur at a lower (inflationary) rate. The risks inherent in owning a hotel and associated required capital expenditures are generally not adequately compensated with a 3 percent to 4 percent annual inflation-driven increase in cash flow and value. The exception is a well-diversified portfolio that is investing in hotels purely as an inflation hedge.

## [7] When to Sell

Signs that selling a hotel may be appropriate include:

- When a value estimated using the market data approach (comparable sales) exceeds that arrived at using the income approach or cost approach valuations.
- When national occupancy levels exceed 68 percent–70 percent;
- When gross domestic product (GDP) declines materially;
- When new construction occurs at a rate above demand growth;
- When comparable sales occur at or near historically high levels;
- When sales occur at capitalization rates that exceed the normal cap rates of the industry over a long-term period.

Exit strategies for investments in the fee, leasehold, or leased fee estates of real property can include, but are not limited to, the following:

- Sale of assets individually, as a group or a combination of group and individual sales;
- A public offering as a real estate investment trust (REIT) or other public offering;
- A securitization or other refinancing;
- Contributing the equity value in the assets to capitalize a new investment;
- A leveraged buyout;
- A syndication; and
- Conversion to time share, an alternative use, or term interval ownership (time share for a limited number of years which then reverts back to original estate interest).

Investments that have a high likelihood of being acquired by strategic buyers and/or are likely candidates for public offerings enhance the potential profitability of the exit or residual return.

## [8] Public vs. Private Ownership

Does real estate belong in a public company? Should it be privately held, either wholly or with others? Consider the following when answering these questions:

- Depreciation depresses earnings and therefore stock prices.
- The public market historically has had difficulty measuring unrealized asset appreciation and value changes.
- Hotels have an earnings volatility that is greater than other forms of real estate because of high fixed costs, high leverage, and event sensitivity. An aberrational quarterly earnings report can dramatically change a company's stock price. This causes a drive to consistently improve each quarter's cash flow. The danger of this situation is that it may change management's focus from a value creation and appreciation maximization strategy to a high current cash-on-cash yield acquisition strategy. Current income is often not a true indicator of underlying asset value, and current yield can be more than offset by capital losses.
- Because of quarterly earnings pressure, public companies are more likely to hold a property for a period beyond a one-to-three-year turnaround-and-stabilize period. This is antithetical to short-term holding periods and locking in gains, and it may minimize the value of underlying assets.
- Public market pricing often results in a significant premium over market value of the assets. Public hotel companies are currently trading at multiples of 15 to 20 times earnings before interest, taxes, depreciation, and amortization (EBITDA). EBITDA is roughly the public market equivalent of the private market's net operating income or the REIT market's funds from operations (FFO). The reciprocal of an earnings multiple is a cap rate, and therefore the reciprocal of a 20 EBITDA multiple is a 5 percent capitalization rate (1/20 = .05). The assets held by the companies that are trading at 20 multiples would not be worth a 5 percent cap rate if sold in the private markets. For this reason going public can be an excellent portfolio exit strategy. The execution of this strategy however, will require a growth story.

The current difference between public and private market hotel valuation creates the question: Why are the public markets valuing these hotel companies so highly? The standard answer is that they will grow quickly and that today's 5 percent cap rate will grow into a 15 percent cap rate. The second question is What distinguishes a public company's growth prospects from a private company's growth prospects? The answer to this question is simply that public companies typically have greater access to capital. In essence, today's public companies are realizing a value arbitrage that doubles their value simply because they have ready access to capital.

In order to maintain this value arbitrage, public companies must meet the market's growth expectations. This can put pressure on the acquisition and development strategy at public companies. Valuations of public companies are often based on a single quarter's or a single year's performance. Therefore, fluctuation in revenues and cash flows leads to increased risk and volatility of share values. To attract investors, properties may be chosen on the basis of their *current* cash, which translates into the desired yield. As a result, sourcing product on the basis of high current yields may favor short-term, high-risk properties over high-quality, but developing, long-term prospects.

The public markets are fickle and do not completely understand real estate. Today's favorable valuation could easily be tomorrow's unfavorable valuation. The public markets are best used either as an exit vehicle or as a means to fund an aggressive growth plan and achieve critical mass.

Because of high fixed costs, marginal revenue creates disproportionate increases in net income. Publicly held companies, whose critical mass (growth) is supplemented by ready access to capital, should increase market share.

## [9] Equity Leveraging

Equity leveraging, like debt leveraging, is designed to maximize the impact and return of equity capital. Equity leveraging generally consists of either (1) selling a partial interest in an asset, or (2) making acquisitions through a joint-venture arrangement. A joint-venture arrangement may consist of a new joint venture with, for example, one-third of the funding coming from an operator contributing the equity value of its owned real estate and a passive capital source contributing two-thirds in the form of cash. The advantage to the capital source in its investment is, for example, one-third specified, and is not completely blind. This arrangement provides an immediate cash-on-cash return. Presupposing that both joint venture partners receive the majority of their compensation on the same bottom line, this arrangement is very effective in aligning the interests of the operator and the passive capital source.

Selling a partial interest is a similar idea applied to a single asset. By selling a partial interest in an asset, generally 49 percent to 90 percent, the seller is able to free up equity for additional investment while still retaining a portion of a property's future appreciation. Equity leveraging is particularly useful when an investment strategy includes a market recovery bet. Equity leveraging a single asset occurs most often with larger more expensive hotels.

## [10] Diversification Strategy

Because of event sensitivity, several smaller investments of any type are better than a single big bet. Because hotels are market- and management-sensitive, diversification is particularly beneficial. A strategy designed to accumulate a well-balanced portfolio that spreads market and product risk among different hotel types, affiliations, and sizes in a variety of locations reduces volatility. Diversification by strategic objective, quality of facilities, age, types of demand generators, financial structure, and seasonality as well as market segmentation increases stability and reduces risk.

## [11] Miscellaneous Strategies

### [a] Broker Relations

It is important to maintain regular and honest communication with the brokerage and investment banking community. A steady and consistent deal flow ensures that an investor is in tune with market conditions. Additionally, strong personal relationships with the agency community means that investors will be exposed to listings with short marketing periods.

Often the highest bidder is not the prevailing party. Issues such as speed and track record are important considerations. A personal relationship with your broker can help you in these "soft" considerations.

### [b] Brand Creation and Critical Mass

Buy assets that can be leveraged into chains. Critical mass in the hotel industry is central to the success of most hotel companies and essentially separates the major chains from the minor ones. It may best be defined as the minimum number of hotels and hotel rooms that will economically support a full-service corporate structure. Typically, one hundred hotels in the US constitutes critical mass. Included in the full-service corporate structure are the advertising and consumer brand awareness of the chain as a whole, a central marketing staff, and a central reservations system. Additional benefits that might be derived from critical mass include the availability of chain-wide purchasing contracts for both goods (furniture and equipment as well as consumables) and services (notably advertising and marketing services), and may also include such items as insurance.

When critical mass is achieved, having your own brand is cost-effective. Royalties paid to franchise companies are usually 3 percent of rooms revenue and generally represent the franchise's profit. Three percent of the rooms revenue for 100 hotels represents a substantial expense savings. The development of a brand also creates franchising as an option. Upon reaching critical mass, franchising can be very profitable. One of the criteria for a hotel to be a trophy hotel is whether its name is well-known enough to merit development as a brand name. If this criterion is met, part of the purchase price may be allocated to launching a brand as opposed to the acquisition of real estate.

Devotion to expanding a brand, however, might slow the pace of growth and cause an investor to miss good hotel real estate and business investment opportunities. The ideal situation, provided there is sufficient capital, is to have the ability to grow both a proprietary brand and other brands.

#### [c] Barriers to Entry

Because supply increases are driven by capital availability and not by industry fundamentals, it is a good idea to search for markets with high barriers to entry. The premium hotel in a premium market strategy should be combined with high market barriers to entry to justify the premium price paid. Barriers to entry include hotel mortgage financing and hotel equity availability, market values that are less than replacement cost, tax laws, interest rates, environmental issues, local protectionist sentiment, prevailing mechanisms for project approval, and local politics.

## ¶ 14.05 MANAGEMENT ISSUES

### [1] Aligning With a Hotel Management Company

The investor should carefully choose and then limit the number of people he does business with. Funding long-term relationships and not deal-by-deal transactions and aligning with a value-adding management company willing to be compensated on the bottom line are ways to accomplish this. The profit on management fees enables management companies to pay more (10 percent–20 percent) than passive investors, to whom management/affiliation fees are simply an expense.

#### [a] Congruent Interests

Passive institutional investors, the public capital markets, and savvy but passive, high net-worth individuals are now focused on aligning their interests with management's interest. These entities generally recognize hotels as retail-oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. They acknowledge that unlike hotel operators, they are not industry insiders and are not comfortable relying solely on the management contract to align their interests with management's. Therefore, many passive investors require, or are attracted to, the following:

1. Management that has enough confidence in itself to invest in the asset.
2. Management compensation that is based on net income rather than gross revenue.

One way to align the interests of operators and passive investors is for the passive capital source to purchase a majority interest in the real estate and a minority interest in the management company. This feature, ownership in both the operator and asset, is similar to the paired-share real-estate investment trust (REIT) now known as Starwood Lodging Trust. Starwood purchased its predecessor REIT, Hotel Investor Trust, not for its poor-quality assets, but because it is the only hotel REIT in the United States that pairs shares in the operator and asset with every share purchase. This structure provided investors with such confidence that they were able to raise almost one-half billion dollars. Several REIT initial public offerings, including Hospitality Investors Trust, were not successful because the market was concerned about the nonaligned interests of the passive investors (shareholders) and management.

Investment performance is maximized by aligning the goals of the owner and manager so that both entities benefit mainly from residual capital appreciation and equity cash flows rather than from front-end and ongoing fees that are unrelated to financial performance. Management contracts with competent operators should be structured at reduced base fees (2 percent or less), for much shorter lengths of time (one to five years is not uncommon now), with meaningful incentive payments (a percentage of improved cash flow after debt service and after a preferred equity return) and performance clauses and guarantees. Earnout provisions by which the management company forgoes some cash flow in exchange for a percentage of the residual and/or refinancing proceeds are also a good idea. The manager, for example, may be compensated with a percentage of the return earned by the investment, after a 9 percent–15 percent preferred return to the investors. There should be no charges for acquisition or asset management and no placement fees of any kind for property selection, underwriting, due diligence, or technical service fees for the management of property renovations.

To maximize capital return upon divestment, management contracts should be cancelable without penalty upon a sale. That way, property can be sold unencumbered by a management agreement. Meaningful performance clauses should be negotiated where possible so that non- or underperforming management companies can be terminated. Considering the recent consolidations of management companies, an investor should attempt to eliminate the right of any management company to sell, transfer, or assign its rights, except to a wholly owned subsidiary.

### [b] Selecting a Management Company

Selecting a hotel management company with the specific capabilities necessary for running a particular property is a key step in a hotel investment. Knowledge of the financial and market capabilities of a variety of management companies is helpful in selecting appropriate management companies. One should match the various characteristics of the asset (e.g., size and type of hotel, class, geographic representation in local and feeder markets, critical mass, market segments served, and facilities offered) with the operator that has the best track record, operating performance, and experience in handling these characteristics profitably. Factors to consider when selecting a management company include the following:

- Geographically clustered hotel companies with strong centralization tend to outperform the median.

- Because of high fixed costs, incremental business is most profitable. Therefore, marketing skills add the most value.
- Technology (yield management) can improve marketing, income, and value.

The investor should also consider the management company's rate of growth, expertise and track record, depth of management, turnover of corporate staff and key personnel, years that management has been together as a team, present and future company profile and philosophy, reasons for any past contract terminations, operating policies and procedures, owner references after a competitive bidding process, and fee structure.

## ¶ 14.06 CONSOLIDATION

Mergers and strategic alliances can enhance returns through synergy, economies of scale, a harvest strategy (otherwise known as milking the cash cow), and risk-pooling. Principal reasons for mergers include access to capital for future growth, improved critical mass and economies of scale, and shareholder value enhancement. When two complementary companies are brought together with minimal initial cost, earnings may receive an immediate boost.

Mergers can be a quick way to grow, but they are not without risks. Mergers present the risk of an unsolicited, and possibly hostile, offer from a third company. Another problem with mergers is that the number of reasonably priced available suitor companies with real growth potential is often quite small. Early on, a decision should be made as to whether the goal is simply to acquire real estate assets at favorable pricing or whether the acquisition of an ongoing effective company is the goal. It is a good idea to seek valuable business assets locked inside weak capital structures. If there is a desire to keep the target company operating, then issues such as the following are important:

- Cultural fit, style, trust, similar philosophy;
- Product compatibility, with manageable hotel location overlap;
- Credibility and reputation;
- Financial strength, performance, and value of assets.

Tender offers for REITs and public hotel companies when their stock market capitalization is less than the value of the assets also constitutes an attractive consolidation strategy.

## ¶ 14.07 MEZZANINE FINANCING

Mezzanine financing is supplemental debt financing that is either (1) wrapped around an existing first mortgage, like a bridge loan or second mortgage; or (2) a single debt instrument tranched (split) into a first mortgage component and a mezzanine, earnout, subordinated, or "B-rated" component. Generally, mezzanine financing is flexible and customized and provides for a high loan-to-value ratio (ratios in excess of 90 percent are not uncommon) or a below-market interest rate. In return, the provider of mezzanine financing receives interest payments and a significant portion of a property's future appreciation. Additionally, the mezzanine financing provider may receive other "equity-like" rights, including management contracts and affiliation agreements. A mezzanine financing arrangement, which generally includes a sharing of future appreciation, can be structured so that appreciation sharing is a percentage split, predetermined fees paid upon maturity, or as a negative amortization loan. Mezzanine debt is usually short term (two to five years). Mezzanine financing can be used in the following ways and under the following circumstances:

- To bridge the gap between low loan-to-value public bonds and equity downpayments.
- When the buyer does not have sufficient cash, or chooses to deploy his cash resources elsewhere.
- For asset repositionings that involve a renovation.
- To achieve full or partial takeout of existing financing at a higher loan-to-value.

In many cases the operator/owner becomes the prevailing bidder when buying hotel assets because they receive the additional benefit of management and/or affiliation fees and are able to economically offer a higher price than the non-operator. This "operator arbitrage" could be applied to the debt markets.

Buying nonperforming debt, with a subsequent foreclosure planned, is another way to gain control of property. However, foreclosure laws vary by state and this strategy is more viable in certain states. Further, this strategy carries the additional risk that the foreclosure may not be successful and the debt buyer will remain a debt buyer. In a worst-case scenario, some or all of the debt buyer's expenditure could be dismissed by a bankruptcy court. This strategy works best when the principals have legal backgrounds.

## ¶ 14.08 DUE DILIGENCE

As discussed in detail in Chapters 6 through 10, the following market and site/property items should be reviewed.

### [1] Market Analysis

The economic vitality of the area encompassing the subject property and its feeder markets is an important consideration in forecasting future demand and income potential. Trends that foreshadow probable future economic patterns of the market as well as the vulnerability of the lodging market to economic trends should be evaluated. The size of the market and the demand for transient accommodations should be investigated to identify the various generators of visitation operating within the local market. The current and anticipated potential of these demand generators should be evaluated. An investigation should be made of the respective strengths of the market in terms of seasonal volatility and other demand fluctuations, price sensitivity, required facilities and amenities, and changes in travel patterns and other related factors. The market's diversity, or reliance on a few demand generators, and the economic volatility, seasonality, and prospects of significant demand generators should also be analyzed.

Economic diversity within the local market has an important effect on the area's stability, growth, and risk. Economically diversified markets generally have reduced volatility. Seasonality creates volatility and risk. Large variations between months or daily occupancies and weekday versus weekend occupancies limit upside.

In analyzing demand, the overall transient lodging market should be subdivided into individual segments based on the type or nature of travel because individual classifications generally exhibit unique characteristics. Market segmentation helps to define major types of demand and to estimate future growth rates and customer characteristics. The market's and the subject property's reliance on or diversification by market segment, including contract business, should also be evaluated.

Competitive lodging facilities should be evaluated to determine their position, rank, and other pertinent operational characteristics with respect to the subject. An analysis of existing and proposed competition provides an indication of the current accommodated and latent demand, relative market shares and penetration, and price/value relationships for customers. Some of the competitive factors that should be specifically reviewed include:

- Number of rooms;
- Average rate;
- Occupancy;
- Market orientation and segmentation;
- Location;
- Chain affiliation;
- Age;
- Quality;
- Condition;
- Rate structure and pricing strategies;
- Class and type of facilities;
- Size of meeting facilities;
- Level of services and recreational amenities;
- Type of food and beverage outlets;
- Management difficulty and expertise;
- Frequent guest programs;
- Travel agent commission policy; and
- Market perceptions and the comments of property management.

The nature and status of projects under construction, proposed or merely rumored, that might be competitive with the subject property should be evaluated. Barriers to entry for new competition should be evaluated. The probability that existing, older, noncompetitive lodging facilities will receive substantial capital upgrades and thereby increase their level of competitiveness should also be considered.

## [2] Site and Neighborhood Analysis

A thorough inspection should be made of the subject site that takes into account its physical and functional utility for hotel use, including its size, shape, topography, utilities, access, visibility, zoning, neighborhood, and other relevant location factors (e.g., proximity to both transportation systems and lodging demand generators). The supportive nature of surrounding land uses and patterns reflecting growth, stability, or decline should also be evaluated. The subject hotel's location, as compared with competitor locations and vacant developable hotel sites and relative to current and future demand generators, is a prime location issue. Plot plans including frontages, total site dimensions, access points, orientation of the improvements, and survey and legal descriptions should be reviewed. In addition, soil tests and seismographic studies may be advisable.

## [3] Subject Property Analysis

The physical improvements, facilities and amenities, should be inspected for their quality, style, design, layout efficiency, functionality, and effect on operating efficiencies and profitability. An evaluation considering size, condition, and suitability relative to the local market demand, segmentation, and competitive supply is necessary. As-built architectural/floor plans detailing the layout and relationship of spaces and areas within the property should be reviewed. This evaluation should include public areas, meeting facilities, restaurant and lounge facilities, back-of-the-house areas, mechanical equipment, and a sample of all guestrooms. Furniture and equipment are essential to the operation of a lodging facility, and their quality often influences class, image, and income. An assessment of the subject property's remaining useful life and the quality of its construction and materials used, including furniture and equipment, should also be required.

Historical refurbishment, FF&E and capital expenditures, maintenance records and programs, current budgets, engineering studies, ADA Compliance Reviews, and Phase I and II environmental studies should be reviewed. Deferred maintenance and other mechanical, building, or FF&E issues that require remedial attention must be identified. The sufficiency of proposed capital budgets, FF&E reserves, and insurance coverages should also be evaluated.

Franchise agreements; reservation reports; franchise inspection and deficiency reports; health, fire and building inspection reports and employee manuals should be reviewed as aids in evaluating the probability of losing or changing the current chain affiliation.

It is important to inspect the subject property's technology. This technology includes systems for yield management, accounting, property management, point of sale, building operations, sales and catering, life safety, security, and guestroom access. Yield management maximizes the ability to sell more higher-priced rooms during times of peak demand periods by specifying a varying number of rooms available at discounted rates during a given period, depending on overall demand. This technique reduces the likelihood of turning away guests who are willing to pay a higher rate because the units are occupied by patrons paying lower rates.

## [4] Supply-and-Demand Analysis

A supply-and-demand analysis should be used to understand and quantify the subject property's competitive positioning with respect to other lodging facilities. This analysis integrates all information regarding the data and information gathered during the fieldwork inspection, such as the subject site and facility analysis, area hotel and economic trends, demand characteristics, and competitive analysis. The supply and demand analysis results in a quantification and documentation of probable future trends in the subject property's market share, occupancy, average rate, and overall rooms revenues. Markets in which competitors have a lower cost basis should be carefully evaluated, because the competitors can then profitably afford to undercut your rates.

## [5] Financial Analysis

All practices and procedures involving financial management and results should be reviewed. In particular, the following items should be analyzed:

- Historic income and expense statements with full supporting schedules for the past three years (if available). Any audits or financial reviews should also be considered when available;
- Balance sheets (audited when possible);
- Operating budgets and projections;
- Annual reports (if a public company);
- Actual operating data from comparable lodging facilities;
- Marketing plans;
- Reservation system reports;
- Current definite and tentative pre-bookings and rate structures;
- Historic pre-booking conversion rates, booking pace, and rate structures;
- Occupancy and average rate summaries by month;
- Local expense factors relating to items such as labor, food and beverage costs, energy rates and bills, assessed values and taxes;
- Contractual obligations under frequent traveler programs;
- The relationship between rooms revenue and total revenue; and
- The level of fixed costs.

A projection of income and expenses representing future expectations of income potential, and corresponding to the level of activity and quality of operations indicated by the projected occupancy and average rate, should be developed. Various scenarios or "stress tests" (including best and worst case) should also be developed to test the sensitivity of various assumptions and projections. Actual inflation that varies significantly from projections can alter anticipated yields. The sensitivity of projected investment yields at different inflation rates should be tested. Because of the effects of compounding, a small deviation in assumptions can have a large impact on value.

## [6] Other Analyses

Any property, equipment, ground or tenant leases or subleases, management contracts, union agreements, service contracts and key supplier relationships, or trademarks/trade names and any documentation pertaining to in-lieu of property taxes or other property tax concessions should be reviewed by a hotel real estate professional for business issues, as well as by an attorney for legal issues. Appraisals, market and feasibility studies, and impact studies should also be reviewed to discover any previously unknown facts, and to evaluate the reasonableness of the assumptions and conclusions. An accountant should be used for financial audits and reviews and to evaluate tax returns and other relevant tax and accounting considerations.

Payroll is generally a lodging property's greatest expense. The current staffing level, any wage and benefit surveys, qualifications, and compensation of on-site management should be reviewed and compared to industry norms, as should existing labor control systems.

A detailed ownership record and history of the subject property with names of legal owners is important. Legal due diligence should include all contracts and current letters of intent, including any existing mortgages to be assumed or wrapped, title reports and insurance, stock or partnership agreements, major group booking contracts, frequent traveler programs, and service and maintenance contracts. A zoning and life safety compliance analysis should also be undertaken and any Hart Scott Rodino and tax issues investigated. The existence of any violations and the transferability of all licenses, permits, franchises, and other documents also must be evaluated.

In the case of mortgage due diligence, the borrower's credit history and reports, track record, and references should be reviewed, along with the history of any existing indebtedness, both secured and unsecured. If due diligence is for a purchase, an inventory list of all furniture and equipment, supplies, and consumables will be necessary, as will a list of all employees and appropriate personnel information. Due diligence for acquisitions should also include a detailed list of advance room and catering reservations and bookings, including the name of the party, deposit received, rate guaranteed, dates, status, and other relevant information.

Understanding and staying current with the hotel industry is a full-time endeavor. Third-party due diligence is not a substitute for full investigation by principals to a transaction. Instead it is an extra set of trained eyes and independent confirmation that appropriate questions have been asked, answered, and understood. In addition, third-party due diligence may save time for principals by focusing their time and efforts on areas of greatest need. Due diligence is analogous to insurance in that it reduces, but does not necessarily eliminate, risk.

CHAPTER 15

# Ownership Considerations



## ¶ 15.01 OVERVIEW OF OWNERSHIP ENTITIES

The form of hotel ownership is a very important decision that must be made in the early stages of the hotel development process. Usually the decision is based on tax, legal, or business considerations. For example, an owner might choose to form a corporation instead of individual ownership in order to limit his personal liability.

In this chapter, the following forms of business entities are discussed:

1. Individual ownership
2. Concurrent ownership (by two or more individuals)

3. Partnership (general and limited)
4. Regular corporation (C corporation)
5. S corporation
6. Limited liability company (LLC)
7. Trusts
8. Real Estate Investment Trust (REIT)

## [1] Tax Considerations

Each form of business entity has its own tax consequences; therefore, it is important to study each entity's tax impact on the hotel venture before deciding on a particular business entity. A brief description of the tax treatment for each type of ownership follows:

- *Individual ownership* lumps income, gain, and loss from hotel properties together with the owner's other items of income, gain, and loss.
- *Concurrent ownership* taxes each owner as an individual owner to the extent of his percentage interest in the property.
- *Partnerships,* whether general or limited, are not taxable entities, but are merely tax conduits; taxable income, gain and loss is passed through directly to the individual partners, who then treat these items as though they were individual owners of the property.
- *Regular (C) corporations* are taxable entities separate from their shareholders; they report income, gain, and loss separately. Consequently, corporate income and gain is subject to a double tax, once on the corporate level and again on the shareholder level when the income or gain is distributed as dividends.
- *S corporations, LLCs, and REITs* are separate legal entities that distribute income and losses in a way similar to partnership forms. There are, however, very specific statute requirements in the Internal Revenue Code that must be met to qualify for these entities.
- *Trusts* are taxable entities separate from their beneficiaries and thus similar to regular (C) corporations.

## [2] Business and Legal Considerations

It is important for the hotel owner to look at the various business situations that he is likely to encounter and to determine thereby what form fits best. The wrong choice could mean missing a business opportunity that could cost the hotel owner severely. Some of the more important nontax considerations to review when choosing an entity are as follows:

- Cost of formation
- Number of people and type of management needed to run the hotel
- Degree of flexibility required to conduct the activities
- Extent of and probability of exposure to liability
- Ease of transferability of interest in the entity

- Estate planning
- Ease of transferability of the hotel property
- Expected duration of the venture

## ¶ 15.02 INDIVIDUAL OWNERSHIP (SOLE PROPRIETORSHIP)

The simplest business form is individual ownership (sole proprietorship). A sole proprietorship is any business that is owned by one person as an individual. As such, there is no legal distinction between the owner and his business. The owner establishes the sole proprietorship simply by opening up his hotel for business.

Under sole proprietorship, the owner keeps track of his business income and expenses and reports the results on his schedule C federal tax form along with other income and deductions that he has on his individual tax form. A major tax disadvantage of sole proprietorship is that the owner is responsible for paying both the employer and employee portion of the social security tax on earnings from the hotel. However, the owner is allowed to deduct half the payments on his federal tax return.

Sole proprietorships are usually found in small family-run businesses where the hotel property is the major asset of the owner. Most potential liability claims can be handled by the purchase of insurance. Also, if the owner should need to borrow money to build the property, the lending institution would more than likely require the owner to personally guarantee the loan even if the entity were in a corporate form of business. Thus, there is little incentive for a small operator to incur the expenses of doing business as a corporation.

## ¶ 15.03 CONCURRENT OWNERSHIP

Hotels can be held in one of three forms of concurrent (i.e. multiple) ownership:

- Tenancy in common
- Joint tenancy
- Tenancy by the entirety

Because concurrent ownership requires a high degree of cooperation between co-owners, it is normally used only when property is acquired by members of a family or by a small group of investors who have had a long association. The ownership is reported on each individual's tax return in accordance with the ownership interest and thus is similar for tax purposes to a sole proprietorship.

### [1] Tenancy in Common

A tenancy in common is created when hotel property is transferred to two or more persons without express language creating one of the other two types of concurrent ownership (i.e., joint tenancy or tenancy by the entirety). For example, a tenancy in common is created by either of the following two conveyances: (1) To *A* and *B* or (2) To *A* and *B* as tenants in common.

The term "tenant" is used in its original sense as a co-owner of property, not in the sense of one who possesses real estate pursuant to a lease.

When two or more persons hold as tenants in common, each has an "undivided interest" in the entire property to the extent of his or her ownership share. For example, conveyance to three persons, without designation of any percentage to each, would give each tenant in common a one-third interest in the entire property. Alternatively, the conveyance may allocate different shares to each co-tenant: for example, one of three co-tenants may own a 40 percent undivided share, with each of the others owning a 30 percent share.

All decisions with respect to the co-owned property must be unanimous; the property may not be sold, mortgaged, or leased without the consent of all the co-tenants. For this reason, tenancy in common usually is considered a viable form of ownership only for a small hotel project with very few investors. Co-tenants can agree that one or only a few of them shall have the authority to make all decisions with respect to the property; however, this creates a risk that the relationship may be deemed an association taxable as a corporation.

Each tenant's right to possession of the property is subject to the rights of the co-tenants. Each has the right to an accounting of rents and profits, and in the event any tenant spends money for the payment of taxes, insurance premiums, or necessary maintenance and repair, he is entitled to reimbursement by the other tenants for their share of the expense. If the co-tenants are unable to agree as to the management or disposition of the property, any one of them is entitled to begin a legal proceeding known as an action for partition. If the hotel property cannot be equitably divided, the court can order that it be sold, with the proceeds to be divided among the co-tenants according to their interest.

Each co-tenant may sell, mortgage, or give away his interest during life or transfer it at death. When the interest of a co-tenant is transferred to another, the new owner becomes a tenant in common with the remaining owners.

For tax purposes, each tenant in common reports his share of income, gain, or loss. If a co-tenant makes a gift of his share, the usual rules of gift taxation apply. In addition, a gift is deemed to have been made if one tenant in common pays more than his share of costs and is not reimbursed by the others. The interest of a deceased tenant in common is taxed as part of his estate, according to its value on the date of death or on the optional valuation date. The heirs acquire the interest of the deceased tenant in common at a stepped-up basis equal to the value used for estate tax purposes.

## [2] Joint Tenancy

A joint tenancy is similar to a tenancy in common, with one very significant difference—the right of survivorship. If any joint tenant dies, his interest automatically passes in equal shares to the remaining joint tenants. If three joint tenants had owned the property and one died, each of the two survivors would take one half of the deceased joint tenant's interest. At the same time, in a joint tenancy as in a tenancy in common, all tenants are deemed to have an equal undivided share of the property; in other words, three joint tenants each own a one-third undivided interest.

A joint tenancy can be created only by express language in a conveyance, for example, "John Jones and Mary Jones as joint tenants with right of survivorship and not as tenants in common." A conveyance merely to "John Jones and Mary Jones" normally creates a tenancy in common, not a joint tenancy. Joint tenancies, because of their unusual survivorship feature, normally are used only among family members. One advantage is that this arrangement not only designates ownership of property, but also can serve as a substitute for a will. Thus, no public record will exist of the transfer of the property and no probate proceeding will be required; this is an attractive feature to many wealthy people. In addition, except for unusual circumstances, creditors of the deceased joint tenant cannot reach property that has passed into the hands of the surviving joint tenant (or tenants).

However, a disadvantage of the joint tenancy in owning property is that it does not permit other types of disposition at death that may prove more beneficial to the overall estate.

Although a joint tenant cannot devise his interest by will, the interest can be sold or given away during his lifetime. If this is done, the new owner becomes a tenant in common, not a joint tenant, with the remaining owners. This reflects the conceptual basis of early English common law, which conceived of joint tenancy as a merger of four unities: interest, time, title, and possession. The time requirement means that all the joint tenancies must be established at the same moment. Consequently, if one joint tenant later transfers the interest to another, the unity of time is broken and the new owner becomes a tenant in common. Similarly, any joint tenant (like a tenant in common) may start an action of partition; if the property cannot be equitably divided, the property will be sold and the proceeds will be distributed to the parties.

A joint tenant reports his share of income, gain, and loss from the property. However, unlike the case with tenants in common, if one joint tenant pays expenses in excess of his proportionate share, the full amount of such expenses is deductible.

## [3] Tenancy by the Entirety

A tenancy by the entirety is a joint tenancy between husband and wife. The tenancy carries with it the same right of survivorship as a joint tenancy so that, upon death of either spouse, the survivor takes the entire estate. Unlike a joint tenancy, however, neither spouse can convey any part of the property during their joint lives unless the other spouse joins in the conveyance. Thus, tenancy by the entirety (like the ancient right of dower) acts to protect the rights of the surviving spouse in property owned during the marriage. In most states recognizing the tenancy by the entirety, any conveyance to a husband and wife is presumed to be to them as tenants by the entirety, unless the title is specifically indicated to be otherwise.

Property held under tenancy by the entirety is not subject to levy by creditors of only one of the owners. In the event that the owners are divorced, the tenancy is destroyed and the divorced spouses become tenants in common. Where the spouses choose to file separate instead of joint returns, each tenant by the entirety reports his own share of the income, gain, or loss from the property on his separate return.

The major disadvantage of the joint tenancy or the tenancy by the entirety is their inflexibility with regard to planning to minimize federal estate taxes. Since there is now an exemption of $600,000 for a decedent, a co-owner whose estate is not likely to reach this figure (even after inclusion of the full value of the jointly owned property) need not be concerned. However, in many cases, the estate may exceed $600,000; consequently, a federal estate tax (which begins at 37 percent) may be payable. In discussing this problem, a distinction must be made between jointly-owned property between a married couple and between unmarried persons.

If a husband and wife are joint tenants of property or tenants by the entirety, one half of the property value is included in the estate of the first spouse to die, regardless of the amount each contributed to the purchase. The half so included will receive a "step up" in basis to current market value (thus eliminating any future tax on the appreciated value of that half prior to the date of death). At the same time, the transfer of the decedent's interest to the spouse is tax-free because of the unlimited marital deduction.

*Example:* $H$ and $W$ are joint tenants of property worth $1 million that cost $500,000. The property is their sole asset. On $H$'s death $500,000 (one-half the value) is included in his taxable estate. No federal estate tax is payable because of the $600,000 exemption (and also because of the unlimited marital deduction). $W$ then becomes sole owner of the property. Her tax basis is $750,000, consisting of her one-half share of the original cost, or $250,000, plus $H$'s stepped-up basis of $500,000. If she sells the property for $1 million, she will pay tax on only $250,000 of gain.

The situation so far is favorable. However, $W$ now is the sole owner of an asset with a value of $1 million. Upon her death, the general $600,000 exemption will be available, but the remaining $400,000 would be subject to federal estate tax. The tax on this amount is approximately $153,000 (assuming no taxable gifts during $W$'s life).

The federal estate tax would be eliminated completely in the foregoing example if the property were held by $H$ and $W$ as tenants in common. Upon $H$'s death, his $500,000 share would be exempt from tax, because it is less than the $600,000 exemption. If $H$'s share were left to his children (or in trust with income to $W$ for her life), the property would not be included in $W$'s estate. Thus, on her death, her estate would amount to only $500,000, which would be fully exempt from tax, on the basis of the exemption. In both cases, the value of the real estate would be stepped up to the value at date of death.

If the joint tenants are not married to each other, one important distinction must be made from the previous situation. If one co-tenant dies, only the value of the property representing his contributed share of the original cost is included in his estate. So if a parent and child create a joint tenancy, with the parent contributing 100 percent of the cost, the entire value of the property will be included in the parent's estate. If the child is the first to die, no portion of the property will be included in the child's estate.

## ¶ 15.04 PARTNERSHIPS: IN GENERAL

Partnerships are one of the most common entities used to own hotels. Partnerships are popular for three reasons:

- *Tax factor.* A partnership is not a taxable entity, so no double tax is imposed at the partnership and the partner level; alternatively, tax losses can be passed through directly to the partners in many instances.
- *Legal factor.* The partnership agreement can be amended at any time and thus provides a great deal of flexibility with respect to allocation of profits and losses, division of management responsibility, and the settlement of disputes.
- *Business factor.* A partnership often involves lower organizational costs, state fees and taxes, and administrative costs than a corporation.

A partnership has some disadvantages, notably the absence of limited liability for general partners and the lack of free transferability of ownership interests, both of which are provided in a corporation. In recent years, the limited liability company (LLC) has been chosen by many hotel investors as a preferred alternative to both the partnership and the corporation.

A partnership is a form of business organization in which two or more persons are associated as co-owners in a continuing relationship for the purpose of carrying on a common enterprise or business for profit. A written agreement of partnership (also called articles of partnership) defines the rights and obligations of each partner and sets forth how profits and losses are to be shared. The two types of partnerships are general partnerships and limited partnerships.

The term "partnership" is sometimes used interchangeably with the terms "joint venture" and "syndicate." Although a joint venture or syndicate may take the form of a partnership (either general or limited), the terms are not synonymous, because a joint venture or syndicate may also use some of the other legal forms of ownership, such a regular (C) corporation, S corporation, tenancy in common, or business trust.

## [1] Legal Characteristics of a Partnership

The legal characteristics of a partnership (both general and limited, except as otherwise indicated) are as follows:

*Separate legal entity.* For most purposes, a partnership is recognized as a legal entity separate from its individual partners. As such, the partnership may sue and be sued, and may hold and convey real property in the partnership name. In actions brought in federal courts, partnerships are recognized as separate legal entities, but diversity of citizenship (often a condition for bringing a federal lawsuit) is determined by looking at the individual partners.

*Agency relationship between partners.* Each individual partner in a general partnership (and each general partner in a limited partnership) has unlimited liability for any and all obligations of the partnership. This follows from the legal principle that every partner is the agent and principal of every other partner. Consequently, any debt incurred by any partner with apparent authority to do so in carrying on the business of the partnership is a debt of every other partner. A partner may have the right, under the partnership agreement, to have other partners contribute a portion of the liability or indemnify the partner held liable. A third party dealing with the partnership without actual notice of a lack of authority is not required to look into a partner's individual authority and thus may look to any of them to satisfy an obligation regardless of the terms of the partnership agreement.

*Management of partnership.* Unless they agree otherwise, all members of a general partnership (or all general partners in a limited partnership) have equal rights in the management of the partnership business.

*Dissolution of partnership.* The agency relations among the general partners is a personal relationship that cannot be changed without the consent of all the partners. Consequently, the partnership is automatically dissolved by the death or withdrawal of any general partner, notwithstanding any other provision in the partnership agreement. In effect, this means that any partner may dissolve the partnership at any time. No partner has the power to substitute another person as partner without the consent of the remaining partners. On the other hand, a partner who dissolves the partnership in violation of the agreement, or who refuses to consent to a substituted partner when such substitution is permitted by the partnership agreement, may be liable for breach of contract to the other partners. Nevertheless, the partnership is dissolved. In the situation in which all partners consent to the addition of a new partner, the partnership is not dissolved under the terms of most partnership laws.

*Nature of interest.* A general or limited partner's interest in the partnership is inheritable personal property consisting of the partner's pro rata rights in the specific partnership property, rights to a share of profits, and the right to participate in management (in the case of a general partner) and inspect the partnership books. The right to profits is expressly made assignable to third parties by UPA, regardless of any partnership agreement to the contrary. The result is that an assignee of profits has a legal right to claim the profits as against the partnership, although the partnership itself may have causes of action against the assignor for a breach of contract. The assignee, however, does not become a partner unless the other partners agree. An assignee who is not admitted as a partner lacks the right to participate in management, inspect the books, dissolve the partnership by death of withdrawal, or demand an accounting prior to dissolution of the partnership. It is not clear whether an assignee not admitted as a partner is liable for losses (although it would seem that either the assignor or the assignee must be liable).

## [2] Checklist for a Partnership Agreement

The following checklist includes factors that should be considered in drafting a partnership agreement:

- ☐ *Name of the Partnership.* While a partnership can choose any name under which to conduct its operations, its name should not be too similar to that of another business organization. How the participants' individual names are used as the partnership name—whether or not the partnership name will continue to be used after the death or retirement of a partner and whether or not it is permissible to do so under local law—must be considered.
- ☐ *Registration of name.* In some states, a partnership name must be registered with a public agency or officer—for example, a county clerk or secretary of state.
- ☐ *Nature of business.* The nature of the partnership business must be clearly spelled out.
- ☐ *Permits and licenses.* The partnership agreement should provide that it is not to become effective unless and until required licenses or permits are procured.
- ☐ *Partners' contributions.* These may be in the form of property, cash, or services, or any combination thereof. In addition to making a capital contribution to the partnership, a partner may make a loan or sell property to the partnership either for cash or on an installment basis. In each instance, the legal, tax, and accounting consequences to the partner and the partnership must be examined and dealt with.

  Where property is contributed, the partners' right to reconcile the tax bases and accounting values of the contributed property in order to prevent distortions should be taken into account.
- ☐ *Duration of partnership.* The parties may agree to a definite term, or the partnership may continue at will. As mentioned previously, a partner may terminate his relations with the partnership even if doing so breaches the partnership agreement.

  If the partnership agreement specifies a fixed term, the parties may continue the business beyond that term as a partnership at will, extend the term, or enter into a new partnership agreement.
- ☐ *Partnership profits and losses.* In cases in which the partners share both profits and losses, they are usually shared in the same proportion. However, the partners may agree that different kinds of partnership income shall be distributed among the partners in different proportions. Whatever the arrangement may be, it should be carefully set out in the partnership agreement.

  A partnership is not an entity separate from its members for income tax purposes. Each partner is taxed on his share of the partnership income and profits and is entitled to deduct his share of the partnership losses. The partnership files only an information return, not the income tax return that an individual or corporation would file.

- ☐ *Compensation of partner for services to partnership.* In the absence of an express provision in the partnership agreement to the contrary, a partner is usually not entitled to compensation for his services to the partnership. If a partner is entitled to and does receive compensation for his services from the partnership, this is a deductible business expenditure of the partnership.
- ☐ *Withdrawal of capital.* When it is anticipated that the partnership will accumulate a substantial amount of money, the partners should be permitted to withdraw a sufficient sum to meet their income tax obligations. The partnership agreement should clearly spell out the parties' understanding with respect to the partners' rights in this regard.
- ☐ *Management of partnership affairs.* All partners have an equal voice with respect to the management and conduct of the business affairs of a general partnership, unless they agree otherwise. The partnership agreement should clearly state each partner's rights and duties as well as the extent to which the partners are authorized to bind the partnership by their contracts.
- ☐ *Accounting.* The partnership agreement should require all partners to account to the partnership with respect to all matters affecting the partnership.
- ☐ *Partnership property.* Property acquired with partnership funds is partnership property, unless an intention to the contrary is clearly established.
- ☐ *Partners' death or withdrawal.* The partnership agreement may provide for the continuation of the business after the death or withdrawal of a general partner. Partners should be careful when crafting the partnership agreement to provide for the valuation of any partners' partnership interest following death or to withdrawal.
- ☐ *Indemnification of partner.* The partnership may be required to indemnify each partner for payments made and personal liabilities reasonably incurred in the ordinary and necessary course of the partnership business.

## [3] General Partnership

The simplest ownership form to use for two people who operate a business is the general partnership. This form of business can be as informal or formal as the partners wish it to be. General partnerships that have been formed with a simple handshake have lasted for many years. Although the requirements for forming the general partnership today have been made more formal by states adopting the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA), hotel developers should be careful when choosing partners. In fact, partnerships among individuals have led to many court battles over such issues as control, valuation, and succession. Therefore, it is extremely important to state as clearly as possible in the partnership agreement all the relevant duties and obligations of the individual partners and the means of dissolving the partnership upon dissolution.

The UPA and RUPA both require that a general partnership file and record in a public office a certificate identifying the names and addresses of each partner. The certificate must be amended in the event of a change in the partners.

However, it is possible for a partnership to exist without the knowledge or the intent of the partners; on the other hand, investors may believe they are in partnership when in fact they are not. Under UPA, the following three rules aid in determining whether a partnership exists:

1. Persons who are not partners with respect to each other are not partners as to third persons except where, by their conduct, they have led others to believe that they are partners and to rely on that belief to their disadvantage so as to create a partnership by estoppel.
2. The mere existence of joint or part ownership of property does not establish that a partnership exists, regardless of whether or not the co-owners share the profits made by the use of the property.
3. The sharing of gross returns from property does not, in and of itself, establish the existence of a partnership, regardless of whether or not the persons sharing the returns have a joint or common right or interest in the property from which the returns are derived.

Proof that an individual shares in the profits of a business is prima facie evidence that he is a partner in the business, unless he receives the profits as payment of a debt (installment or otherwise), wages, rent, an annuity paid on behalf of a deceased partner, interest on a loan (even though the amount of the payment varies with the profits of the business), or consideration for the sale of the good will of a business or other property by installments or otherwise. There are four basic disadvantages in choosing the general partnership form of ownership:

- *Personal liability for partnership debts.* Each partner is personally liable for the partnership debts—that is, all of the partner's assets may be reached by a creditor of the partnership in the event that the partnership assets are not sufficient. For this reason, the general partnership is normally used only by a small group of investors who know each other.
- *Authority of individual partners to bind the partnership.* Those who deal with a general partnership have the right to assume that each partner has broad authority to bind the partnership, provided the transaction fits within the scope of the partnership's business and apparently relates to that business. Because each partner is jointly and severally liable for the partnership's obligations, a partner may find himself in the unenviable position of having to dig into his own pocket to pay an obligation that was incurred by another partner apparently on behalf of the partnership.
- *Limited transferability.* UPA permits a partner to assign his share of the profits from a partnership, but the assignee does not have the right to participate in the management or administration of the partnership business.
- *Less privacy and anonymity.* Generally, a partnership offers less privacy, anonymity, and confidentiality than does a trust or corporation. The requirement of filing a certificate (and sometime publishing it) forces the disclosure of the identity of the owners. In a partnership, any partner may inspect the books; in a corporation, however, the identities of the stockholders are confidential and the contents of the business records rarely have to be disclosed, even to stockholders.

## [4] Limited Partnerships

One of the most popular business forms used for owning and operating hotel properties is the limited partnership. A limited partnership makes it possible for the hotel developer to combine his own skills with the financial resources of passive investors in an organization that allows flexibility of operation, limited liability for his investors, and the tax benefits of the pass-through of taxable income, gains, and, in certain circumstances, losses to investors.

A limited partnership is one formed by two or more persons, having as members one or more general partners and one or more limited partners. The general partner or partners manage the affairs of the partnership and are personally liable for the debts and obligations of the partnership. The limited partners, who are the passive investors, are not bound by the partnership debts and obligations, except to the extent of their equity investment.

A limited partnership is a hybrid of a corporation and a general partnership. A limited partner's exposure, like that of a corporate shareholder, is limited to his equity investment, and his status as a limited partner does not give him the right to control or actively participate in the affairs of the partnership. A general partner's role and is analogous to that of the director or officer of a corporation.

In other respects, a limited partnership resembles a general partnership. For the most part, the rights and liabilities of the general partners in a limited partnership are similar to those of a partner in a general partnership. Additionally, a limited partnership has the same problems of continuity of existence and transferability of interest as a general partnership.

While it is possible for one person to be, at the same time, both a general and a limited partner in the same partnership, such a person will be in the same position as to the general partners except that, in respect to contributions, this partner will be treated the same as the other limited partners.

States have adopted either the original Uniform Limited Partnership Act (ULPA) or the later Revised Uniform Limited Partnership Act (RULPA). Any hotel developer should check his or her state statute to determine which act controls in the state the partnership will be created. The discussion that follows is based on both the original statute and revision.

## [a] Creating a Limited Partnership

There are four factors to note when creating a limited partnership:

1. *Public filing of certificate.* The ULPA requires that a new partnership make a public filing of a certificate of limited partnership that sets forth its name, capital contributions, and profit shares of the partners.
2. *Use of partners' names prohibited.* Limited partnerships are prohibited from using the name of any of the limited partners' names as part of the partnership name. Also, no name that is deceptively similar to that of any other corporation or limited partnership may be used in the name of the partnership. Both the ULPA and RULPA require that the partnership name include the words "limited partnership" in full. In addition there is a convenient procedure to reserve names for future limited partnerships.
3. *Maintaining office and records.* The ULPA requires that the partnership maintain continuously within the state an office at which basic organizational and financial records are kept. This requirement assures certain minimal contacts between the partnership and its state of organization and assures that the limited partners have access to vital partnership information.
4. *Avoiding liability in case of a defect in forming partnership.* Under ULPA, a person who has contributed to a business (an "equity participant") erroneously believing that he has become a limited partner in a limited partnership, is not liable as a general partner, provided that when he realizes his mistake, he promptly renounces his interest in the profits of the business. Un-

der RULPA, if the equity participant wishes to avoid liability as a general partner, he must withdraw from the business and renounce future profits or file an amendment curing the defect. Nevertheless, this equity participant is liable to any third party who has transacted business with the enterprise before the withdrawal or amendment and in good faith, believes that the equity participant was a general partner at the time of the transaction.

### [b] Status of Limited Partners and Extent of Limitation of Liability

The most appealing feature of a limited partnership is the limited personal liability it offers. However, this protection is subject to three conditions:

1. There must be substantial good-faith compliance with the requirement that a certificate of limited partnership be filed.
2. The surname of a limited partner may not appear in the partnership name.
3. The limited partner may not take part in control of the business.

As long as the limited partners abide by these conditions, their liability for any and all obligations of the partnership is limited to their capital contribution.

A general or managing partner of a limited partnership occupies a fiduciary position with respect to his limited partners. The fiduciary duty imposed upon the general partner protects limited partners who are, as a general rule, at the mercy of the general partners' managerial power.

All the limited partners stand on equal footing vis-à-vis each other as to the return of their contributions, their right to income, and any other partnership matter, unless there is an agreement providing for priority as to such items. Such priority provisions must be stated in the partnership certificate.

Generally, a limited partner cannot bind the partnership by his acts, nor is he liable to partnership creditors; however, this does not mean that he is completely free from obligations arising out of the partnership. For example, he is liable to the partnership for the contributions he has agreed to make to the partnership and for any breach of the partnership agreement by him. Also, he may be held liable to the partnership for a sum equal to the amount he has received, plus interest as a return of his capital contributions where necessary to discharge the partner's liabilities to creditors who extended credit to it, or whose claims arose before his contribution was returned to him.

An important question for a limited partner is at what point would he be considered a general partner and thus lose his limited partner status. RULPA imposes general partner's liability only on a limited partner who takes part in control. If the control exercised by a limited partner is substantially the same as the power of a general partner, then he assumes the liability of a general partner to all third parties who conduct business with the partnership. However, if the limited partner's participation in control of the business is not substantially the same as the exercise of the general partners, his liability extends only to those persons who transact business with the limited partnership with actual knowledge of his participation in control. This approach recognizes the difficulty of determining when the control line has been overstepped and reflects the fact that the purpose of imposing general partner's liability is for the protection of creditor's expectations.

In addition, the RULPA enumerates certain activities that a limited partner may carry on without being deemed to have taken part in control of the business:

- Serving as contractor for an agent or employee of the limited partnership or of a general partner.

- Consulting with and advising a general partner with respect to the business of the limited partnership.
- Acting as surety for the limited partnership.
- Approving or disapproving an amendment to the partnership agreement.
- Voting on one or more of the following matters:
  - —The dissolution and winding up of the partnership.
  - —The sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business.
  - —A change in the nature of the business.
  - —The removal of a general partner.

The death or incompetence of a limited partner does not result in the dissolution of the partnership. The personal representative of a deceased limited partner has all his rights for the purpose of settling his estate, including the right to constitute an assignee of the limited partnership interest as a substituted limited partner. The estate also remains liable for the decedent's liabilities as a limited partner.

## [5] Qualifying as a Partnership for Tax Purposes

An entity formed as a general or limited partnership by following appropriate legal procedures does not automatically qualify as a partnership under the Code. Rather, the classification of the entity as a partnership depends on meeting certain regulatory tests that distinguish a partnership from an "association taxable as a corporation." The determination is based on six criteria. Two of them—whether the entity includes "associates" and whether the entity has an objective to carry on a business for profit—are clearly common to both partnerships and associations (i.e., corporations). Thus the essential distinction rests on the remaining four criteria discussed in the following paragraphs.

The tax rules state that to qualify as a conduit for the pass-through of taxable gains and losses to its investors, a limited partnership must not show more than two of the following four corporate characteristics:

1. *Continuity of life.* Because a limited partnership can provide that death, insanity, or retirement of a general partner terminates the partnership, this characteristic is not usually present. The IRS has taken the position that a partnership subject to UPA or similar statute does not possess continuity of life.
2. *Centralized management.* A fundamental characteristic of a limited partnership is that the general partner (or partners) manages the partnership while the majority ownership usually lies in the passive investors who are the limited partners. Thus management is centralized. Consequently, this corporate characteristic is present in a limited partnership.
3. *Limited liability.* For income tax purposes, limited liability is not present and partnership treatment is indicated if the general partner is personally liable for the partnership's non-mortgage debts and also has substantial assets. Thus, neither a dummy corporation nor an individual who is judgment proof can be made a general partner so as to give the appearance, without the reality, of unlimited liability. Since most real estate partnerships are set up with

a general partner having substantial assets, partnership treatment should be indicated.

When a corporation, rather than an individual, is the general partner in a limited partnership, specific requirements have been set forth by the IRS in connection with the limited liability test. The limited partnership will not pass muster unless the following requirements are met:

— *Net worth requirement.* If the total contributions to the partnership are less than $2.5 million, then at all times during the life of the partnership the corporate general partner must have net assets equal to 15 percent of the total contributions or $250,000, whichever is less. If the total contributions are $2.5 million or more, the corporate general partner must have net assets equal to 10 percent of total contributions.

— *Ownership requirements.* The limited partners cannot own, directly or indirectly, more than 20 percent of the stock of the sole corporate general partner. If there are several corporate general partners, the assets of the corporate general partners can be combined for purposes of the net worth requirement. However, the ownership requirement is applied individually to each corporation; the limited partners cannot own more than 20 percent of the stock of any one corporate general partner.

4. *Free transferability of interest.* There is no free transferability of partnership interest, and partnership treatment is indicated if a limited partner needs the general partner's consent to transfer his partnership interest to a substitute limited partner. A provision requiring the general partner's consent is common in real estate limited partnership agreements. Likewise, there is no free transferability of partnership interests if a partner's right to assign his interest is limited to assigning his share in the profits of the enterprise. Free transferability of partnership interests is also lacking where the transfer of a partner's interest results in the dissolution of the partnership and the formation of a new partnership under state law.

There can be a modified form of transferability of interest under which each partner can transfer his interest in the partnership to an outsider only after offering it to the other partners at fair market value. This modified form of transferability is less likely to be viewed as a corporate characteristic than full transferability.

Because most hotel-formed limited partnerships do not show continuity of life, limited liability, and free transferability of partnership interest, partnership treatment—that is, the pass-through directly to the partners of taxable partnership income, gains, and losses—can reasonably be assured.

## [6] Taxation of Partner's Share of Income, Gain, or Loss

The rules for the taxation of partnerships and partners (constituting Subchapter K of the Code) are among the most complex provisions in the entire tax law, and the advice of professional counsel is always beneficial in connection with partnership tax planning or tax reporting.

Each partner must report his distributive share (whether or not actually distributed) of partnership income, gain, or loss on his income tax return. The distributive shares of partnership items are shown on Schedule K and Schedule K-1 of IRS Form 1065.

A partner may deduct his share of partnership losses only to the extent of the adjusted basis of the partnership interest in the partnership. A partner's tax basis generally includes the amount of money the partner contributes to the partnership, the adjusted basis of any property contributed by the partner, and the partner's share of partnership liabilities that is allocated or assumed by the partner.

A partner's ability to deduct a share of partnership losses is further limited to the amount for which the partner is "at risk." A partner is considered at risk with respect to the sum of money and the adjusted basis of property he contributes to the partnership, including amounts contributed from funds borrowed by the partner or the partnership from third parties, but only to the extent to which the partner is personally liable to repay such amounts. In addition, nonrecourse financing (i.e., under which the partner is not personally liable) will be included as an amount at risk in either of the following two cases:

1. When the loan is from a qualified lender (i.e., one engaged in the business of making loans) or any federal, state, or local government or instrumentality, provided that the lender is not the promoter or seller of the property or a party related to either.
2. When a loan is from a qualified lender that has an equity interest in the venture as long as the terms of the financing are commercially reasonable and on substantially the same terms as loans by lenders that do not have an equity interest in the venture. The terms of nonrecourse financing are commercially reasonably if the following apply:
   - The borrower executes a written unconditional promise to pay on demand or on a specified date.
   - The amount to be paid is a fixed sum of money.
   - The interest rate is a reasonable market rate of interest, taking into account the maturity of the debt.

Another significant limitation on the ability of partners to deduct losses are the passive activity loss rules. When the amount at risk is reduced below zero at the end of a taxable year, the partner must recognize income to the extent that his or her at-risk basis is reduced below zero.

## [7] Organization and Syndication Fees

A partnership often incurs significant expenses in connection with its organization or the sale of a partnership interest. Such costs may not be deducted in the year incurred. However, the partnership can elect to amortize certain of these costs over a period of not less than sixty months, beginning with the month the partnership begins business. If the partnership is liquidated before the end of the sixty-month period, any remaining balance can be deducted as a loss. The costs that may be amortized are organization fees but not syndication expenses.

Organization fees are expenses related to the creation of the partnership and that are chargeable to capital accounts. They include legal and accounting fees related to the organization of a partnership, and filing fees. They do not include expenses of acquiring assets for the partnership, or those connected with the admission or removal of partners other than at the time the partnership is first organized, or those connected with any contract relating to the partnership trade or business. Syndication expenses are specifically nondeductible expenses. These are expenses connected with the issuing and marketing of partnership interests, and include the following:

- Brokerage fees
- Registration fees
- Legal fees of the underwriter or placement agent and the issuer
- Accounting fees in connection with the offering material
- Printing costs of the offering material
- Other expenses relating to selling and promotional material

### [8] Disposition of Partnership Interests

The disposition of a partnership interest generally results in capital gain or loss to the partner. The amount of gain or loss generally is the difference between the amount realized by the partner and the adjusted basis of the partner's interest in the partnership. If the partner is relieved of any liabilities of the partnership, the amount of such liabilities is included in determining the amount realized by the partner.

## ¶ 15.05 REGULAR CORPORATIONS

A corporation is a separate legal entity—an artificial person—created in accordance with the laws of a particular state; the federal government does not have the power to create business corporations. A corporation's charter may provide that it will have a perpetual life, and it establishes its operation through a board of directors elected by the shareholders. However, for business and tax purposes, the corporation is an entity entirely distinct from its stockholders. Thus, the major advantage of, and original purpose for, the corporate form was to limit each shareholder's liability to the amount of his capital investment; a secondary purpose was to make shareholder interest freely transferable by means of assignable corporate shares.

The basic legal and economic incidents and consequences of operating under the corporate form of ownership can be summed up as follows:

- *A corporation:*
  - —Can hold and deal in property in its own name.
  - —Can sue and be sued in its own name.
  - —Has only those powers and can engage in only those activities that are within the scope of the powers expressly or impliedly granted to it under its state charter or certificate of incorporation.
  - —Continues to exist until it is dissolved by law, unless a statute limits its duration.
  - —Can raise capital by the sale of new shares, bonds, debentures, or other securities.
  - —Can, apart from its shareholders, seek out sources of credit and borrow funds. Also, in a closely held corporation, the corporate shares can be used as collateral for a corporate loan.
- *Corporate shareholders:*
  - —Are not, merely by reason of being shareholders, personally liable for corporate debts and liabilities; each shareholder has at stake only the amount of his capital contribution.

— Can freely sell or otherwise transfer their shares, in the absence of a provision to the contrary.

— Are not responsible for the management of the corporation or for any venture conducted by the corporation.

- *Corporate Directors:*

  — Are the repository of the central authority of the corporation. The board of directors manages the affairs of the corporation and acts according to the vote of a majority of its members.

  — Must account to and are responsible to their stockholders for their acts, or for conduct that is outside the scope of their charter powers, or that is otherwise improper or unlawful.

- *Corporate officers:*

  — Can exercise only such authority as is delegated to them under the corporate charter or certificate of incorporation.

  — Can bind the corporation by their acts or conduct that is within the scope of their actual or apparent authority.

  — Are answerable to the board of directors and must account to the board for their activities.

## [1] C Corporations

The major disadvantage in using a C corporation to own a hotel development is that the corporation is recognized as an independent entity for tax purposes. Thus, tax losses from corporate-owned real estate cannot be passed through to the individual shareholders, but can be used only by the corporation itself; because it may not have any other income against which the losses may be offset, the losses may be of no use.

On the other hand, if the corporate property produces net income, a problem of double taxation must be faced. The corporation first must pay a corporate income tax on its net income; then, to the extent the income is distributed in the form of dividends, the shareholders must pay a personal income tax on such income. In the case of a closely held corporation (known as a close corporation), the problem of double taxation can often be avoided by distributing corporate income to the shareholders in the form of salaries or other compensation. In this situation, the corporation may deduct the cost of such salaries and thus reduce its own income, although the shareholder-employees will be taxed on the income they receive.

In addition, a corporation can accumulate income (up to a point) that can ultimately be passed through to shareholders as capital gain when the shareholders sell their shares at prices that reflect the earnings that have been accumulated. Important tax factors to consider in choosing the C corporate form of ownership include:

- Principals, as officer-stockholders or as employee-stockholders, can have a tax-favored retirement or pension plan set up for them.
- Principals can be paid a salary that the corporation can deduct as an ordinary business expense.
- The compensation paid to a principal as a corporate officer or employee is subject to withholding and social security taxes.
- While a shareholder can assign his shares as he sees fit in the absence of restrictions imposed by agreement, corporate charter, or otherwise, he cannot assign earnings separate from the shares.

- Corporate income is taxable to the corporation and not to the shareholders until it is distributed to them in the form of dividends.
- A corporation is subject to various sate and local taxes, which are deductible on its federal income tax return.
- Death benefits of up to $5,000 can be received tax-free by a stockholder-employee's beneficiaries.
- Income accumulated in the corporation is not taxable to the shareholders, but there is a penalty tax if the purpose of the accumulation is to avoid the corporate surtax and the accumulation is greater than is permissible.
- A corporation may be able to use a loss generated by a hotel investment to offset income from its other properties, or it can carry over the loss to offset future income.
- Low-bracket taxpayers can manage the hotel and be paid salaries by the corporation for their services. The salaries can account for a substantial portion of the corporate income and thus reduce the corporate tax burden. The salaries would be taxed at ordinary income rates, but only at the taxpayers' low tax brackets. The corporation would be entitled to deduct the amounts it paid as salaries from its gross income, provided the salaries are reasonable and are paid for actual services rendered to the corporation.

## [2] S Corporations

The corporate form of ownership has many limitations as far as its use in hotel development. Since hotels are capital-intensive projects that generate substantially early deductions for depreciation and debt service, the hotels usually show losses for many years. Corporate ownership of real estate prevents those losses from being passed through to the individual shareholders. In addition, if the corporation begins to generate income sufficient for distribution, then the hotel earnings are taxed twice, once at the corporate level and again when distributed as a dividend.

However, for many closely held corporations, the Internal Revenue Code provides for loss and income passthrough similar to a partnership, if the owners have elected the S corporation. As will be demonstrated subsequently, the S corporation is ideal for the hotel development when either the investors contribute proportionally, or are family members using the S corporation as a means of splitting income among family members.

S corporations are organized for the purpose of insulating their shareholders from personal liability for corporate obligations, and for making the transfer of ownership of stock certificates a simple matter. At the same time, they are not independent tax entities and, just as a partnership, are able to pass through to shareholders the profits and losses from operations.

### [a] Eligibility Requirements

The following are five requirements for S corporation status:

1. *Domestic corporation.* This category includes any incorporated organization taxed as a corporation.
2. *Number of shareholders.* The maximum number of shareholders is thirty-five, but spouses holding shares are treated as one shareholder. Shareholders must be individuals, estates, or grantor trusts; they cannot be nonresident

aliens or foreign trust. Shares cannot be held in a custodial account for a minor.

3. *Shares.* An S corporation must have only one class of outstanding stock, and all outstanding shares must carry identical rights to share in corporate profits and assets. Differences in voting rights in common stock, however, are permissible. In addition, a debt instrument may not be reclassified by the IRS as stock, so as to constitute a disqualifying second class of stock, if it complies with the safe-harbor rules for debt instruments provided by the Subchapter S Revision Act of 1982.
4. *Affiliation.* A member of an affiliated group of corporations cannot be an S Corporation.
5. *Companies eligible for special tax treatment.* Banks, financial institutions, and insurance companies cannot elect S corporations status even if they can meet the eligibility requirements of the act.

### [b] Election and Termination of Status

An S Corporation election made on or before the fifteenth day of the third month of a corporation's taxable year is effective beginning with the year made if all eligibility requirements are met during the preelection period, and all persons who held stock during that period consent to the election. The reason for requiring such unanimous consent is to prevent the allocation of income or loss to preelection stockholders who are either ineligible or do not consent to such allocation. If the eligibility requirements were not met during the preelection period or if the election is made late, it does not become effective until the following taxable year.

The following events will cause the S corporation status to be terminated effective on the date on which the event occurred:

- Exceeding the maximum number of shareholders
- Transfer of stock to an ineligible shareholder
- Creation of a second class of stock
- Acquisition of a subsidiary

In addition, an S corporation can be voluntarily revoked by its shareholders. If holders of more than 50 percent of the voting stock agree, the corporation may voluntarily revoke the S corporation status of the corporation. A revocation, filed up to and including the fifteenth day of the third month of a taxable year is effective for the entire taxable year unless a prospective date is specified. A new shareholder cannot terminate an election by refusing to consent to the election, unless he owns more than 50 percent of the voting stock.

### [c] Comparison With Limited Partnerships

Many people assume that the limited partnership and S corporation are the same, but there are some major differences that usually make the limited partnership the preferred form of hotel ownership. Some of the more important differences are listed as follows:

- *Allocation of income and losses.* Both the S corporation and the limited partnership are conduits for tax purposes. However, the limited partnership has a greater flexibility in allocating income and losses to its partners than S corporations. A limited partnership can allocate income and losses to the partners providing economic substance to the transaction. For example, a partner contributing property to the partnership may receive the depreciation expense, whereas the S corporation must allocate income and losses to each shareholder in direct proportion to their percentage of stock ownership.

- *Unlimited members.* A limited partnership has no specified limit on the number of partners, while the S corporation is limited by law to thirty-five shareholders.
- *Tax basis.* A major distinction between an S corporation and a partnership involves the tax basis for the investment. In a partnership, each partner receives a tax basis in his partnership interest equal to his capital contribution plus his share of partnership debt. Even limited partners share in partnership nonrecourse debt (but they may share in recourse debt only to the extent of any unpaid capital contributions). By comparison, S corporation shareholders receive only basis for their capital contributions plus their loans to the corporation.

  Basis is important because losses may be taken by the individual investors only to the extent of their basis (assuming other hurdles, such as allocations, at-risk, and passive loss limitations, are overcome). In addition, excess financing and refinancing proceeds can be distributed tax free only to the extent of basis.
- *Tax status.* The Subchapter S Revision Act of 1982 simplified the rules affecting S corporations, making it far less likely that an S corporation's status as such will be challenged by the IRS. Partnerships are subject to a somewhat greater risk of challenge. In either case, a successful challenge by the IRS would bar the pass-through of taxable losses to investors, because the corporation or partnership would be considered a C corporation and taxable as such.

## ¶ 15.06 LIMITED LIABILITY COMPANIES

The Limited Liability Company (LLC) is a fairly recent entity development that has been adopted in many states. The LLC can limit liability more effectively than a limited partnership and is less restrictive than an S corporation; for certain hotel developments, it may become the preferred form of ownership.

An LLC is an entity formed under state law to conduct a business or investment activity. It is created by filing articles of organization with the appropriate state agency in a manner similar to that required for corporations. Its bylaws are called regulations and its participants are called members. The three major advantages of an LLC are as follows:

1. *No double taxation.* When properly structured, an LLC is treated for federal income tax purposes as a partnership; therefore, no tax is payable at the partnership level but only by the individual partners.
2. *Flexible ownership.* Like a partnership, the LLC permits its members significant freedom in making disproportionate allocations of income, gain, loss, and cash flow. A major advantage of the LLC over an S corporation is that no limitations are imposed on the types and numbers of owners. For example, corporations and partnerships may be members of an LLC, but are ineligible to the shareholders of an S corporation. More than thirty-five individuals and/or entities may be members of an LLC, whereas S corporation shareholders are limited to that number. (However, an LLC must have more than one member as compared with an S corporation, which can have a single shareholder).

3. *Limited liability.* As its name indicates, an LLC puts only the assets of the company at risk. In comparison with a partnership, in which the general partner or partners must accept personal liability, all members of an LLC are protected against personal liability. Furthermore, any member of an LLC can be active in the management of the business while still retaining limited liability; in a limited partnership, the limited partners must be careful not to step over the line between passive investment and active management.

The four significant disadvantages of an LLC are as follows:

1. *State taxation.* Although an LLC is generally exempt from federal income tax, state tax rules may differ. For example, in Florida (which does not have an individual income tax), LLCs are treated as corporations subject to the Florida corporate income tax rate. At the same time, partnerships and S corporations are exempt from Florida income taxation. In addition, a state may seek to apply its franchise tax, which does not normally apply to a partnership, to an LLC.
2. *No perpetual life.* As in the case of a partnership, the LLC cannot have a perpetual life. For example, in several states, an LLC dissolves upon the earlier of the following:
   —Expiration of its state term
   —Agreement of all members to terminate
   —Death, retirement, insanity, bankruptcy, or expulsion of a member (unless all remaining members consent to continue the business pursuant to rights stated in the organizing articles).
3. *Limits on transferability.* The LLC (like a partnership) lacks the easy transferability of corporate share. Recipients of membership interests in an LLC often do not have full rights of ownership or management participation unless consent to the transfer is received from all members, thus restricting free transferability.
4. *Lack of legal precedent.* Finally, the short existence of the LLC as an entity means very few court decisions have been rendered. Thus, a good deal of uncertainty exists as to the legal status of the LLC and its members. Furthermore, it is not all clear as to the status of LLC members in states not having LLC statutes. For example, would a member of an Florida LLC be protected from personal liability for LLC obligations incurred while the LLC was operating in a state without an LLC statute? Additionally, the application of the partnership's tax concepts to an LLC may become complex. For example, allocating liabilities to determine tax basis and amounts at risk may produce unexpected results.

## ¶ 15.07 TRUSTS

Trusts are the least frequently used form of ownership entity for hotels. A trust is a legal relationship in which a trustee holds legal title to property (the hotel property or otherwise) with the responsibility of administering it and distributing the income for a beneficiary who is deemed to be the holder of the equitable title.

Three kinds of trusts can be distinguished. The first is a real estate investment trust (REIT), which is a creation of the federal tax laws. This form of business entity will be discussed in more detail in the following section.

Personal trusts are those set up for the benefit of members of a family, particularly the spouse or children of the grantor of the trust. They can be an effective means of shifting the tax burdens of property to persons in lower tax brackets, while at the same time reserving essential control of the property to the grantor or his associates. However, the Tax Reform Act of 1986 (TRA) limits the tax benefits formerly available from trust. Because the subject of trust and estate taxation is highly specialized, and because such taxation is applicable to all forms of property, not merely hotel development, a discussion of trust and estate taxation is not included here.

The third type of trust, the business trust (also known as the Illinois Land Trust, because it originated there), has a long history as a real estate–owning entity. However, its use today is limited to five states besides Illinois: Florida, Virginia, North Dakota, Hawaii, and Indiana. The land trust is a device by which a hotel or other real estate is conveyed to a trustee under an arrangement reserving to the beneficiaries of the trust the full management and control of the property. The trustee executes deeds and mortgages or otherwise deals with the property at the written direction of the beneficiaries, who exercise all rights of ownership, other than holding or dealing with the legal title.

The benefits of a land trust include the following five points:

1. *Secret ownership.* In states that recognize the use of a land trust, the identity of the beneficiaries is not contained in any public record. Only the name of the trustee, the date of the trust agreement, and the number of the trust is disclosed in the deed in trust. By comparison, all other states require that the name of an owner of real property, be it an individual, corporation, or other legal entity, be shown on the deed and be available for public inspection in the appropriate records office.
2. *Transfer tax avoidance.* In those states that recognize the land trust, the use of the entity may permit the avoidance of payment of a real estate transfer tax, since the real estate in the trust is not transferred as such; instead, the beneficial interest in the trust is assigned or sold, and these are designated as personal property.
3. *Insulation from judgment liens.* In Illinois, and possibly in other states that recognize the land trust, a judgment against a beneficiary does not create a lien against the title of the real estate held in the trust. The trust property, in effect, is insulated from the legal process (although the judgment creditor may be able to claim against the beneficial interest).
4. *Ease of transfer.* Because the beneficial interest in the land trust is treated as personal property, it may be transferred from one party to another by means of an assignment rather than by the more cumbersome process involved in transferring real estate, which involves examination of title, agreement as to covenants and warranties by the seller, and so forth.
5. *Not subject to partition.* Unlike other forms of concurrent ownership (i.e., tenancy in common and joint tenancy), land held in trust is not subject to the remedy known as partition, by which one co-owner may seek to have the property sold and receive his share of the proceeds. Usually, the withdrawal of a beneficiary from a land trust is a matter of voluntary agreement among all the beneficiaries.

## ¶ 15.08 REAL ESTATE INVESTMENT TRUST

Real Estate Investment Trusts (REITs) have been around since 1960, when they were made part of the Internal Revenue Code. A REIT is strictly a creation of the federal tax laws. It must have at least 100 shareholders to qualify for special tax treatment, and more commonly is in the form of a corporation, rather than a trust. A qualified REIT is entitled to conduit tax treatment (i.e., it may distribute income to its shareholders without the imposition of a corporate tax, thus avoiding the "double tax" burden on regular business corporations). The congressional purpose for creation of REITs was to make real estate investments more accessible to the general investing public; at the same time, REITs enabled real estate developers and owners of large real estate portfolios to tap the general capital markets for financing.

As Exhibit 15-1 indicates, REITs have shown a high rate of return in recent years. It will be interesting to see if they are able to maintain that high level of return.

**Exhibit 15-1 Total REIT Returns (1990–1997)**

*Source: NAREIT. (NAREIT reported a total return of 30.09% for lodging REITs in 1997.*

| Year | All | Equity |
|---|---|---|
| 1990 | (17.35)% | (15.35)% |
| 1991 | 35.68 | 35.70 |
| 1992 | 12.18 | 14.59 |
| 1993 | 18.55 | 19.65 |
| 1994 | 0.81 | 3.17 |
| 1995 | 18.31 | 15.27 |
| 1996 | 35.75 | 35.27 |
| 1997 | 18.86 | 20.26 |

## [1] Organizational Requirements

A REIT must be a corporation, trust, or association managed by one or more trustees or directors. Many REITs have chosen the corporate form over the business trust form, because it is simpler in terms of state law considerations.

The REIT must have beneficial interest represented by transferable shares or certificates of beneficial interest. There may be two classes of stock or shares (e.g., a second class with a preference as to dividends and liquidation). A REIT must be beneficially owned by at least 100 persons for at least 335 days of a tax year of 12 months, or a proportionate part of a short year. The attribution rules under the Code are not applied in making the determination; consequently, the number of shareholders, not the relationship among them, is the only determinant of whether the test is made.

The tax year must be the same as the calendar year.

At no time during the last half of the REIT's tax year can more than 50 percent of the value of a REIT's outstanding stock be owned by five or fewer individuals. Certain attribution rules are applied in this determination.

A REIT can be self-managed or can operate through an external adviser. A self-managed REIT operates in much the same manner as a corporation, with a board of directors (or trustees), officers, and employees. A REIT may also contract for an external entity to manage its operations and investments. Both types of management forms are widely used—the objective of the REIT determines which form is more desirable. A self-managed REIT is more logical for an active organization needing full-time operators, while an externally advised REIT is probably more useful in instances in which the REIT is one element of a larger organization.

## [2] Income Requirements

REITs are required to receive 95 percent of their gross income from the following sources: dividends; interest; rents from real property; gains from the sale or disposition of stock, securities, and real estate; abatement and refunds of real property taxes; income from foreclosure property; commitment fees; and gains from the sale of real estate assets that are not prohibited transactions (i.e., assets that were held primarily for sale, with the exception of foreclosure property).

Of the foregoing, 75 percent of the gross income of the REIT must be derived from the following income sources: rents from real property; abatements and refunds of real property taxes; foreclosure sales; commitment fees; gains from the sales of real estate assets; interest on obligations secured by mortgages on real property or interests in real property; gains from the sale of real property not held primarily for sale to customers; dividends or other distributions and gain from the sale of shares in other REITs.

Income derived from rents contain a number of restrictions, the most important of which is that any amount received with respect to property is not rent if the REIT furnishes services to the tenant or manages or operates the property without an independent contractor. The independent contractor may be affiliated with the adviser to the REIT; however, the independent contractor cannot hold more than 35 percent of the shares or beneficial interest in the REIT. In addition, the REIT is not to receive any income from the independent contractor.

Less than 30 percent of the REIT's gross income can be derived from the sale or other distribution of the following: stock or securities held for less than six months; sales or dealer property; and real property (including interests in real property and interests in mortgages on real property) held less than four years, other than foreclosure property or involuntarily converted property.

## [3] Asset Requirements

At least 75 percent of the value of the REIT's total assets must consist of real estate assets, including land, interests in real property mortgages, shares in other REITs, and partnership interests to the extent of the interest's proportionate share of partnership real estate assets; cash; cash items (including receivables); and government securities. Mortgage-backed securities qualify as real estate investments.

No more than 25 percent of the value of the REIT's total assets can be securities (other than those included in the 75 percent asset test above). The securities of any one issuer cannot be more than 5 percent of the REIT's total assets, and the REIT's interest in an issuer's stock cannot be more than 10 percent of the outstanding voting securities of the issuer.

## [4] Dividend Distributions and Taxation

To avoid paying taxes at the corporate level, the REIT must distribute to the shareholders dividends in the amount of 95 percent of its taxable income, less net long-term capital gains, any net income from foreclosures, and certain other items. If the REIT does not distribute at least 95 percent of its taxable income during each taxable year, it is subject to a 3% excise tax on the amount of the underdistribution.

There is generally no tax liability for a REIT, because its income is taxed only at the shareholder level. The REIT is not a true pass-through entity like a partnership, but it is still effectively not subject to taxation because it is eligible for a deduction for dividends distributed and must distribute nearly all of its taxable income as dividends. As a result, the typical REIT has an insignificant amount of taxable income, taxed at the corporate level.

Dividends received by the shareholders are ordinary income to the extent of the REIT's earnings and profits. The earnings and profits of a REIT are computed using a forty-year straight-line depreciation. Distribution of greater than 100 percent of earnings and profits, however, are treated by the shareholder as return of capital.

The sale of a shareholder's interest in a REIT is taxed in the same manner as the disposition of stock. The return of capital, as opposed to payment of dividends, reduces the shareholder's basis.

## [5] Types of REITs by Asset Holdings

In terms of the type of assets held, REITs are of three types: equity REITs, mortgage REITs, and hybrid REITs.

### [a] Equity REITs

An equity REIT is one that owns real estate directly. The purpose of an equity REIT is primarily to generate rental income that will be passed through to shareholders. The vast majority of REITs are considered equity REITs.

Some equity REITs invest in a diversified portfolio of income-producing real estate, while others specialize in a single category of property (e.g., hotels). Similarly, some REITs concentrate their investments in one geographic area of the country while others buy properties in various locations.

### [b] Mortgage REITs

Mortgage REITs are lenders involved in financing real estate rather than owning it. Only a small percentage of REITs engage in this form of lending activity. However, because traditional lenders to the hotel industry have reduced their lending activities, mortgage REITs could play an important role in the future.

Mortgage REITs have one major advantage over traditional lenders in that REITs are subject to virtually no regulation as to the type of mortgages that they can make. Thus, a mortgage REIT can make loans in the form of participating mortgages that not only provide the REIT with a fixed return on invested capital, but also offer the prospect of a share in future growth or a share in the proceeds from any subsequent sale or refinancing of the property. REITs also are in a position to make the various forms of subordinate loans, including second mortgages, wraparound loans, and various forms of refinancing. They can also be a source for gap or bridge loans and other forms of interim financing for borrowers unable to find other lenders, particularly when interest rates are high.

Some mortgage REITs have engaged in land purchase–leaseback arrangements, whereby the REIT purchases the land on which income-producing property has been constructed. The REIT then leases the land for a long term (up to ninety-nine years). With various equity features built into the purchase-leaseback, the REIT can return in the form of ground rent. Finally, REITs still are involved to some degree in short-term construction and development lending.

### [c] Hybrid REITs

As its name implies, a hybrid REIT combines the features of both an equity and a mortgage REIT. The hybrid attempts to structure a mixed portfolio that includes ownership interest in income-producing property, financing of property through mortgage loans, and holdings of short-term government securities and mortgage pass-through securities. The object is to create a balanced portfolio that provides a fixed income return to investors as well as the prospect of future growth in income.

## [6] Structuring a Hotel REIT

A number of hotel chains are currently weighing the advantages of going public, possibly as REITs. The major benefit would be the ability to raise large amounts of equity capital to finance ongoing renovations and new development while avoiding the burden of high debt-service costs. The incentive for public investors would be the opportunity to participate in the enormous growth in travel that is anticipated by the end of the century.

It is true that hotel chains in the past often did not meet standard investment criteria for publicly traded companies. The returns from hotels, as already noted, often come as much from appreciation in value and tax benefits as from operating earnings. Ratios used to measure performance of public companies, however, focus almost exclusively on earnings (in the form of such ratios as price/earnings, return on equity, and return on assets). These and similar factors ignore the appreciation element and the prospects of tax-free distributions resulting from debt refinancing. Finally, earnings of many hotel chains often are extremely volatile because of their highly leveraged position and high level of fixed costs.

If hotel chains can raise equity capital via REITs or other public structures, earnings volatility would be substantially lessened. At the same time, hotel earnings could stabilize at relatively high levels if the trend to increasing travel materializes. The result could well be transformation of a hotel investment from one fraught with risk for the investor to one that compares favorably with other forms of real estate investment.

Hotel REITs are unique because hotel profits are considered "unqualified" income, i.e., not the type of passive income that a REIT is permitted to earn. Thus, instead of a REIT operating its hotels, that REIT must enter into participating leases with an outside entity. To comply with REIT tax rules, the participating lease payments made by the lessee to the REIT must be based on gross revenues (rather than net cash flow).

The debate concerning this structure is whether the lessee should be an independent third party having no interest in the REIT or an entity affiliated with the REIT sponsor. Each structure has its advantages and disadvantages.

The primary appeal of an independent lessee is that the lease terms are negotiated at arm's length and thus gives greater assurance that the lessee's profits are not excessive. The practical problem with this approach is that few, if any, creditworthy lesses are available. Furthermore, even an independent lessee would want a substantial share of the operating profits in light of the risks involved; this would require the REIT to give up a substantial portion of the upside potential. The net result is that the REIT would, in effect, hold a net lease with limited upside potential.

Historically, hotel management companies receive a fee (e.g., 3 to 4 percent) of gross revenues rather than of net cash flow. One cause of the hotel problems of the late 1980s was that third-party lessees were motivated to increase gross revenues without regard to bottom-line performance. The result was that their fees increased while the owners' return declined. For this reason, many investors now favor a lessee affiliated with the owner.

Leasing to an affiliated party has a reverse set of advantages and disadvantages. If the REIT sponsor is also the lessee, questions of fairness can arise from negotiations not made at arm's length. On the other hand, an affiliated lessee offers two advantages to the REIT. First, if the lessee has a substantial investment in the REIT itself (which usually should be the case), it not only has a fiduciary duty to the REIT but also is likely to earn more through REIT dividends than through a management fee. Second, an affiliated lessee is much more likely to accept a rent structure that mirrors the operating performance of the underlying hotel properties, passing as much upside (or downside) as possible to the REIT.

Possibly the best approach is to combine an affiliated lessee with various credit-enhancing structures that reduce the risks of conflicts of interest. For example, the lessee may be required to maintain a substantial reserve to guaranty lease payments before any profits can be retained by the lessee.

CHAPTER 16

# Capital Sources and Financing



## ¶ 16.01 INTRODUCTION

The hotel industry has recovered almost completely from the time in the early 1990s when obtaining any type of financing was difficult. With the renewed success of the hotel industry, lenders are more willing to loan to valid hotel projects. This chapter explores the various financing techniques and sources of capital commonly used in the hotel industry. In addition, this chapter discusses the mortgage loan process and what the hotel developer should consider when obtaining a mortgage.

Exhibit 16-1 indicates the breakdown between various financial institutions that lend to the hotel industry.

**Exhibit 16-1 Who Provides Hotel Financing**

*Source: PKF Consulting. Hospitality Investment Survey (1996)*
**Other sources included investment banks, SBA loans, mortgage funds, conduits, and private equity.*

| Source | Percentage |
|---|---|
| Bank | 58% |
| Other Source* | 36.0 |
| Seller | 24.0 |
| Insurance Company | 24.0 |
| Pension Fund | 18.9 |
| Savings & Loan | 3.4 |

This chapter divides equity and debt sources into the following two categories:

1. Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:
   —Commercial banks;
   —Life insurance companies;
   —Private credit companies; and
   —Pension funds.
2. Investment conduits, which are primarily entities that invest in hotel real estate mortgages and passthrough income and gain to investors (both private individuals and institutions), including:
   —Real estate limited partnerships (RELPs);
   —Real estate investment trusts (REITs); and
   —Commercial mortgage-backed securities (CMBS).
3. Mortgage financing, which is how most hotels are financed. Topics covered include:
   —Types of mortgage loans; and
   —Obtaining a hotel mortgage.

## ¶ 16.02 COMMERCIAL BANKS

Commercial banks have historically played the most significant role in providing financing for the hotel industry. However, they have been hurt by the real estate collapse of hotels during the early 1990s. Commercial banks sold off distressed and foreclosed loans and limited new lending to only the most healthy of hotel developers.

A significant new restraint on future hotel lending by commercial banks and by savings institutions is the Uniform Rule on Real Estate Lending established by the four banking agencies (the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision). The Uniform Rule, issued on December 31, 1992, requires every lender to adopt a written policy establishing appropriate limits and standards for granting real estate loans. Such loans are those secured by mortgages, as well as loans made for financing permanent improvements, whether secured or not.

As a supplement to the Uniform Rule, the agencies simultaneously promulgated a set of guidelines that establish the specific factors banks are expected to consider in establishing real estate (including hotel development) lending policies. Although the guidelines are not mandatory, a lender failing to comply with them invites extra scrutiny from regulators.

A crucial component of the guidelines is the loan-to-value (LTV) limits on real estate loans. The LTV ratio is based not only on the value of the property securing the loan but on the value of any acceptable collateral in addition to the real estate. The guidelines set supervisory LTV limits for various categories of loans as follows:

- For raw land, 65 percent
- For land development loans, 75 percent
- For commercial construction loans, 80 percent
- For improved property, 85 percent

The mere fact that a loan is made within the supervisory LTV limits does not mean it will automatically be deemed sound by a bank examiner. The lending institution must evaluate other credit factors as well, including:

- The capacity of the borrower or the sufficiency of income from the property to service the debt;
- The overall creditworthiness of the borrower;
- The amount of equity invested by the borrower; and
- Any forms of credit enhancement, including guaranties, mortgages, insurance, and additional collateral.

The guidelines also recognize that "exception loans" (those exceeding the supervisory LTV limits) may be appropriate if the credit factors justify the loan. Banks must identify these loans in their records and report all significant exception loans quarterly to their board of directors. As an upper limit, the aggregate amount of all exception loans for commercial loans, agricultural, multifamily, or other residential property (other than one- to four-family homes) may not exceed 30 percent of a bank's total capital.

Several types of loans are excluded from the supervisory LTV limits. These include:

1. Loans renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs) or in connection with a workout, with or without the advancement of new funds, if the restructuring is consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery of the loan;
2. Loans that facilitate the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith;
3. Loans to be sold promptly after origination, without recourse, to a financially responsible third party; and
4. Loans guaranteed or insured by federal, state, or local governments and a wide range of traditional corporate and business loans not considered true real estate lending, even though such loans might involve real estate collateral or improvements.

## ¶ 16.03 LIFE INSURANCE COMPANIES

Life insurance companies have played an important and varied role in hotel development, from providing direct loans for development to participating as equity partners in the ownership of the hotels. Life insurance companies are among the largest financial institutions in the world. Their primary function is to provide financial security to policyholders through life insurance. The premiums collected by the companies are used largely to maintain reserves from which benefits are paid; these reserves constitute enormous capital pools that must be invested for long periods. Because the inflow of funds from premium payments can be predicted with great accuracy, and because fund outflows (upon the death of individual policyholders) can also be estimated with great accuracy, insurance companies are in a position to commit several years in advance to providing loan funds to borrowers and to make long-term commitments of capital.

Because an insurance company's obligations usually are measured in fixed dollars (e.g., the face amount of a life insurance policy), in theory it need not be overly concerned with the depreciation of the dollar through inflation. As a result, insurance companies always have been a major source of fixed-interest mortgages for hotel developers. However, during the period of high inflation that began during the Vietnam War and lasted throughout the 1980s, insurance companies found it necessary to offer a variety of indexed or variable insurance and annuity plans that gave insured persons some hope of hedging against the continued erosion of the dollar. Thus, insurance companies themselves were forced to seek an inflation hedge, resorting to financing techniques such as variable interest rates, equity participation, and other formulas.

Because of their volume of lending and the fact that they are subject to much less regulation than commercial bands and savings institutions, insurance companies have been responsible for many of the creative financing techniques that have surfaced during the past quarter century. Indeed, some insurance companies in the 1980s became virtual partners with developers or property owners by entering into joint ventures and participating loan arrangements that enabled the insurance company to share in any future growth of the property. This trend has all but disappeared following the real estate crash that began in the hotel business in 1987.

Insurance companies are still a significant financing source for the hotel industry. However, they have been reluctant to originate new mortgage money for hotels because of the serious overbuilding that occurred in the early 1990s. With occupancy rates increasing in both 1995 and 1996, it remains to be seen whether insurance companies will once again take the lead in financing of hotel projects.

Insurance companies along with commercial banks are turning with increasing frequency to the purchase of real estate securities rather than whole mortgages.

## ¶ 16.04 PRIVATE CREDIT COMPANIES

In the early 1990s, when the traditional financing sources—commercial banks, savings institutions, and insurance companies—were unwilling or unable to provide real estate capital, private credit companies sought to expand their normally small share of the market. Credit companies, often called "lenders of last resort" because of their typically high interest rates and arduous terms, are usually real estate subsidiaries of large industrial companies. They generally peg their lending rates as a float over prime or at a comparable spread. Although credit from these lenders is generally expensive, they have become especially useful in providing the funds needed to acquire underutilized hotel property with appreciation potential.

At the height of real estate financing in the late 1980s, twenty-one major credit companies offered funding programs. The most prominent companies included European, Japanese, and American corporate loan subsidiaries. By the mid-1990s, the picture was quite different. Only a few major credit companies remained active; although they had an abundant supply of funds, they were highly selective. Nevertheless, they were prepared to extend their lending capabilities to a wide range of underwriting alternatives, as is discussed subsequently.

1. *Permanent loans.* Credit companies invade life insurance company and pension fund territory by structuring fixed-rate permanent mortgages, junior debt, and participating debt/equity deals. Unlike other permanent lending sources that loan for ten years or more, credit companies typically structure loans on a shorter term of three to seven years. Credit companies match their yields to their own commercial paper offerings, which are short-term obligations.
2. *Construction loans.* Credit companies are formidable competitors for the banking industry. Although both credit companies and banks use short-term capital that is suitable for funding construction and variable rate loans, credit companies are not governed by federal, state, and local banking regulations. Credit companies are more flexible while having the same financial understanding as banks because of their asset-based lending experience, including corporate lending and paper financing.
3. *Other types of financing.* Although credit companies are known for funding highly aggressive risk-oriented projects, the real estate credit crunch created excellent opportunities for them in conservatively underwritten real estate transactions. For example, credit companies frequently charge rates of as much as 1 and 2 percent of the total transaction amount per year for funding a standby commitment.

Credit companies also fund standby transactions with the expectation of taking a short-term ownership position in the property until the project has an opportunity to stabilize cash flow in a tough market condition. Of course, under all such conditions, credit company pricing reflects risk and reward return.

The credit company's biggest funding advantage over its competitors is its ability to provide commitments for financing on projects before or during cash flow stabilization. Although such lending underwriting involves higher risk, credit companies use a variety of deal structures that enhance the quality and reduce the risk of the total financing package.

Credit companies have been highly selected in financing hotel projects. They often demand that the investment returns exceed 20 percent. Hotels require significantly higher debt coverage ratios, often one-and-one half times the debt-service payment. Although they are rare, LTV ratios of as high as 85 percent are available. The higher-risk hotel deals require the borrower to give the lender a significant equity position (often as much as 50 percent or more).

Credit companies are a creative and active force in the real estate market. They have a direct link to the capital markets by their ability to raise capital through selling and guaranteeing commercial paper. As a result, credit companies may capture a larger market share from traditional lending sources in the future years.

## ¶ 16.05 PENSION FUNDS

Pension funds are tax-exempt capital funds held by corporations or labor unions (private pension funds) or state and local governments (public pension funds). Their purpose is to pay retirement benefits to employees or union members. They represent the fastest growing pool of capital in the United States, and they undoubtedly will play a major role in hotel real estate financing in the future.

Only a small percentage of pension fund assets are invested in real estate mortgages or real estate equity. The percentage seems certain to rise, possibly to as much as 10 percent of total assets. The asset and liability structure of pension funds is somewhat similar than that of life insurance companies in that the inflow of funds is continuous and stable and payment obligations are actuarially determinable (i.e., accurate predictions can be made of the payments that must be made in future years). Consequently, pension funds would seem to be a logical source of long-term real estate loans.

However, just when pension funds started to invest significantly in the real estate market, the market crashed in the period between 1987 and 1993. Many pension funds had invested in real estate funds as part of their investment strategy. These funds for the most part were closed-end funds, from which capital could be withdrawn only in limited amounts and at specified times. When real estate values began to decline sharply, the funds had to wait for a considerable period to close their accounts, at which point they suffered significant losses. As a result of these experiences, pension funds are now turning more and more to direct investment in mortgages and real estate equities. The trend to mortgage securitization offers pension funds an easy way to invest in commercial mortgages, while the resurgence of REITSs and the easing of tax limitations on pension fund investment in REITs are making the REITs an ideal intermediary for equity investment.

## ¶ 16.06 REAL ESTATE LIMITED PARTNERSHIPS (SYNDICATION)

The limited partnership as a form of ownership of real estate is discussed in Chapter 15. In this chapter, the RELP is viewed as a source of real estate capital because of its primary role in the process known as syndication. In its broadest sense, a syndicate is a group of investors who pool their capital for investment in real estate. A syndicate may be any form of business entity, but by far the most popular format has been the limited partnership, because it represents the best combination of tax benefits and business efficiency.

Real estate syndicates experienced a sustained boom in the years prior to enactment of the the Tax Reform Act of 1986 (TRA 1986). However, the TRA 1986, whose fundamental thrust was to minimize the role of taxes in investment decision making, had a major impact on hotel real estate syndication. The use of a RELP to pass losses directly through to investors was reduced almost to the vanishing point by the limitations placed by TRA 1986 on the deductibility of passive losses and the extended recovery (depreciation) period for real estate. The result has been that tax shelter–oriented real estate syndications have essentially been eliminated since passage of TRA 1986. Real estate syndication will remain an important part of the investment scene, but primarily in private rather than in public markets.

### [1] Basic Syndication Structures

In a typical real estate syndicate, the investors constitute a single class, with each receiving a pro rata ownership interest in the syndicate for a one-time investment in cash. New investors are not admitted once the syndicate has been formed, and no provision is made for redeeming syndicate interest during the life of the syndicate.

This basic pattern is subject to a number of variations. Perhaps the most common is to create a multiclass syndicate in order to broaden the market for syndicate shares. A multiclass syndication has more than one class of investors, with each class entitled to different investment returns. The idea is to offer investors a range of choices, similar to the choices available to purchasers of securities, who may choose, for example, between bonds, common stock, and preferred stock.

At least three different approaches to the multiclass syndicate can be distinguished: (1) different classes of interest within the same syndicate; (2) land/building split; and (3) equity/loan split.

### [2] Specified-Property or Blind-Pool Syndicates

In a specified-property syndicate, the particular property or properties to be acquired is identified in the offering statement and can be evaluated by the investor before he puts up his money. A blind-pool syndicate raises its capital before it has acquired any or less than all of the properties it will eventually own. A single-property syndicate almost always specifies the property to be acquired, although this is not necessarily the case. On the other hand, a multiple-property syndicate may or may not be a blind-pool syndicate, although it usually is.

### [3] Master Limited Partnerships

Master limited partnerships (MLPs) are large limited partnerships whose interests are publicly traded, either on a stock exchange or in the over-the-counter market. They are designed to combine the investment advantages of partnerships with the liquidity of corporate stock. The high liquidity of MLP units is achieved through the issuance of depository receipts that can be traded freely.

In most cases, a real estate MLP uses a two-tier arrangement in order to simplify ownership of the underlying real estate assets. The MLP (the investment vehicle) has outside investors as its limited partners and the sponsor as its general partner. The MLP itself becomes a limited partner in a second (operating) partnership that owns the real estate and for which the sponsor also acts as general partner. The TRA 1986 sharply reduced the attractiveness of MLPs for real estate by limiting the use of tax losses from properties to shelter income from active sources. As a result, the MLP has been largely replaced by the real estate investment trust (see ¶ 16.07). However, some MLPs continue to be traded in the public securities markets, and it is possible that they may come back into favor once again.

## ¶ 16.07 REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REITs) as a form of real estate business structure are discussed in Chapter 15. In this chapter the emphasis is on REITs as a source of capital. REITs are playing an important role in the development of hotel property, especially since 1990. The resurgence of REITs can be traced to a number of causes:

1. *High yields.* As a result of the real estate collapse following the passage of TRA 1986, hotel properties suffered price declines ranging from 25 percent to 40 percent in most parts of the country. Many investors began to perceive hotel properties as a much more attractive income vehicle than common

stocks or bonds, which generally were becoming quite expensive. In addition, with interest rates having declined sharply, investors holding funds in money market accounts or CDs were seeing their income return decline sharply.

2. *Institutional demand.* A significant source of new investment in REITs has come from such institutional investors as common stock mutual funds, pension funds, and yield-seeking institutional investors.
3. *Financing source.* In the early 1990s, the traditional sources of real estate financing (thrift institutions, commercial banks, and insurance companies) sharply reduced their lending because of the high volume of distressed and foreclosed loans in their portfolios. Hotel developers, managers, and owners saw REITs as a means of raising new capital from the general market to pay down debt and grow their asset bases. Learning the lesson of previous REIT excesses, the new REIT sponsors structured their offerings on a much more conservative basis.

The resurgence of REITs in the early 1990s largely reflected the public's view of REITs as investments capable of generating high current yields as well as moderate appreciation in value over a period of years. Investors came to understand that cash flow was a more appropriate measure of a REIT's income than the "net income" measure used by business corporations. Cash flow (now known as funds from operations or FFO) disregards the paper write-offs for depreciation and amortization but reflects interest and amortization costs associated with debt financing.

One concern about REITs is whether high yields can be sustained if cash flow declines on underlying hotel assets. This could happen as a result of competition by the many new REITs to acquire desirable properties. The answer to this concern is that REITs can use two types of leverage to maintain or even increase yields: debt leverage and equity leverage.

## [1] Debt Leverage

Leveraging yields with debt encompasses traditional mortgage financing as well as various corporate financing techniques. Mortgage financing, while not easily avoidable in the early 1990s, undoubtedly will make a comeback as the hotel market improves and valuations become more stable. A REIT generally must meet the underwriting standards for mortgage financing as a non-REIT borrower of equivalent credit standing and with an equivalent asset portfolio.

REITs do have an advantage over non-REIT borrowers in that their large diversified portfolios enable them to use non–real estate financing techniques as well. For example, a REIT may issue long-term debt in the form of a bond or note that may be sold either to the general public or to private institutional investors. As long as the cost of such debt capital is below the free-and-clear return from the real estate portfolio, the REIT achieves positive (upside) leverage.

Another approach is to issue commercial paper or to use a bank credit. Commercial paper consists of corporate notes having maturities from 5 days to 270 days. The notes can be sold directly by the REIT to the customer-buyer or through a dealer. A bank line of credit will carry a floating rate of interest over prime and may require a compensating balance to be maintained whether the credit is used or not. In both cases, the short-term nature of the borrowing means that interest rates paid by the REIT are likely to be very volatile. This may affect the stability of the yield, an important consideration for public investors.

## [2] Equity Leverage

Equity leverage is the process of selling new equity at a premium over the book value (original issue price) of existing equity. To illustrate, assume that a single share issued by a REIT for $10 earns 10 percent ($1 per share) on its original cost. Assume further that investors now are willing to buy this stock at a price-earnings ratio of 20, to yield 5 percent. The result is a market value of $20 per share.

If a second share of stock is then issued by the REIT, it can invest a total of $30 (the initial $10 plus the new $20) and the same 10 percent yield will then earn $3 (or $1.50 per share). The trust has increased earnings per share by 50 percent but also the market value per share by the same amount.

Thus, equity leverage may be undertaken at any time at which the market value of a trust's stock commands a premium over original issue price. (If the stock is at a discount from that price, however, the issuance of new stock at that level will *dilute* the original issue price per share owned by existing stockholders.) It follows that the higher a trust's return on book value (original issue price), the greater is its capacity for growth.

Note that the use of debt leverage can achieve the same result as that just described. Suppose the REIT, instead of issuing another share of stock at $20, borrows $25 at 8 percent interest. If the REIT can maintain this 200 basis point (2 percent) spread between its free-and-clear return on assets and the loan interest rate, it will achieve the same 50 percent increase in earnings per share from $1 to $1.50; with the same market yield requirements, its stock will increase from $20 to $30 per share.

# ¶ 16.08 COMMERCIAL MORTGAGE-BACKED SECURITIES

Commercial mortgage-backed securities (CMBS) are a major source of debt capital for commercial real estate and the hotel industry in particular. This section provides a brief historical overview of CMBS, which shows why securitization has become a favored method of financing for hotel owner/operators and other commercial property borrowers. It then explains the different roles that investment banks may play in the securitization process, outlines the steps involved in the underwriting and rating processes, and concludes with a focus on recent economic trends in the hotel industry and how these changes influence the industry's relationship with CMBS as an ongoing provider of debt funding.

## [1] The Evolution of CMBS

Commercial mortgage-backed securities are bonds or other debt instruments collateralized by loans secured by commercial real estate. CMBS are created by combining loans into pools of $100 million or more and depositing them into a trust that then produces fixed-income securities sold to institutional investors.

Mortgage-backed securities (MBS) have a longer history as a source of debt financing for single-family housing. CMBS evolved from this residential market and arose as a thriving source of debt capital for income-producing property during the real estate recession and savings and loan (S&L) collapse of the early 1990s. (A major difference between MBS and CMBS involves prepayment provisions. Whereas MBS loans are prepayable, mortgages in CMBS are generally locked out from prepayment; consequently, the investor does not have reinvestment exposure.)

The collapse in commercial real estate values triggered a major recapitalization beginning in 1989, when the Resolution Trust Corporation (RTC) was appointed chief liquidator of S&L loans and real estate owned (REO) properties. The tidal wave of RTC offerings that followed during the next several years created a need to tap into the securities market to bring liquidity to commercial real estate. Investment banks were hired as loan sale advisors, and they consequently beefed up their commercial mortgage departments with real estate professionals who helped underwrite and dispose of the RTC offerings, incorporating mortgage securities structuring technology learned from the residential mortgage arena. Independent rating agencies at the same time increased their commitment to this emerging market by standardizing the underwriting criteria by property type, which was incorporated into the sizing of debt proceeds and the structuring of the underlying CMBS pools. This RTC-driven market was mainly functioning as an agency, or "best efforts" business, yet a small group of investors were earning an arbitrage by acting as a principal, purchasing RTC loans and selling them as rated and non-rated securities independently.

By the end of 1992, the RTC had disposed of approximately $11.6 billion of commercial real estate assets financed by CMBS, while the industry's traditional lenders (S&Ls, commercial banks, and life insurance companies) were experiencing unprecedented loan losses. This prompted these conventional lenders to move away from direct lending on commercial real estate. Instead, they bought long-term Treasury securities, enjoying a favorable spread between short-term and long-term rates (the Federal Reserve lowered short-term Treasury securities 200 basis points during this period).

Concurrently, stricter commercial real estate lending regulations were imposed by the Federal government. These restrictions led to larger loan loss reserve requirements and provided another impetus for traditional lenders to shift capital away from direct lending to buying CMBS—a natural for life companies that were already familiar with commercial real estate as collateral.

A dramatic transformation of commercial real estate finance was in full swing in 1993. In addition to the change in the role of traditional lenders—who were quickly becoming the largest buyers of CMBS—property owners were also changing the ways in which they raised equity, forming real estate investment trusts (REITs) and other capital markets vehicles to recapitalize their portfolios while issuing CMBS for leverage. Many borrowers looked to Wall Street to provide debt capital and issue single-borrower, multi-class transactions using sophisticated underwriting and structuring techniques.

By mid-year 1993, the RTC had securitized nearly $14 billion in performing commercial mortgages. This liquidation forced the markets to confront the issues of securitization. The establishment of underwriting standards, rating criteria, valuation techniques, and more standardized structures paved the way for further growth in CMBS and allowed the private sector to take the helm from the RTC and become the dominant issuer of CMBS.

Since that pivotal year, CMBS issuance has grown to reach approximately the $100 billion mark for total issuance. As the market matures, it has encompassed a broader group of both issuers and property types. In a 1994 study on income property securitization, Kenneth Leventhal & Co. pointed out that the market will continue to be influenced by interest rate fluctuations, competition from other lending sources, underlying real estate market conditions, regulatory changes, and information technology developments.

Despite such variables, the CMBS market has nonetheless witnessed increased efficiencies, including better availability and analysis of information to investors, improved reporting from servicers, better performance monitoring by rating agencies, and further standardization of transactions. All of these are becoming more uniform in terms of both structure and collateral, according to Duff & Phelps, a rating agency, which reported in early 1996 that such increased consistency translates into lower capital costs for borrowers. Another sign of the CMBS market's underlying strength was that in 1995, CMBS substantially outperformed corporate bonds at a time when spreads were largely unchanged.

## [2] Roles of Investment Banks in CMBS

Investment banks that represent borrowers in a CMBS transaction act in either a best efforts or a principal capacity. This distinction has important implications for borrowers in terms of allocation of risks.

Some securities firms do not commit capital to transactions, but rather act in a financial advisory and/or brokerage capacity to borrowers and investors. Such firms are said to act on a "best efforts" basis. They assist in structuring the transaction and brokering the rated certificate classes to investors. After the certificates have been rated and sold, the borrower is funded from the proceeds of the sale. In such a best efforts transaction, the borrower does not know the rate or amount of debt proceeds to be received until the securities have been sold, and the borrower assumes all of the risks involved in the transaction, including:

- The risk that the transaction can be rated.
- The risk of what rating each class of certificates will be assigned (i.e., the amount of certificates that receive high ratings versus those that receive low ratings).
- The risk that the certificate classes, including the unrated classes, can be sold, and assuming that the classes can be sold, the risk of at what spread to Treasuries (i.e., price) each class of certificates can be sold.
- The risk regarding how long a period of time it will take to consummate the transaction. (The pricing and funding of a principal transaction typically takes between 60 and 90 days, while a best efforts placement can be expected to take between seven months and one year.)
- The risk that interest rates will increase during the processing period for the transaction. (In a best efforts placement, since there is uncertainty as to whether and when the transaction will close, it is not possible for the borrower to effectively hedge this risk.)
- The risk of assuming all costs of the transaction, regardless of whether it is consummated.

While a best efforts transaction may result in lower costs to the borrower, the foregoing risks make it clear that any savings over a principal transaction can be lost by interest rate movements and unfavorable rating agency treatment during the securitization process.

In a principal transaction, the investment bank/lender makes a permanent mortgage loan to the borrower, who is funded at the inception of the transaction. The aforementioned risks involved in a best efforts placement are assumed by the lender, who shepherds the loan through the rating and securitization process.

This distinction was particularly important from 1993 to 1995, when traditional lenders (who had always provided certainty of funding) remained on the sidelines. At that time, investment banks such as Bear Stearns, CS First Boston, Lehman Brothers, and Morgan Stanley were accustomed to acting as an agent on CMBS because of their experience at working with the RTC, but they were reluctant to risk their own capital. As conventional lenders returned to aggressive lending again in 1995, more Wall Street firms did begin to act as principal.

## [3] Underwriting Criteria for Hotel Property Loans

Despite their better economic performance after the early 1990s, hotels did not derive any immediate capital benefit from CMBS, because rating agencies and bond buyers (many of which were former hotel lenders with unpleasant memories) were hesitant to put capital back into the sector. Gradually, though, CMBS investors have developed greater comfort with hotel collateral.

Each segment of the hotel industry—resort, full-service, limited service, or extended stay—has its own unique characteristics that need to be examined in the context of underwriting. What follows is an overview of general underwriting criteria for the structuring of securitizable hotel loans.

In general, hotels are underwritten to ascertain a stabilized net operating income (NOI) from a trailing twelve-month cash flow to determine supportable debt proceeds at different debt service coverage ratios (DSCRs). NOI equals the actual net income of the properties before interest, depreciation and income taxes for the trailing twelve-month period adjusted if necessary to cap the growth of departmental profit and occupancy. In addition, NOI takes into account all of the various operating expense line items to make sure they are consistent with historical and market performance. The underwriter evaluates the performance of the property over the previous five years to look for consistency while researching demand and supply characteristics of the market to essentially "mark the property to market." After a stabilized NOI has been determined, debt proceeds and pricing can be determined by applying a pricing matrix based on DSCRs at various proceeds levels with different amortization schedules. The price of a hotel loan or the all-in rate is based on a spread over the yield on the ten-year or fifteen-year Treasury security. Pricing varies by the quality of the collateral, but the most favorable pricing is generally given to loans with the highest DSCR.

## [4] Role of the Rating Agencies in CMBS

Independent rating agencies (i.e., Standard & Poor's Corporation, Moody's Investors Service, Inc., Fitch Investors Service Inc., Duff & Phelps, and others) assign ratings on debt and other securitized transactions with regard to the capacity of an issuer to meet its debt obligations in a variety of economic circumstances. Higher ratings come from the issuer's ability to make interest and principal payments under severe economic conditions.

The four highest ratings categories—Triple A, Double A, Single A, and Triple B—represent what is referred to as "investment grade" CMBS. A typical CMBS issue is divided into several classes by payment priority with each class receiving a separate rating.

The rating agencies have been careful to establish very conservative criteria for rating CMBS—in most cases, the result of in-depth studies of historical loan performance data (e.g., American Council of Life Insurance (ACLI) loan performance data and the Russell-NCREIF property performance indices). Through such studies, the agencies have sought to identify loan characteristics that influence performance and to establish reasonable assumptions regarding defaults and losses resulting from foreclosures. While such studies provide the basic framework for the rating process, the agencies adjust their expectations according to the unique characteristics of each transaction, especially those that most influence real estate performance.

Rating agencies review the economics for the property type that collateralizes the loans in a CMBS pool the same way that they consider the economics of the industry in which a borrowing company belongs when rating a corporate debt transaction.

Hotels are generally considered to be the most risky type of commercial property—clearly different from other sectors in that they provide services to short-term guests with revenues coming largely from room rents as well as such extras as restaurants and meeting rooms, especially at luxury hotels. Small increases in occupancy rates or room prices go a long way toward improving profitability because of considerable fixed costs. Yet unlike other income-producing properties, hotels do have increased expenses as occupancy increases; therefore, maximizing occupancy does not always equal maximizing long-term profits.

Because the performance of hotels depends largely on the active management of operations, the rating agencies place particular emphasis on the quality of property management teams. Well-managed properties with competitive positions in their regions present attractive collateral for commercial mortgages.

## [5] Outlook for the Hotel Industry as a Component of CMBS

Smith Travel Research reported that 1995 was the most profitable year in the lodging industry, and as of mid-year 1996, hotel fundamentals remain strong. Industry occupancies for 1995 were at a 10-year high, averaging 65.5%, and room rate increases continued to outpace inflation in 1996, leading to further improvement in industry profits and operating margins. Revenue is expected to grow at slightly under 7 percent, with an operating leverage of 67 percent, meaning that 67 cents of every dollar earned is profit.

As profits continue to rise substantially, the hotel investment market is witnessing accelerated activity. Although this has fueled a rise in hotel values, it is still less expensive to buy rather than build, although the margin continues to narrow. In 1996, hotels in most segments could be purchased for approximately 80 percent of replacement costs, up from 1995 levels of 50 to 70 percent, according to HVS International.

Combine that with forecasts of historically high hotel profits in the next two years, and it is obvious why the industry is in an expansion mode. Construction starts are up, concentrated mostly in the limited service sectors, such as extended stay hotels. Many hoteliers have recently announced plans to expand their sets of offerings and markets, and some industry experts report expectations of overbuilding in the economy segment within the next few years. This may cause some concern that the hotel market is once again heading toward an overbuilt bust reminiscent of the 1980s. The pessimism may be largely unfounded, however, as several basic market characteristics are, thankfully, very different now. Some examples:

- Demographics are heading in the right direction for continued hotel demand. A robust level of business travel as well as a steady growth in leisure travel are both expected to continue as baby boomers reach middle age.
- Most new hotel construction is concentrated in the budget and extended-stay segments, which has been undersupplied and should be able to accommodate new supply in balance with rapidly growing demands. Meanwhile, the full-service sector has the advantage of essentially no new supply coming on board.
- The possibility of some oversupply on the horizon is offset by lower leverage ratios and, inherent in the CMBS process, the stricter underwriting criteria that come from rating agency review—a marked difference from the lending attributes of past periods of excess.

The health of the hotel industry at large combined with the ability of the CMBS market to better scrutinize funding requests and make more rational lending decisions should ensure that CMBS lenders remain committed to providing hotels with a viable borrowing option. This will allow hotel owner/operators to continue to take advantage of reasonable acquisition and expansion opportunities and eliminate overleveraging in their existing debt, which in many cases is based on higher interest rates or overinflated values of the past.

# ¶ 16.09 MORTGAGE FINANCING

Hotel owners use a wide variety of mortgage loans to structure a financing package that meets their objectives. The following sections discuss the various types of loans typically employed in hotel financing.

## [1] Construction Loans

A construction loan is a short-term loan made during the period in which a project is under construction. The moneys from a construction loan are disbursed over the development period for amounts determined by the actual progress of construction. Interest is typically tied to a floating rate (usually prime), exceeding this rate by one to three points. Most construction loans call for interest only. Personal guarantees, as well as completion bonds, are normally required by construction lenders. Construction loans are paid off when the project is completed and the hotel opens. The lender that provides the permanent financing after the construction loan has been paid off is called the take-out lender.

## [2] Construction and Mini-Permanent Loans

When a lender provides both the construction financing and a short-term permanent loan (two to five years), the arrangement is called a construction and mini-permanent loan. The terms of the construction segment of the loan are similar to those of normal construction loans. The mini-perm often has a fixed interest rate rather than a floating rate, and it may have an amortization. The advantage of construction and mini-perm financing is that the borrower does not have to find a permanent take-out lender, which can be difficult to locate for a new hotel without an operating history. Once the hotel has been operating for two to four years and has an established track record, the borrower is better able to attract a long-term permanent lender at more favorable terms.

## [3] Permanent Loans

A permanent loan is obtained after the term of a construction or mini-permanent loan that are used to pay off the previous lender. Sometimes sufficient funds remain to allow the equity investors to remove some capital. The permanent loan carries either a fixed or floating interest rate and amortization over a twenty- to thirty-year term. The length of the loan typically extends for five to twenty years, depending on the lender. Most permanent loans made on stable hotels with established earnings do not require personal guarantees. If they do, the borrower can generally negotiate removal of the guarantee when a certain debt coverage has been achieved.

## [4] Term or Bullet Loans

If a construction lender does not want to provide a mini-permanent loan after the construction has been completed, the borrower can line up a term or bullet loan as the take-out. By using this type of loan until the property establishes a track record, the borrower is better able to obtain more favorable terms on a long-term permanent loan.

The terms of a bullet loan are similar to construction financing—it carries a floating interest rate of one to three points over prime, has little or no amortization, and personal guarantees are sometimes required.

### [5] Accrual and Zero Coupon Financing

An accrual loan is a mortgage where all or part of the interest accrues and is not paid until some point in the future—sometimes at the maturity of the loan. This structure reduces the amount of the debt service that has to be paid and assist hotels during initial start-up years when there is usually insufficient cash flow to cover debt service.

## ¶ 16.10 OBTAINING A HOTEL MORTGAGE

Obtaining mortgage financing for a hotel venture is probably the most critical step in both the hotel development and the acquisition process. Since mortgage debt generally represents the largest source of cash invested in a hotel transaction, finding a mortgage lender is a make-or-break issue. Without a lender, the contemplated transaction will usually die.

Lenders, realizing this great power, are often difficult to approach. Coupled with the fact that most mortgage lenders do not make hotel loans, finding suitable financing can be difficult.

The key to obtaining hotel financing is to put together a transaction that clearly shows excellent financial potential and low investment risk. It must be presented to the lender in a highly professional manner so that the opportunity stands out from all the other submissions.

The following steps are involved in obtaining a hotel mortgage:

1. Determine how to approach the lender.
2. Put together a mortgage submission.
3. Negotiate the important terms.
4. Submit an application.
5. Obtain a commitment.
6. Fulfill the terms of the commitment.
7. Close the loan.

### [1] Approaching the Lender

The first step in obtaining a hotel mortgage is to determine whether to retain the services of a mortgage broker or to attempt the process alone. A mortgage broker's services can cost between 1 percent and 3 percent of the amount borrowed. While this might seem expensive, it may be worth the expense, since the transaction cannot be completed unless sufficient financing is secured. For new hotel owners without a lengthy track record of successful projects, the services of a hotel mortgage broker can be invaluable. Owners with extensive experience in the hotel industry and good financing contacts are better able to successfully complete the process without a broker. In any event, contacts are vitally important, and the proper introduction to the right person and the right lenders will give a project the necessary initial attention.

## [2] Compiling a Mortgage Submission

A mortgage submission is a package of information that describes the hotel investment, the financing requirement, and the structure of the contemplated transaction. It should provide the lender with sufficient information to generate interest in pursuing the mortgage. As with the overall process, the mortgage submission should be complete and have a professional appearance. The information a lender looks for in a mortgage submission includes the following:

- Description of the hotel project and contemplated transaction.
- Description of loan and requested terms.
- Resumes and financial statements of owners.
- Economic market study and appraisal.
- Owner's projection of income and expense.
- Description of management company experience and operating ability.
- Operator's projection of income and expense.
- Rendering or photograph of the property, including an aerial photo of the site with appropriate maps, plans, and legal description.
- Architectural plans and specifications.
- Estimate of all project costs—particularly if the hotel is to be constructed or will undergo a major renovation.
- Identification of project team, including architect, interior designer, and contractor.
- Copies of all major contracts—management contract, franchise agreement, ground lease, and tenant leases.

## [3] Negotiating the Terms

Once the lender shows interest in the contemplated project, the important mortgage terms are negotiated, including the following:

- Interest—rate, fixed or floating
- Term
- Amortization schedule
- Prepayment
- Personal guarantees
- Accrual facility
- Commitment and closing fees
- Timing

## [4] Submitting a Mortgage Application

When the borrower and the lender have agreed on the terms of the loan, a mortgage application is submitted. A mortgage application formalizes the information generally provided in the mortgage submission.

## [5] Obtaining a Mortgage Commitment

Once the loan has been approved by the lender, the lender issues a mortgage commitment, which describes the loan and its terms. The commitment may also contain a request for additional information as well as contingencies. Normal contingencies in a mortgage commitment include (1) an appraisal showing that all the property has a specified minimum value; (2) a satisfactory title report; (3) a survey guaranteed to the lender; (5) an engineering report showing a sound structure and equipment; and (6) satisfactory credit reports for the principals.

The borrower is usually required to sign the commitment letter and return it to the lender with a nonrefundable commitment fee of between 1.5 percent and 3 percent of the amount borrowed.

## [6] Fulfilling the Terms of the Commitment

The bank's commitment letter generally states that the borrower must provide additional information (e.g., appraisals, studies, and certified financial statements) and fulfill certain obligations (e.g., subordinating the management contract, obtaining rights under the franchise, and transferring the liquor license). These must be completed before a specified date or prior to closing the loan.

## [7] Closing the Loan

When the borrower has complied with all the provisions of the commitment and the transaction has reached its culmination, the loan is ready to close. At this point the borrower and the lender (and the seller if appropriate) meet and exchange and sign the necessary documents, and the moneys borrowed are exchanged.

CHAPTER 17

# Buying, Selling and Exchanging Hotel Properties

# ¶ 17.01 PURCHASE OR SALE OF HOTEL PROPERTIES

Because the purchase or sale of a hotel property is basically the opposite sides of the same coin, when discussing purchases or sales, investors should realize that the motivation for one party will usually be a factor for the other party as well. There are no easy answers when a hotel owner should sell a property. Many factors play into the decision to sell a property. What will the future hold? Is the market expanding or contracting? How much competition is coming on line in the next few years? Will supply be expanding or contracting? All these questions need to be guessed at as best as the seller can in making his determination to sell or not. Of course the buyer is doing the same type of analyzing and is hoping that he may be able to buy at an opportune time and thus increase his overall value.

The seller motivation is always on the mind of the buyer. Some of the more common reasons for selling a hotel property include:

1. *Change of corporate policy.* Many large conglomerates may feel a particular hotel chain or group of hotels no longer fit within their corporate strategy.
2. *Need the money.* Many property owners borrowed so much money on the hotel's value that the property has a difficult time servicing the debt load. Of course this puts the buyer who has this information in a very strong position. For example, the Asian crisis has forced many foreign-owned hotels to be put up for sale because the corporate owners are in need of capital.
3. *Changes in perceived future market values.* Many hotel owners wish to get out because they see a peak in values that they feel will not be duplicated again in the near future.
4. *Retirement of key personnel.* Many hotel owners simply wish to get out of the business because there is no one to take over the business.
5. *Declining depreciation and other tax shelter aspects of the property which results in more taxable income being attributable to the owner.* The owner may wish to capitalize on lower capital gains rates.
6. *Changing neighborhood.* The owner may realize that new competition is coming into town and may wish to sell out before the information is generally known or that a key reason for travelers to visit the location is in jeopardy of leaving.

These are just some of the more common methods that motivate an owner. The buyer needs to beware of any or all possible motives for the sale of the properties. This is why an indispensable part of any purchase is for the buyer to ascertain as realistic as possible the true value of the hotel that he is about to purchase.

## [1] General Legal Requirements to a Real Estate Contract

When a hotel is purchased, the key instrument in the purchase is the sales contract or agreement of sale. This document spells out in great detail the rights and obligations of the parties during the contract period. It also will detail the manner in which the party will eventually be transferred.

Since real estate contracts need to be in writing in order to be enforceable, the sales contract is the essential agreement of exchange of promises which makes the sales transaction enforceable under law. Once the document has been signed, it is enforceable on both parties unless both parties assent to the changes. Throughout our legal history it has been well established that contracts must contain certain provisions in order to be enforceable.

☐ *Mutual agreement.* A basic requirement of any contract is that the parties have a "meeting of the minds." Mutual agreement is met when one party makes an offer and the other party accepts that offer.

- Any offer must meet certain well-accepted rules in order to be considered a valid offer. The offer must (1) be definite and certain; (2) define the precise subject matter of the proposed contract; and (3) be communicated by the one making the offer to the recipient of the offer.
- Once the recipient receives the offer it remains open and capable of being accepted until (1) it expires by its own terms; (2) the recipient rejects the offer; or (3) the person making the offer revokes it before the recipient accepts. The offer is also canceled by the destruction of the hotel property or by circumstances that make the contract illegal.
- The recipient accepts the offer only when his deed or words clearly indicate acceptance of the terms of the offer. An acceptance must (1) be positive and unequivocal; (2) conform precisely to the terms of the offer; and (3) be communicated to the person making the offer within the permissible time period.
- Any counteroffer is considered a new offer and the above-mentioned criteria then is applied as if the contract is being offered for the first time. The parties may go through several counteroffers until final acceptance or rejection has taken place.

☐ *Reality of assent.* The assent of a party is real when it is given freely and with full knowledge of the circumstance affecting the agreement. When assent is not freely given, the contract may not be valid depending on the cause. The four such causes are fraud, mistake, duress, and undue influence.

- Fraud is the intentional misrepresentation of a material fact in order to induce another to part with something of value. It clearly indicates there must be a misrepresentation of a fact, not merely an opinion. The misrepresentation also must be significant and substantial, and it must be made with the intention that the other party rely on it to his detriment.
- Mistake is a difficult concept to apply to invalidate a contract. Generally, only mistakes of fact can invalidate a contract, and only if the mistake is material and the other party should have realized a mistake was being made.
- Duress occurs when one of the parties uses threats or coercion to obtain consent.
- Undue influence is when a party in a confidential relationship uses improper or excessive persuasion to obtain a consent.

☐ *Legal capacity to contract.* Each party must have the legal capacity to enter into valid legal contract. Legal capacity means the ability to reason and understand the significance of an agreement.

- Minors (children under the age of 18 or 21, depending upon the particular state) lack legal capacity to enter into a contract for the purchase of real estate. Any contract that the minor should make on real estate can be disaffirmed on reaching the age of majority. This type of contract is called voidable because it is considered to be valid until the minor takes steps to disaffirm his obligations.

- Persons found to be insane, incompetent, and at times, intoxicated at the time the contract was entered into may be held to lack the legal capacity to contract.

☐ *Consideration.* Contracts cannot be enforced unless consideration has passed between the parties. This is a fundamental requirement of all contracts. Consideration includes promises and actions that can include anything that constitutes a benefit to the promisor (the one whom makes the promise) or detriment to the promisee (the one to whom the promise is made). The law does not look at the adequacy of the consideration but merely whether consideration was actually bargained for.

☐ *Legality of the transaction.* A contract will be enforceable only if the purpose of the contract is legal. A contract to buy or sell a hotel property for an illegal purpose (e.g., gambling in a state that bars this activity) would be void and unenforceable.

☐ *Contract in writing.* Finally, real estate contracts must be in writing in order to be enforceable. This requirement originally was imposed by an English statute, the Statute of Frauds, enacted in 1677. Its purpose was to prevent many fraudulent claims that were based on alleged oral promises or agreements. All states recognize the writing requirement and apply them to all transactions involving the sale and purchase of real estate and all leases of real property that exceed a specified time period (usually one year).

The Statute of Frauds will be satisfied so long as the person against whom the contract is sought to be enforced has signed it. It is not necessary that the person seeking to enforce the contract has signed it. Generally, the writing must contain the following information:

1. The identity of the parties
2. The identification of the property of the contract
3. The consideration

The writing need not be designated a contract. Any written memorandum will suffice to satisfy the statute, provided it contains the requisite information.

Appendix 2, Sample Clauses for Hotel Purchase and Sale Agreement, contains an excellent checklist of what is included in most hotel sale agreements. Below is a summary of that checklist and some considerations that the buyer and seller may want to ensure are included in the contract.

## [2] General Provisions of a Sales Contract

### [a] Real and Personal Property Being Sold

A contract for the purchase and sale of a hotel should accurately describe the property to be conveyed and also the personal property to be included in the conveyance. The description may be by street address, full legal description, or reference to a public map; by plat attached to documents or schedules; or by some combination of these. Regardless of the method used, however, unless the description burnishes the means of determining with reasonable certainty the property intended to be conveyed, the contract is unenforceable.

Sources for the description of the hotel would include current surveys, copies of the seller's warranty deed or title policy, and current title reports or binders. If a current, accurate description is not available or if the parties contemplate that a survey will be made before the closing, it is advisable to provide that the description that will be used at the closing be based on the survey.

All descriptions of property should be independently verified by the purchaser. Also, if rights of access or other rights affecting adjoining property are important to the use and enjoyment of the property being purchased, those rights should be specifically included. Where appropriate, clauses may be included to cover such items as air rights, rights in adjoining streets, easements, and leaseholds.

### [b] Business Assets Being Sold

Some of the most important assets of the hotel will be the right to operate the property through various government permits. If a government license or permit has already been issued for the property, the seller will want assurances that the seller will transfer these valuable rights. Success in obtaining a license (e.g., gaming license) or in obtaining the transfer of an existing license may be essential to the right of the purchaser to conduct or continue the conduct of the hospitality business located thereon. For this reason, contracts for the sale of hotel properties frequently contain provisions concerning the seller's duty to keep necessary licenses or permits (e.g., liquor license) in force and cooperate with the purchaser in obtaining the transfer of a license or permit to him.

### [c] Closing

The closing is the final meeting of the parties at which the instruments necessary for conveying title to the premises and to the personal property from the seller to the purchaser occur. It is also when the consideration from the purchaser to the seller takes place. Also at the closing, the final documents are signed and delivered, expenses are apportioned, income from the property is prorated, and all closing adjustments are made.

### [d] Purchase Price

The purchase price for the hotel must be readily ascertained from the sales contract or be calculated with a degree of certainty. Often, the contract will provide certain clauses that make the final purchase price unknown, but the price will be able to be ascertained by closing, thus meeting the requirement of certainty.

The contract should specify how payment of the purchase price shall be made; any down payments or earnest money payments that are required; and the method, medium, and time of payment.

[i] **Adjustment of purchase price.** Often the total purchase price will only be determined after a final audit of the property. The contract should specifically spell out what items will be used in adjusting the purchase price. For instance, liquor inventory at the time of closing would be an adjustment to the final purchase price.

[ii] **Allocation of price among different assets.** Although not required by law, the parties should consider allocating the purchase price of the hotel among the various assets. The reasonable allocation of purchase price among assets is an excellent method of avoiding trouble with the IRS over the value placed on personal property vs. real property. Of course, the seller would like as much as is reasonable, allocation of purchase price to real property for capital gain treatment and less to personal property, which would be taxed as ordinary income. The buyer has the opposite needs and wants, and therefore a goodfaith allocation is usually acceptable to the IRS.

[iii] **Allocation of price between land and buildings.** In order to maximize depreciation deductions, purchase price needs to be allocated to the building as opposed to land which is not a depreciable asset.

The Treasury regulations require that when nondepreciable and depreciable properties, such as land and building or improvements, are acquired together for lump sum, the acquisition cost must be allocated on the basis of the respective values of the land and the building or other improvements on the land. The Treasury regulations do not state how the respective values are to be ascertained. One way is to use a professional appraisal; other ways are to base the allocation on the relative values placed on the land and building by the local tax assessor or on the buyer's own information resulting from his personal familiarity with the area in which the property is located. Still another method is for the buyer to evaluate the buildings situated on the land from the investment point of view by capitalizing its cash flow. This may produce a particularly favorable allocation in the case of a hotel which is old is a very profitable one.

## [e] Earnest Money

Almost all major hotel sales require that the buyer put a substantial down payment or earnest deposit to show good faith in the purchase of the property. This goodfaith deposit will be held in escrow during the period between the signing of the sales contract and the closing on the property (transfer or title). Also, in complex hotel sales there may be substantial performance clauses in which the buyer or seller may place funds in an escrow, in which case the escrow deposit is used as a security for the performance under the agreement.

An escrow deposit may be in cash, securities, promissory notes, letter of credit, or such other device that the parties agree will suffice as to proper value. Cash deposit is the most common method for securing a down payment. The cash deposit will be credited against the purchase price of the hotel and paid over to the seller at the closing, unless the purchaser has committed a breach of contract. Often the deposit is returned to the buyer if the sale is not consummated due to some other reason than a breach of contract.

Most escrow agents in the sale of hotel properties are brokers, attorneys, title companies, financial institutions, or escrow companies. The escrow agent by law must follow the specific instructions agreed to by the parties concerning his custody and disposition of the funds entrusted to his care. The law puts an escrow agent in a fiduciary bound duty to act according to the dictates of the escrow agreement. His duties should be strictly ministered, limited to the safekeeping of the funds in a separate, properly identified, interest-bearing account, and paying over the funds at the proper time and place to the proper person when required to do so under the terms of the escrow arrangement.

Often when the contract for sale requires the purchaser to make the deposit as security for his performance, the seller may insist on a provision declaring that the sum placed in escrow shall constitute liquidated damages if the purchaser subsequently defaults or breaches the contract. The purchaser, on the other hand, may insist on placing provisions in the sales contract that if certain contingencies are not met or that if the seller defaults in his performance, the escrow deposit is to be returned to him.

## [f] Due Diligence

Usually in the purchase of a hotel property a prudent purchaser will insist that the seller expressly warrant the condition of the property, but also insist in the sales contract to the right to physically inspect the hotel and its record prior to closing. The purchaser should place in the sales contract a provision that if the condition of the hotel proves to be unsatisfactory or not as warranted or represented by the seller, the purchaser has the right to rescind or cancel the contract.

The purchaser will also want to insist that all existing leases and tenancies be disclosed in the contract. The purchaser will also want to put in the contract that the seller continue to perform any service and repair arrangements with the tenants until title passes to the purchaser.

Anytime that the purchaser is given the right to enter upon the premises and inspect the property before title is transferred to him, the seller should insist on the right to be indemnified or held harmless by the purchaser against any and all losses, damages, or claims arising out the purchaser's entry and activities on the premises. The seller should also require that the tests the purchaser conducts in the course of the inspection are at the purchaser's sole cost and expense.

If there are major physical problems with the hotel, the seller could be held liable to third parties after the sale of the property unless the purchaser hides and/or fails to disclose the dangerous or defective condition to the seller. Therefore, the purchaser should require provisions in the contract offering him protection against defective conditions existing at the hotel.

The purchaser's protective provisions may take several different forms. For instance, he may require the seller to fix the problems before closing will take place. The buyer could insist that the seller place in escrow sufficient funds as security against his performance of the necessary work within a specified time after closing.

The seller may want the contract to afford him the option to cancel the contract and return the purchaser's earnest money if the cost of remedying the offending conditions or securing the violations exceeds a specified amount.

## [g] Terms of Purchase Financing

[i] **Third-party financing.** Most hotels usually involve some type of mortgage financing in order for the purchaser to buy the hotel. Because the loan authorization process is often a very lengthy affair, the sales contract is made contingent on, or subject to the purchaser's procurement of a mortgage loan commitment meeting specified requirements. Some of the more common requirements for a loan include interest rate, amount, and duration.

Another important clause in the sales contract is the amount of time that the purchaser will have in order apply for and to procure a loan commitment. The parties may agree that the purchaser's procurement of the loan commitment within the required time and containing the required terms shall be a condition precedent to the obligation of either party to perform, or that the purchaser's failure to obtain the required mortgage loan commitment within the allotted time may be grounds for rescission or cancellation of the contract.

The sales contract should provide for a refund to the purchaser of the sums paid by him to the seller where the contract is canceled for failure to obtain the necessary financing within the required time; if the seller is entitled to his costs, the contract should clearly state exactly what he is entitled to.

[ii] **Purchase-money financing.** Often the seller will be willing to help finance in whole, or in part, the purchase price of the hotel property by extending a purchase-money loan to the buyer secured by a mortgage, land contract, or deed in trust on the property sold. The most frequent use of the purchase-money loan will be as a second mortgage on the hotel property. Under these conditions, the purchase-money loan will be used to fill the gap between the purchase price of the property and the aggregate of the purchaser's cash investment and the proceeds of the existing outside-mortgage loan.

Sellers frequently enter purchase-money financing arrangements with their buyers on smaller hotel properties where financing of any kind is difficult to obtain or in times of high interest rates, which make the purchase of a hotel prohibitively expensive. Many sellers may prefer to enter into purchase-money financing because it will generate interest income for the seller.

It is important that any purchase-money mortgage loan arrangement be reflected in the sales contract and the material details of the mortgage, land contract, or deed of trust including the property that secures the obligation. Some of the more important details include the amount of the loan, the loan term, the debt service payments, and the interest rate.

If the purchase-money mortgage is to be junior to an existing mortgage on the property, the contract should so state; and if it is to be subordinate to a new mortgage on the hotel property in favor of an outside lender, the contract should clearly state that fact. Finally, the sales contract should state whether the purchase-money loan is to be a recourse or a nonrecourse obligation; that is, whether the purchaser is to be personally liable for the loan or whether the seller's sole remedy in case of default is to proceed against the property.

[iii] **Existing mortgage.** Often there is an existing mortgage that is in existence at the sale of hotel property. The contract should spell out whether the hotel is to be purchased subject to an existing mortgage. If the buyer takes the property subject to an existing mortgage, the parties understand that the mortgage will not be satisfied by the seller by the time the title is transferred to the seller (closing). Instead, the purchaser will be responsible after the closing to make the mortgage payments under the original terms of the mortgage document.

Of course, any purchaser who takes subject to an existing mortgage should realize that the financial institution still maintains a lien on the hotel property and can foreclose and sell the property if the purchaser defaults on future mortgage payments. However, because he is not personally liable for the mortgage obligation, he cannot be held personally liable for the deficiency if the proceeds of the foreclosure sale are not sufficient to satisfy the balance due under the mortgage obligation plus intuits and costs. Instead, the mortgage holder (mortgagee) must look to the original seller (mortgagor) to recoup the deficiency, assuming that the mortgage obligation is a recourse obligation.

Another type of existing mortgage arrangement is when the purchaser assumes an existing mortgage. Rather than merely taking the title subject to the mortgage where the purchaser assumes a mortgage on the property, he undertakes personal liability for payment of the existing mortgage indebtedness. If the seller was personally liable to the mortgagee or the mortgage obligation before the sale, he remains personally liable after the sale even though the purchaser assumes the mortgage, unless the assumption of the mortgage obligations by purchaser is accompanied by a novation (new contract). Thus, if the holder of the mortgage agrees to substitute the personal liability of the purchaser for that of the seller (in other words, if the mortgage holder agrees to a novation), the seller remains personally liable and, in most jurisdictions, the purchaser is also personally liable to the mortgage holder. If the seller becomes liable to pay any part of the mortgage debt, he is entitled to reimbursement from the purchaser since, as between them, the purchaser is primarily liable.

Today, however, many mortgage agreements carry a due-on-sale clause under which the mortgagee may accelerate the mortgage debt so that it becomes immediately payable in the event that the property is sold by the mortgagor. If such payment is forthcoming and the sale takes place, the mortgagee may proceed to its remedies under the mortgage. That is to force the payoff of the mortgage and force the purchaser to secure a second mortgage at supposedly a higher interest rate.

Finally, if there is a mortgage on the property, the purchaser should request before purchasing the hotel a duly executed estoppel certificate, statement, or letter from the mortgagee that states all the current particulars with respect to the mortgage, including the interest rate, balance due, and that there has been no default under the mortgage. The party executing the estoppel certificate cannot later claim that the facts stated are different, since the statement was issued with intention that it be relied on by the purchaser, and the purchaser bought the property with reliance on it.

### [h] Title Commitment and Survey

It is very important that the seller be able to convey title to the purchaser. If the seller can not convey good title, he will want provisions in their agreement so as not to be liable to the purchaser or to cure the defects of title regardless of the cost to him. The purchaser, for his part, will want assurance that the seller will be obligated to convey a good title when the closing date arrives. Within this framework, the parties may agree that the purchaser shall either accept, without abatement of the purchase price, such title as the seller can convey, or terminate the agreement and receive a refund of his earnest money deposit. Another option is to require the seller to remove, at his own expense, any and all defects of title that are subject to removal regardless of cost.

A contract that specifies that a marketable title is required refers to a title that (1) is free from liens or encumbrances except those specifically set forth in the contract; (2) discloses no serious defects; (3) does not depend for its validity on doubtful questions of law or fact; and (4) will not expose the purchaser to the hazard of litigation. In addition, the title should be such that a reasonable, well-informed, and prudent person acting on business principles with full knowledge of the facts and their legal significance would be willing to accept with the assurance that he, in turn, will be able to sell or mortgage the property at fair value.

The following examples have been ruled to render title unmarketable:

- A reasonable hazard of litigation
- Title acquired by adverse possession
- An outstanding right in a third person that interferes with the use or transfer of the property or subjects the property to an obligation, leases, liens of any tax assessment, or water charge
- Debts of decedents or a reasonable possibility of their existence
- Easements
- Outstanding mineral and oil rights

Regardless of the agreement reached by the parties, with respect to defects of title, the purchaser will want to include a provision that if the sellers inability to convey good title results from his own acts or omissions, he will be considered to be in default under the contract and will continue to be liable to the purchaser for any damages resulting therefrom.

One way to avoid many problems with title questions is for the purchaser to acquire a title insurance policy. The purchaser will still insist that the seller fix defects of title where the condition of the title is unsatisfactory, and that if title defects are not rectified, the purchaser should have the right or option to terminate the contract.

Although the title insurance does not cure a defective title, it does, however, protect the buyer against loss as a result of defects and encumbrances that are not specifically expected from the insurance coverage. In this regard, it is important for the purchaser to understand the legal implications of the endorsements to the title insurance policy and the exception contained therein.

A title insurance policy ensures against loss or damage to the insured by reason or defects, liens, or other encumbrances on his title that are not specifically excepted from, or excluded by, the policy. The policy does not cure a defective title; if the defect is such as to render the title unmarketable, title insurance will not render the title marketable.

In most jurisdictions, all title policies cover losses or costs arising from defects disclosed by the pubic records; defects not disclosed by the public records; the costs of defending title, whether justified or not; and mistakes of the title examiner, whether errors, omissions, or mistakes or judgment.

The purchaser will also insist that within a given number of days after the signing of the sales contract, a current survey of the property be prepared by a licensed surveyor.

Surveys, on the other hand, give the purchaser a description of the property by describing the property by metes and bounds and show the gross number of acres as well as the number of "net acres." The survey will also show all existing easements, rights-of-way, alleys, streets, and roads, and any encroachments upon the property.

## [i] Seller's Representations and Warranties

A warranty may be distinguished from a representation in that a warranty is a promise that is given contemporaneously with, and as part of, the contract, while a representation is of an existing fact and usually precedes and induces the contract. All hotel sales unless prearranged sales between related parties should have warranties as part of the sales contract. In the case of a breach of warranty, the contract remains binding, but the opposite party may sue for damages by reason of the breach. On a false material representation, however, the opposite party may elect to avoid the contract and recover the entire price paid or he may affirm the contract and sue for damages.

Representations and warranties may be expressed or implied. For this reason, the contract may include provisions that the seller makes no representations or warranties, whether express or implied, and that the purchaser is not relying on any representation or warranties made by the seller. Alternatively, the contract may state that no representations or warranties should be made or relied on other than those expressly stated in the contract as being made.

The specific representations and warranties that the parties will want to insist on depend on the situation of the parties and the nature of the transaction and the property. However, basic representations and warranties such as marketability of title or that no condemnation proceeding is pending, should be considered to be fundamental in any contract for the sale of the real estate.

[i] **Building and zoning regulations.** Of critical importance to the purchaser is that any use of the hotel property comply with proper building and zoning ordinances. It is important for the purchaser to make sure that he puts in the right protective language in the contract even if he is accepting the hotel "as is." The purchaser's worse nightmare is to purchase a hotel property that he cannot use or develop for the purposes or in the manner contemplated.

In order to protect himself, the purchaser should place a clause which makes the sale conditional on obtaining the required zoning change or accommodation. A contract so conditioned should clearly state who will be responsible for the approval and expenses of any zoning changes or accommodations required. As a general rule, the purchaser will want the option to rescind the contract and have the down payment or earnest deposit returned to him if the zoning change or accommodation cannot be obtained.

The purchaser should also be concerned about building violations such as violations of regulations adopted by local or state governmental entities concerning the construction, design, quality, use, occupancy, and maintenance of the hotel.

The purchaser should be assured that an existing hotel structure meets all the current government building codes and regulations. Depending on the severity of the violations, the parties can most likely negotiate any compliance measures needed to bring the hotel up to code.

[ii] **Franchise agreements.** Any franchise agreements need to be examined; generally, approval is needed to transfer to a new owner. See Chapter 18, Hotel Franchises, for a complete discussion of the hotel franchise process.

## [j] Closing Documents and Procedure

[i] **Title deeds.** A deed to real property is a written instrument by which title to the property is conveyed by the owner (grantor) to the buyer (the grantee). A deed is not valid as between the grantor and the grantee unless it is delivered to and accepted by or on behalf of the grantee and it also meets the following requirements.

- ☐ Each grantor must be identified and he must be a competent adult. While there must be a valid consideration that is set forth in the deed, the actual consideration need not be set forth and nominal consideration may be stated.
- ☐ A deed must contain language (e.g., "grant and convey") that shows that the property is being conveyed and the property conveyed must be sufficiently described to identify it.
- ☐ A deed must be signed by the grantor, and under the statutes of some states, the signature must be witnessed and/or notarized. Generally, a deed must be delivered by the grantor to the grantee and, unless delivered, it is invalid and ineffective to transfer title. The grantee must be in existence at the time the deed is delivered.

Deeds are of several different types; the key distinction among them is related to the precise responsibilities that the grantor assumes in connection with the conveyance. These responsibilities are called warranties. A warranty combines a representation that a certain state of facts is true and the responsibility to make good any damages if the facts turn out to be otherwise.

- ☐ *General warranty deed.* This deed includes the broadest warranties by the grantor and so would be most preferred by the grantee. In fact, it is the most common method of transferring title in this country. A warranty deed usually contains four basic covenants:

1. The covenant of seisen, by which the grantor represents that he in fact owns the property
2. The covenant of the right to convey

3. The covenant against encumbrances, that is, a representation that no claims exist against the property other than those specified in the deed or contract
4. The covenant of quiet enjoyment, by which the grantor represent that no person with superior right to the property can interfere with the grantee's use or possession of the property

☐ *Special warranty deed.* This is exactly the same as a general warranty deed with one important distinction. The grantor will be liable for the breach of his warranty only if the cause arose through the grantor's own act or during his period of ownership. The grantor thus disclaims any responsibility for defects that arose before he became the owner.

☐ *Bargin or sale deed.* This type of deed conveys title to property just as effectively as either kind of warranty deed but contains no covenants. Thus, it is also known as a deed without convenants.

☐ *Quitclaim deed.* While this deed, too, can effectively convey title, it is normally used as a means of surrendering a claim to property that may or may not be valid. In effect, the grantor under a quitclaim deed says "I don't know if I own this property, but if I do, I convey to you whatever rights I may have." This type of deed often is used to correct an error made in an earlier conveyance.

[ii] **Closings.** At the time of the closing, the seller will bring all the necessary documents necessary for the title to pass. This should include the deed to the property, and any documentary stamps that may be required will be attached to the deed at that time or immediately before recordation. The seller will also have with him any leases that pertain to the property. He will also bring the insurance policies covering the property (e.g., fire and extended coverage), certificates of occupancy, and all required government inspection documents.

The seller will also bring with him receipted bills for real estate taxes, water and sewer charges, and any other items as to which adjustments will be made at the closing. He may also bring a contract with the labor union representing the hotel workers.

In addition, the seller will have a bill of sale covering personalty ready for delivery to the buyer.

At the closing, the buyer will be ready to deliver a certified check for the approximate amount that will be due from him. While the adjustments are often approximated in advance of closing, they are computed accurately and finally, and often paid by check executed at the closing. The seller will want to obtain an owner's estoppel certificate from the purchaser if a purchase-money mortgage or deed of trust is to be assigned at the time title closes.

As already indicated, the adjustments are made at the closing, and the deed, any mortgages, release of mortgages, or other liens, the check or checks for the purchase price and the adjustments, and other documents are turned over to the attorneys for the parties or the title insurance company to be held until the deed and other documents are recorded. Recordation normally takes place as soon as possible after the closing.

### [k] Brokerage Commissions

Most hotel sales will involve a broker who brought the parties together. The sales contract should identify the broker; the party who is responsible for the payment of the brokerage commission; and the amount, time, and manner in which payment is to be made.

Generally, the seller will be responsible for payment of the brokerage commissions although the parties can agree otherwise. Assuming the seller is responsible for the brokerage commission, he will want to provide that the commission will not be payable unless and until the contract is closed and that it will not be payable if certain circumstances prevent the contract from being closed (e.g., purchaser unable to obtain financing). The brokerage contract is an important document in a hotel transaction and should be analyzed carefully before signing.

### [l] Miscellaneous Provisions

Although the discussion of the sales contract has been extensive, there are still many areas that the parties need to be aware exist although their discussion in detail is beyond the scope of this text.

1. Eminent domain and risk of loss
2. Assignment, successors, and heirs
3. Binding arbitration and other legal means of settling disputes
4. Controlling law

## ¶ 17.02 HOTEL BROKERS

This section discusses the importance of of hiring a professional broker when selling a hotel.

### [1] Creating a Story

Two of the most important factors in achieving the optimum price for a hotel are creating a competitive environment for that hotel and creating a "story." Every hotel has a story that describes its upside potential and opportunities for improvement. The better the hotel's upside potential, the greater the price the market will be willing to pay. Determining and understanding a hotel's highest and best use is the foundation of that hotel's story.

A hotel achieving only an 80 percent RevPAR penetration for its market may or may not be performing at its optimum potential; a hotel achieving a 130 percent RevPAR penetration, however, may or may not be achieving its RevPAR potential. No two hotels are the same physically or financially; none have identical market-demand generators or barriers to entry. Being able to reconcile all of the foregoing variables and accurately determine the weight that should be given to each is the difference between selling a hotel below market or selling a hotel above market. A professional hotel broker with an extensive transaction track record should provide great insight in sorting out the variables.

The story must be credible and intellectually defensible. If it consists of only "pie in the sky" projections, it will do more damage than good. A credible story, by contrast, places the foregoing variables in their proper perspective and can mean the difference of several million dollars in value. For example, consider a 300-room commercial hotel that recently sold at an enhanced price because of a competitive market. This hotel was in a city that had experienced the shutdown of a large military base, which had been the largest single provider of room nights to the city. The initial response of many to this loss of a major room-night generator was that it would hurt the hotel's future performance. However, it did not work out that way.

The military is lower-rated business than other commercial or leisure segments. This particular city ran a high annual city-wide occupancy. There were many days throughout the year in which tourist or commercial travelers who wanted to visit the city were unable to because of the lack of available rooms. With the absence of the military business, this city now can accommodate this latent or unaccommodated demand. As a result, occupancies remain the same as before the base closing, but average rates have grown significantly. Because the creators of the story of this hotel understood that the loss of the military base would ultimately be to the hotel's benefit, the price was enhanced.

## [2] Negotiating From Strength

A strong negotiating position is critical if a seller is to achieve the optimum proceeds from a hotel sale. The seller can lose proceeds from a sale in two ways if he attempts to market the hotel himself. First, purchasers discount the valid strong points made by a seller. If the seller describes the demand generators for a hotel as growing significantly over the next several years, a buyer will not only disregard this potential, but will argue, convincing himself, that the hotel's price should be based solely on the hotel's historic performance.

The second risk the seller runs by marketing a hotel himself is that the buyer wil detect any weakness in the seller's position. When a seller pushes a buyer for a decision, the purchaser often perceives this as anxiety and may negotiate a lower price than the purchaser was willing to pay. On the contrary, if a professional hotel broker pushes a purchaser for a decision, the purchaser may perceive the time being of the essence in order to beat the market. This perception and concern on the part of the purchaser may yield a price higher than the purchaser wanted to pay.

## [3] Capital

Another method a professional hotel broker uses to achieve the highest possible price is to be a steady source of capital. An intermediary should be in constant contact with the lowest-cost capital sources and the most creative financing techniques. Consider the following example, wherein the capital helps achieve a higher price.

A buyer perceives that a hotel will produce a $5,300,000 net operating income during its first year of ownership. This purchaser has a source of financing for 70 percent of the acquisition price at an interest rate of 9 percent and an amortization schedule of twenty years, and the purchaser is seeking a 12 percent first-year return on equity. The buyer determines that it can pay a purchase price of $47,500,000 for this hotel. A 70 percent loan is equal to $33,250,000 and the equity required is $14,215,000. Using the foregoing interest rate and amortization schedule, the annual debt service is $3,589,907. The resulting cash flow after debt service is $1,710,093. If the $1,710,093 is divided into the equity investment of $14,215,000, the resulting cash-on-cash return is 12 percent.

If the professional hotel broker is able to source a 70 percent first mortgage at an 8 percent interest rate for 70 percent of the purchase price, the purchaser can then pay $50,000,000 for the same hotel, producing the same income stream and still yielding a 12 percent return on capital.

Mezzanine financing is another case in which the capital can create value, giving the seller a higher price and the purchaser a higher return. This form of debt is subordinate to first-mortgage financing. It may or may not be secured by a second mortgage on the real estate. The cost of mezzanine financing is significantly higher than first-mortgage financing because of its higher-risk position; however, the cost is lower than market equity returns and occupies a priority position ahead of the purchaser's equity.

Assume that a purchaser is acquiring a hotel that is a turnaround opportunity. Although the hotel is currently producing a $500,000 net operating income, the purchaser believes that if the hotel had $5,000,000 invested in renovation and the franchise were changed, the stabilized cash flow of the hotel would be $2,000,000. The purchaser wants a 20 percent cash-on-cash return on his equity. Assume that the first mortgage is 70 percent of loan-to-cost at a debt constant of 10 percent. On the basis of a $2,000,000 stabilized net operating income, the purchaser could pay a purchase price of $10,384,615. That price plus the $5,000,000 renovation makes the total investment $15,384,615. The first mortgage is 70 percent of the total investment—$10,769,231. With a 10 percent debt constant, the annual interest payments on the first mortgage are $1,076,923. The equity, 30 percent of the total investment, is $4,615,385. Subtracting the annual debt service of $1,076,923 from the $2,000,000 net operating income yields a total of $923,077, which is a 20 percent return on the purchaser's equity.

If, instead of the purchaser making a 30-percent equity investment, a mezzanine lender invests half of the equity capital, a higher price can be paid for the hotel. Again, assuming that the purchaser's goal is a 20 percent cash-on-cash return on the stabilized year in which this hotel produces a $2,000,000 net operating income, the use of mezzanine financing can allow the purchaser to be more aggressive against the market and pay $11,326,531 for the hotel—a 9.1 percent increase. In this structure, the first-mortgage lender again makes a 70 percent loan to the total development cost. The purchase price is $11,326,531 plus the $5,000,000 renovation, making the total investment $16,326,531. The 70-percent first mortgage is now $11,428,571, and the annual debt service is $1,142,857. The mezzanine lender in this scenario has a 10 percent interest-only rate and participates in 20 percent of the resulting cash flow. The total debt service of the first-mortgage mezzanine lender is $244,898, resulting in a cash flow after debt of $612,245. Twenty percent of this cash flow is paid to the mezzanine investor and 80 percent is paid to the purchaser. Because the mezzanine lender put up half of the equity, the purchaser has invested only $2,448,980. After the debt service has been paid and 20 percent of cash flow is paid to the mezzanine investor, the cash flow available to the purchaser is $489,796, which is a 20 percent cash-on-cash return to the purchaser.

Obviously, if the purchaser were able to acquire this hotel at the original price of $10,384,615 and use the mezzanine structure, the purchaser's cash-on-cash returns would increase dramatically. In this example, the returns would be $553,846, which is a cash-on-cash return of 24 percent.

## [4] Marketing a Hotel

A professionally assembled marketing package requires 150 to 200 work-hours. Because the marketing package should be designed to convince a purchaser to part with millions of dollars to own a hotel, it must be more than an accumulation of facts. Some packages contain volumes of information but are uninteresting and unpersuasive. A marketing package should succinctly describe a hotel's potential for future cash flow and capital gain increases. An accurate and effective description of this potential can justify a higher price than a review of a hotel's historical performance.

Consider two properties—Property *A,* a hotel at a 12 percent capitalization rate with a cash flow that will remain steady for the next five years, and Property *B*, a hotel at a 9 percent capitalization rate, the cash flow of which will grow at 15 percent per year. Assuming that both hotels originally produce $1,000,000 in cash flow, their purchase prices would be $8,333,333 or $11,111,111, respectively. Property *A*'s cash flow five years from now is still $1,000,000. Assuming that this hotel sells at a capitalization rate of 12 percent, the unleveraged internal rate of return is 12 percent. With Property *B*'s cash flow increasing at a compounding annual rate of 15 percent, at the end of five years, its cash flow is $1,749,006. Assuming it sells at the same 12 percent capitalization rate, its unleveraged internal rate of return is 18.6 percent.

Realistically, Property *B*'s historic rate of growth will allow it to sell at a lower capitalization rate than Property *A*, increasing the already-higher return. An effective marketing package should effectively explain the hotel's growth potential to justify a greater than a "back of the napkin" value calculation.

To market a hotel, significant work-hours are required to make successful sales presentations to purchasers. All information in a presentation should be provided to a prospective purchaser in the context of what that purchaser wants. In other words, each presentation must be custom-made for each prospective purchaser. This can be done only in a one-on-one, give-and-take presentation, and a substantial number of work-hours per presentation is required.

First, a prospective purchaser's existing business and its wants and desires must be understood. This requires an interview. An in-person, face-to-face interview is more effective than one conducted by telephone. To arrange a face-to-face meeting, one to two hours are required. If the prospect is in a different city, an entire day is required to accomplish the interview. Because other work can be done during travel, five hours is a fair estimate of the amount of time needed to accomplish the interview. One hour is required either by telephone or in person to present a hotel's full potential and two hours of follow-up per prospect are required, on average, to determine its interest. To generate ten interested prospective purchasers, at least 100 presentations must be made. This means that, at an average work-hour requirement of 10 hours per presentation, 1,000 work-hours are required to effectively market a hotel. This does not include negotiating the transaction, purchaser's due diligence, purchase and sale agreement negotiation, or the closing process. If performed by one person on a fifty-hour work week who exclusively markets that hotel, forty weeks would be required to perform the marketing function alone. This length in chronological sequence required would prevent a competitive market from being achieved. A prospect whose interest was generated during the first month would most likely not be be willing to wait for the marketer to complete the comprehensive process through the tenth month. Negotiations in a vacuum—with only one prospective purchaser at a time—are likely to result. This takes the competitive environment out of the process and, most likely, will result in a lower transaction price.

Only a professional hotel brokerage organization can provide the required work-hours in a rapid and efficient manner. First, a professional brokerage firm with a long history in the industry has already performed the interview step before even taking the assignment to market a hotel, cutting the required work-hours in half. Second, if the brokerage firm has a multi-person sales force, multiple presentations can be made simultaneously. This can reduce a nine- to ten-month marketing process to a matter of weeks. Additionally, showings can occur back-to-back when a firm has a multi-person sales force.

It is an often-stated truism that "time kills all deals." The professional hotel brokerage firm should greatly increase an owner's closing percentage.

### [5] Preventing Disruptions

All sellers must take measures to prevent disruptions at their hotels. If, for example, the direct management and leadership of a hotel becomes disgruntled or discouraged, the hotel's performance could decline. A negative trend in business could affect the price or derail a closing process.

The hotel brokerage professional can assist in minimizing disruption to the hotel's operations, and the owner can take several steps as well. First, the general manager of the hotel should be informed of the owner's intention to sell and should be made a part of the process. Obviously, the general manager can be quite apprehensive. An owner should structure a bonus for the general manager if the hotel is sold. This bonus should be significant and should be paid regardless of whether the general manager remains at the hotel to work for the new owner.

One potential cause of disruption is the presence of propspective purchasers at the hotel prior to the sale. Understandably, the purchasers will want to spend time at the hotel before buying it to learn as much as possible about it. Unfortunately, their presence could serve to disrupt or otherwise affect the direct management of the hotel. The hotel broker can alleviate this potential problem by providing comprehensive information to a prospective purchaser prior to the purchaser's ever inspecting the hotel. If the broker has diligently provided this information, inspection time at the hotel can be minimized.

## ¶ 17.03 LIKE-KIND EXCHANGES

Today's competitive business environment has forced many changes within the hospitality industry as well as the constant restructuring of hotel properties. In many cases, financing new hotel properties has also become increasingly difficult. Thus, it is more important than ever that hospitality business owners be creative wherever possible in developing cost-saving strategies to achieve their goals.

One strategy often overlooked by hospitality owners is the use of like-kind exchanges to acquire property. The following discussion reviews some alternative methods of like-kind exchanges, which may provide new business opportunities for the hospitality owner as well as lucrative tax benefits.

### [1] Advantages

An exchange of hotels, or an exchange of business property for a desired hotel property, represents one creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, because appreciated property can be exchanged without incurring any tax on the appreciated gain. The deferral of the gain is what makes like-kind exchanges such a valuable tool for hotel owners.

Consider the following example: a hotel owner in New York wishes to retire to Florida but remain active in the business. The individual might be able to find a property suitable to his needs in Florida, one that has an ambitious young owner anxious to relocate to a potentially faster growing market in New York. The two get together, simply exchange properties, and completely avoid tax liability on the appreciated gains of the two hotels. Other valid reasons for engaging in a like-kind exchange might be to reposition one's property into a different market, obtain property that will allow for expansion, allow investors into the hotel business with the exchange of different property; or to allow a hotel owner to leave the hospitality business and obtain other business property without paying any capital gains tax.

Business owners may also have non-business reasons for exchanging property under IRS like-kind exchange rules. It is a commonly used strategy in estate planning to defer taxes on appreciated property. For example, an owner would be required to pay substantial capital gains tax in an out-and-out sale of property that had significantly appreciated in value over the years. If the owner exchanges the property for property at another desirable location, however, all capital gains taxes are deferred until the property is eventually sold. In some cases, in fact, the gain on the property may never be taxed if the owner dies before it is sold and the property is passed on to the heirs.

IRS stepped-up basis rules essentially allow heirs to inherit property at the fair market value of the property at the time of the owner's death. This applies even if the deceased owner had very little basis left in the property. Thus, if the heirs sell the property at fair market value shortly after the owner's death, there is no gain to report. In this case, the basis equals the value of the property. This is known as receiving property that has been "stepped-up" to its fair market value at the time of death. Of course, estate taxation is a difficult, complex area of the law. A business owner getting on in years would be wise to talk to his tax adviser on whether the use of like-kind exchange as an estate planning tool would be advantageous or not in his or her specific circumstance.

There are several important reasons why the hotel industry is ideal for using business options such as like-kind exchanges. For one, the hotel industry is considered a specialized component of real estate and it is treated very favorably under like-kind rules. Second, the hotel industry is subject to market saturation. Therefore, there are a great many excellent hospitality properties operating in the market, providing a multitude of possibilities for an owner wishing to exchange properties to enter a desired market or better fit his or her strategic goals.

## [2] General Requirements

A like-kind exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money only. But an exchange can occur even where cash (boot) is part of the consideration, if the transaction otherwise qualifies as a like-kind exchange. Like-kind property must be both given up and received in the exchange in order to satisfy the "exchange" requirements.

There are several requirements that must be met for a taxpayer to take advantage of a like-kind exchange. The exchanged property must be:

1. Held for the productive use in a trade or business, or for investment; and
2. Exchanged solely for property of a like kind, which is to be held for either productive use in a trade or business, or for investment.

If a taxpayer has a qualified like-kind exchange transaction in any given year, he or she is required to file the transaction on IRS Form 8824 along with his or her regular tax return.

## [3] Real Estate Qualifications

Whenever making business decisions in accordance with the Internal Revenue Code it is imperative to look closely at the language to determine the exact meaning of the statutes. For example, "like-kind" as used in this chapter means "alike in terms of nature or character of the property." It does not refer to its grade or quality. Thus, one class of property cannot be exchanged for another class.

This means that real estate can not be exchanged for personal property. However, when real property is exchanged for real property, it does not matter whether the property is similar, or even whether one of the properties is unimproved. Thus, the exchange of vacant land for a hotel would qualify under the like-kind exchange rules. The existence or lack of improvements merely affects its grade or quality, not its class.

The following examples of exchanges have been held to qualify as like-kind transactions:

- Rental housing for farm property.
- A commercial building for a condominium interest in a newly constructed commercial building.
- Real property subject to a lease for real property not subject to a lease. The existence of the lease affects the grade and quality of the property, rather than its nature and character.

Consequently, a hotel could be exchanged for a different type of business real estate and be within the like-kind exchange guidelines. For example, a hotel owner could exchange his property for a bowling establishment. The transaction would still qualify under the like-kind exchange rules, because both the properties are classified as real estate.

There are certain properties that do not qualify for tax-free exchange (e.g., inventory stocks, bonds, and partnership interests). The property for exchange must be similar in nature or character to the transferred property, notwithstanding differences in grade or quality as shown in the preceding examples.

However, there are cases in which real estate exchanges are not considered as like-kind exchanges. Listed below are some circumstances under which a real estate transaction will fail to qualify under the like-kind exchange rules:

1. *Foreign property.* This is never considered like-kind property under the like-kind exchange rules.
2. *Sale of an apartment building in which the taxpayer used the proceeds from the sale and other property to acquire a like-kind property.* The fact that the taxpayer first sold the property invalidated any exchange opportunities.

It is important to keep in mind, however, that the IRS rules regarding property exchange transactions are mandatory, not optional. In a transaction structured as an exchange, all gain must be deferred on the property. Although this is generally good strategy, there are times when this should not be done. These occasions are discussed subsequently in this chapter.

## [4] Utilizing Deferred Exchanges

One of the biggest controversies involving like-kind exchanges occurs when exchanges are deferred, or do not take place at the same time. Because the Supreme Court stated in the now famous *Starker* case that exchanges do not have to occur at the same time to qualify as like-kind, Congress acted in 1984 to stipulate exchange time limits. It was not until 1991, however, that the IRS finally got around to issuing regulations that provided rules for complying with the deferred like-kind exchange requirements.

A deferred exchange is defined as an exchange in which, under the terms of the agreement, the taxpayer transfers qualified property (relinquished) and after the transfer, receives qualified property (replacement property).

Strict requirements have been established concerning when exchanged property must be identified and accepted in the exchange for the "like-kind" aspect to qualify the exchange as tax free. The property will not qualify as like-kind property if:

1. The replacement property is not identified as property to be received in the exchange within forty-five days after the date on which the transferor transfers the old property (the identification period requirement); or
2. The replacement property is not received by the earlier of 180 days after the date on which the transferor relinquishes the old property, or by the due date (including extensions) for the transferor's tax return for the taxable year in which the old property is transferred (the exchange period requirement).

An example how of the deferred exchange rule might work is as follows: On May 17, pursuant to a deferred exchange agreement, hotel owner Astor transfers his 100 room hotel property with a fair market value of $200,000 to Baker for a hotel property to be identified later. On or before July 1, (the end of the 45-day identification period), Astor is required to identify the like-kind replacement property to be received from Baker. Astor must then receive from Baker on or before November 13 (180-day receipt requirement) the property identified as the like-kind replacement property.

Neither party can extend the foregoing limitation periods for any reason. Therefore, if a hotel owner fails to identify replacement property or take possession of the replacement within the required time limit, the transaction will not be treated as a like-kind exchange. The gain on the transaction would thus be taxable.

For a hotel owner to properly identify any replacement property, he or she must send a description of the property in writing to the qualified parties before the end of the forty-fifth day. If the replacement property is transferred to the hotel owner before the forty-fifth day, the identification requirement is satisfied.

The hotel owner can identify more than one property when using the deferred exchange method. A hotel owner can, subject to the "three-property" and "200%" rules (explanation to follow), identify more than one replacement property regardless of the number of properties he has relinquished in the same exchange. Under the three-property rule, a hotel owner can select up to three properties without regard to their aggregate fair market value. Alternatively, a hotel owner, under the 200% rule, can select any number of properties as long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of all the relinquished properties.

Using the preceding example, Astor on May 17 transfers his 100-room hotel valued at $200,000 to Baker. On or before July 1, Astor is required to formally recognize the like-kind replacement property. Astor identifies three potential hotel replacement properties (Properties 1, 2, and 3) in a written document that he signs and personally delivers to Baker on June 28. The written designation also provides that Astor will orally inform Baker by Aug. 1 which of the three identified hotel properties he wants to receive. Since Astor did not choose more than three properties, all three have been properly identified before the end of the identification period. It does not matter whether the aggregate fair market value (i.e. $500,000) exceeds 200% of the fair market value of the relinquished property ($400,000).

## [5] Related Party Transfers

There are specific rules covering transfers among family members. There is a special two-year holding period requirement for exchanges between related parties. This rule requires the hotel owner to report to the IRS on the property in the sale year of the like-kind transaction and again at the end of the two-year holding period. The related party rule does not bar like-kind exchanges between related partners; it merely imposes a two-year holding period.

Related parties for purposes of this rule include most family members and corporations in which the party holds more than 50 percent ownership. Special rules also govern transactions between partnerships and their partners.

There are three exceptions to the two-year waiting rule, permitting a holder to claim a nonrecognition provision for the like-kind exchange:

1. Any disposition of the property after the death of either the taxpayer or the related person.
2. Any disposition that is caused outside the control of the taxpayer, such as an involuntary conversion.
3. Any disposition to the satisfaction of the IRS that the main purpose was not to avoid income tax on the transaction.

Any taxpayer who feels that he or she may qualify for an exception to the general rule must attach an explanation to his or her tax return explaining the qualifying exception.

## [6] Determining Basis

Generally, the basis of property acquired in a like-kind exchange is the same as the basis of the property transferred. There is an exception, however, if money (called "boot" by accountants) or certain debt is involved.

Many times in a like-kind exchange, the properties will not be equal. The taxpayer may receive or give money, or other property, to equalize the transaction. As previously stated, the basis of property received in a like-kind exchange is the same as that of the property given up.

If money or other property not of a like-kind (boot) is received in the exchange, gain is recognized, but only to the extent of the money or boot received. If a party to the exchange assumes debt on the property, or acquires property from the taxpayer subject to a liability, then the debt assumption will be treated as boot.

It is important to remember that even if the taxpayer receives boot and shows a loss, the loss is not recognized under like-kind exchanges. Therefore, the taxpayer needs to be careful to analyze the transaction in terms of the possibility of realizing a loss. If a loss is probable, the trade must be structured so that the transaction does not qualify as a like-kind exchange. The same rules apply to recipients who receive money or property not qualifying as like-kind exchange property in a deferred exchange.

When a person gives boot instead of receiving boot, the non-recognition rules still apply to the person giving the boot. However, a taxpayer could recognize gain if certain nonqualified property is given as boot in the exchange.

A common practice is to give and receive property subject to a mortgage. The assumption of a liability or a transfer subject to a liability is treated as boot. The taxpayer who assumes a liability or accepts property subject to a liability receives boot.

If each party to an exchange assumes the liability of the other party, the liabilities assumed by one party are offset against those assumed by the other. Only the excess is treated as part of the boot given or received. The following example will help explain how debt exchanges work.

*Example:* Hotel owner *A* in New England owns a property that has an adjusted basis of $80,000. It is subject to a $70,000 mortgage. He makes an exchange with hotel owner *B* for realty on another hotel in Florida worth $120,000, which is subject to a $50,000 mortgage. In addition, owner *A* receives $10,000 in cash. The gain *A* recognizes on the exchange is $30,000, computed as follows:

**TABLE 17-1**

| | | |
|---|---|---|
| **Hotel owner *A* received:** | | |
| Property worth | $120,000 | |
| Cash | 10,000 | |
| Mortgage on hotel given in exchange (treated as cash received): | 70,000 | |
| Total consideration: | | $200,000 |
| **Hotel owner *A* gave in exchange:** | | |
| Hotel at its adjusted basis | $80,000 | |
| Mortgage on Property received (treated as cash paid): | 50,000 | |
| Total given: | | $130,000 |
| Maximum recognizable gain to *A*: | | $ 70,000 |

In this scenario, however, the amount of gain recognized is limited to the net cash received by hotel owner *A*. If the mortgage on the property given is counted as cash received and the mortgage on the property received as cash paid, or $30,000, it computes as follows:

**TABLE 17-2**

Mortgage on property given up by hotel owner *A* [$70,000] –
Mortgage on property received by hotel owner *B* {50,000) =
Net reduction of hotel [$20,000]

Owner *A*'s indebtedness [$20,000] +
Cash paid to hotel owner *A* [10,000] =
Gain recognized by hotel owner *A* [$30,000]

The final calculation a hotel owner needs to make in analyzing a like-kind exchange is to determine the tax basis for the properties. The tax basis is the value that the IRS recognizes when and if a property is sold. Generally speaking, the basis of the new property is the same as the property exchanged. However, if boot was given or received in the exchange, the basis on the new property could be affected.

If any gain is recognized because of receipt of money or other boot, the basis of all the property received is adjusted to include the old property, increased by the gain recognized and decreased by the money received.

If a loss is realized, but not recognized in an exchange in which a taxpayer receives money or other boot, the basis of all the property received is the adjusted basis of the old property, decreased by the money received.

The following is a simple formula for determining basis of property acquired in a like-kind exchange:

**TABLE 17-3**

| | |
|---|---|
| Adjusted basis of old property | $ ...... |
| Add: | |
| Cash or value of non–like-kind property given | $ ...... |
| Gain recognized | $ ...... |
| Subtract from this total: | |
| Cash or non–like-kind property received | $ ...... |
| Loss recognized on non–like-kind property given (excess of adjusted basis over trade-in allowance) | $ ...... |
| The resulting total is the basis of the new property. | |

Finally, a hotel owner must carefully examine his basis to determine whether property transferred will actually result in the deferral of a gain, and not a loss. This is an important concept to remember, because there are situations when it might be more beneficial for a business owner to structure such a transaction so that it is taxable. In this case the hotel owner will want to intentionally avoid meeting the like-kind exchange requirements, because the rules are not optional.

For example, a hotel owner may want to recognize gain, because he or she has just recently experienced a loss, which could be offset by a gain on the trade. This results in the hotel owner's getting a higher basis for the property received, which in turn, results in larger depreciation deductions.

The like-kind exchange rules are a valuable planning tool often overlooked by hospitality owners. Like-kind exchanges allow property relocation without recognizing any taxable gain on appreciated real estate. Like-kind exchanges can also be used as a strategy for family members wishing to exchange properties to better position family holdings. Finally, the like-kind exchange can be a valuable estate planning tool. Since step-up rules regarding estates value inherited property at fair market value at the time of an owner's death, taxes on his or her deferred gain may never be realized. Although like-kind tax rules appear complicated, the opposite can be true. The rules actually allow considerable flexibility in choosing properties to exchange. In addition, since any recognizable gains are usually very minor, compared with deferred gain on appreciated property, the tax benefits could be substantial.

# CASE STUDY: ¶ 17.04 How Investor Raised Cash To Acquire A Profitable Hotel

Mr. Comer Mann, an experienced hotel investor, wanted to acquire a going hotel that produces an annual operating profit of $1.68 million. The hotel has been doing well for several years, and its profits show an upward trend, as can be seen from the following table:

| Year | Gross Income From Operations | Net Profit From Operations |
|---|---|---|
| 1992 | $ 8,200,000 | $1,300,000 |
| 1993 | 9,000,000 | 1,425,000 |
| 1994 | 10,100,000 | 1,680,000 |

The owner, recognizing the earnings trend, insisted on a total price of $22 million for the hotel. This price covered the land, building, and the supplies, furnishings, and equipment. In addition, he wanted it all in cash.

The hotel was owned free and clear of any mortgages or other liens or encumbrances. It is 40 years old; it has 635 guest rooms and meeting rooms, and has a small ballroom that can accommodate 200 people. The hotel also has a food and beverage operation that accounts for almost 30 percent of its gross revenues.

Mr. Mann believed that if he acquired the property he could increase its operating profits within three years to as much as $2.3 million annually, because the hotel business is booming and the present owner has become less attentive to controlling operating expenses. However, he could not acquire the property unless he found some way that made its acquisition feasible for him. Whatever financing plan he came up with would, or course, have to take into account his front-end fees, expenses, and some immediate profit. He expected these "add-ons" would amount to some $500,000 as follows:

| | |
|---|---|
| Legal fees | $ 75,000 |
| Accounting fees | 25,000 |
| Commissions and finder's fees | 150,000 |
| Promoter's profit | 250,000 |

The total required was $22.5 million.

## [1] METHODS CONSIDERED BY INVESTOR

Mr. Mann's task was to figure how approximately $1,680,000 of annual cash flow could service $22.5 million of financing. He began to think of the prices he would have to pay to attract various sources of investment funds.

### [a] Why $22.5 Million Could Not Be Raised From Tax-Shelter Investors

The lowest price would be demanded by individual investors seeking a tax shelter in the form of large passive losses. If the reportable annual tax losses from the investment could be sufficiently high, these investors would be willing to invest with either no cash return or a cash return ranging up to 7 percent a year. But, there were two problems.

First, even though this was an older hotel with a lot of personal property which had short depreciable lives, not enough annual depreciation deductions could be generated during each of the first five years to satisfy an investor.

Second, a 100 percent equity investment can never be an attractive tax-shelter investment. The reportable annual losses can never be stretched to amount to a significant percentage of the capital contribution. For those investors who want to obtain reportable losses in the first five to eight years in an amount that is greater than their capital investment, their capital investment cannot represent a large proportion of the total cost of acquiring the depreciable assets.

### [b] Why a Tax-Exempt Bond Issue Was Not Available to Investor

Mr. Mann knew that the next cheapest money would be municipal bond money, i.e., the proceeds from the sale of tax-exempt bonds issued by states, cities, and certain governmental authorities. Such investors require a return of 7 to 7.5 percent a year if the bond is issued by a creditworthy issuer and the annual interest payments are tax-exempt. Such financing may be available for the construction of new housing or industrial properties or for the rehabilitation of existing housing, but it is not available for the simple acquisition of an existing commercial hotel whose function will not be changed.

### [c] Other Sources of Funds

Among the other possibilities that occurred to Mr. Mann were:

1. Selling off the land to an investor who wanted a very safe investment and did not need any reportable losses. If the land was not worth more than about 25 percent of the total value of the land and building, the safety of the investment would be so great as to warrant paying a price as low as 7.5 percent per year for the money.
2. Finding equity investors who wanted an annual cash return but did not seek large amounts of tax shelter. Mr. Mann knew that if there was no significant amount of tax shelter to offer, equity investors could be found but would require at least a 9 percent cash return. They would have to be convinced that, in the long run, they could do better investing in this property than in making long-term savings bank deposits, which would pay them 6 percent or so, and would be much less illiquid than a real estate investment. Mr. Mann believed that investors could be found who would put up part of the money he needed, but he did not believe he could raise the full $22.5 million solely from this source.
3. Conventional first mortgage lenders. This source used to be the obvious first choice for financing an acquisition. However, Mr. Mann realized that if he sought even a 70 percent mortgage, that is, a first mortgage of $15.75 million, he would probably have to pay a constant of about 11 percent, or $1,732,500, which would leave him no cash flow available to service the remaining $6.75 million which had to be raised.
4. Financing with first and second mortgages was obviously impossible in this transaction, because second mortgage money, even if it was available, would cost Mr. Mann between 3 percent and 8 percent per year more than first mortgage money. The property simply did not earn enough to carry such a debt structure.

Mr. Mann knew that he would have to break up the investment into a number of different positions that would offer different attractions for investors pursuing a range of different objectives. This is what he did.

### [2] Investor Created a Ground Lease and a Leasehold Mortgage

Mr. Mann was able to arrange for the sale of the land, without the building or improvements, to a pension trust for the sum of $5 million; simultaneously, he leased the land back from the trust under a long-term net ground lease calling for a basic annual rent of $375,000. The ground lease was to run for an initial term of 25 years and figured to provide an annual return of 7.5 percent to the trust. The lease gave the lessee several options to renew for additional terms totaling 80 years. It also called for reappraisals of the land at the end of the first 15 years and thereafter at intervals of 10 years. The rent, on each reappraisal, will be fixed for the next 10 years at the higher of (1) the ground rent during the lease period then ending or (2) 7.5 percent of the fair market value of the land alone if the land was devoted solely to hotel uses.

Mr. Mann, having created the long-term ground lease, then obtained a leasehold and building mortgage loan of $9 million which was to run for a term of 15 years and bear interest at 9.5 percent. The annual debt service came to $945,000, or a 10.5 percent constant. When it matured at the end of 15 years, there would be a balloon of about $6 million.

The leasehold mortgage lender was a large savings bank. The mortgage covered both the lessee' interest in the ground lease and the fee title to the building. The mortgage was subordinate to the fee interest. Because of this, it was not necessary to obtain the consent of the pension trust, as owner of the land, to the terms of the leasehold mortgage. The lender agreed to this because it had appraised the entire property at $23 million, and regarded the land rent as representing only about 22 percent of the value or earnings. If the mortgagor defaulted under the mortgage, the lender could not foreclose the pension trust's fee interest, but could only become the lessee under the ground lease and the owner of the improvements.

### [3] How Investor Then Syndicated the Enterprise and Created a Subleasehold Operating Position

Mr. Mann then decided he could raise the remaining $8.5 million by organizing a limited partnership to own the leasehold estate and the building, and selling (syndicating) $8.5 million of limited partnership shares to passive investors. Because the leasehold mortgage was a nonrecourse mortgage, Mr. Mann was able to offer his investors tax deductions and no risk of personal liability.

At the same time, he chose to create an operating position in a Hotel Operating Company (HOCO), a separate partnership composed of himself and five of his business associates. HOCO sublet the entire property from the partnership under a long-term net sublease which ran from the partnership, as sublessor, to HOCO, as sublessee. This net lease was also for an initial term of 25 years and gave HOCO options to renew for additional terms aggregating 80 years. The basic annual rent HOCO would pay under the sublease came to $1,745,000. This sum was arrived at as follows:

1. $375,000 (annual ground rent to the fee owner) plus
2. $945,000 (annual debt service under leasehold mortgage), plus
3. $425,000 (representing a 5 percent annual cash return before taxes to the syndicate investors), plus a participation in future profits.

This basic rent was somewhat higher than the earnings produced by the hotel at that time. However, the pattern of increasing earnings made it reasonable for Mr. Mann to undertake the risk. What's more, the sublease gave the sublessee the option to walk away from the deal at any time after the first three years without the landlord's consent, and upon an assignment HOCO would have no further liability.

The sublease also contained a profit-sharing formula. HOCO, the sublessee, could retain the first $155,000 of profits after paying $1,745,000 of basic rent annually. If profits exceeded $155,000, HOCO could keep one-half of the excess and pay the other half as coverage rent to the sublessor.

Mr. Mann could have used a general partnership as the legal vehicle for the syndication group. By creating an independent operating sublessee, he removed the risk of any of the investors being liable for the operation expenses of the property. However, he chose to use a limited partnership as the legal form because many investors have become accustomed to it. (They have some hesitancy about entering a general partnership even if they know they have been legally and totally separated from the conduct of the activities that could result in liability.)

Mr. Mann had considered taking a limited partnership interest along with the investors, instead of creating the net sublease. The cash investors would have been entitled to the first available distributions up to $425,000 in each year. Then Mr. Mann's limited partnership interest would have received the next $155,000 of each year's distributable operating profits. If the annual operations produced more than $580,000 of distributable cash (after payment of ground rent and leasehold mortgage debt service), the excess would be divided half to Mr. Mann and half to the other investors. He decided against this course because he preferred to have the sublease, which was a separate, salable asset.

In addition to their 5 percent cash return, Mr. Mann could offer his syndicate investors the benefit of annual depreciation deductions of approximately $959,000 in the first five years of their investment as follows:

| Asset | Basis | Recovery Period | Annual Depreciation |
|---|---|---|---|
| Building | $14,000,000 | 39 years | $359,000 |
| Equipment, furnishings, & supplies | $ 3,000,000 | 5 years (average) | $600,000 |

After the fifth year of their investment, the syndicate investors would no longer receive depreciation deductions for the furnishings and equipment because their replacements would be paid for by the sublessee. At that point, however, they had the expectation of an increased cash flow, most or all of which would be tax-sheltered.

CHAPTER 18

# Hotel Franchises

## ¶ 18.01 INTRODUCTION

A hotel franchise is essentially an agreement between a hotel chain (franchisor) and a hotel owner (franchisee) wherein the hotel chain allows the owner to make use of the chain's name and services (e.g., a central reservation system and defined operational procedures) in return for which the hotel owner pays the hotel chain a franchise fee. Under such an agreement, the chain has no ownership or financial interest in the hotel and is not directly responsible for its economic success.

Hotel companies involved in franchising generally start off as small chains made up of company-owned properties. Over time, they develop a concept, image, and brand name that prove successful in attracting customers. Specific operational procedures (known as the mode of operation) are established that produce a profitable level of efficiency. When the lodging product thus developed becomes successful, and it can be demonstrated that hotel owners using the brand name and mode of operation of the company will also be successful, the hotel company is able to franchise its concept and procedures.

One of the first franchise agreements in the hotel industry occurred in 1907 when Caesar Ritz allowed his famous name to be used on hotels in New York City, Montreal, Boston, Lisbon, and Barcelona. Modern hotel franchising started during the 1950s, when hotel construction resumed after the end of World War II. Hotel chains, realizing that their name, image, goodwill, established patronage, mode of operations, and reservation system all had value, turned to franchising their brand names and modes of operation as a rapid, inexpensive, and profitable means of expanding their holdings. Hotel developers were drawn to this idea because it gave a new hotel an immediate identity and a set of established systems and procedures that provided both lenders and investors with confidence that the property would be financially successful.

Some of the hotel chains that first offered franchises were Holiday Inns of America, Inc.; Howard Johnson's Motor Lodges; and Ramada Inn Roadside Hotels. The first Holiday Inn was a company-owned motel that opened in Memphis, Tennessee in 1952. By 1954, Holiday Inns started to franchise, and within a few years, franchises represented the bulk of the properties with which the company was involved.

Howard Johnson, a successful restaurant company that was founded in 1925, started franchising motor lodges in 1954. These were generally rooms-only facilities constructed in conjunction with freestanding Howard Johnson restaurants. The motor lodges and restaurants were often separately owned and operated.

Ramada Inn started out as a chain called Flamingo Motor Hotels in 1952. The name was later changed to Ramada Inn Roadside Hotels in 1958 when the company started successfully franchising.

Hotel franchising flourished during the 1960s and 1970s when a building boom, fueled by financing made available through real estate investment trusts (REITs), spurred the development of thousands of new hotel rooms. When the benefits of a chain affiliation became apparent to sophisticated hotel investors, particularly mortgage lenders, either a franchise or a first-tier management contract became almost a standard requirement of any development or acquisition deal. At present, very few hotels are developed as independents.

## ¶ 18.02 ADVANTAGES FOR FRANCHISORS

### [1] Inexpensive, Rapid Expansion

Hotel companies that seek to become major chains often use franchising as a growth vehicle, because doing so generally requires a relatively modest capital investment compared with developing or acquiring properties on their own. In addition, franchising does not require the extensive management structure that is needed to operate a hotel management company. Depending on the up-front cost of a central reservation system, the capital required to start a franchise chain can be as low as several hundred thousand dollars for legal expenses, promotional material, and start-up costs. The bulk of the expenses for a franchise company consists of the advertising and promotional efforts needed to sell franchises and obtain the critical mass of franchisees required in order to have an economically viable chain.

Another cost-saving aspect of a franchise system is that development responsibilities are shifted to individual property owners. Because these parties typically have first-hand knowledge of local real estate and business markets, they are usually in a better position than a franchisor to acquire the best sites and to handle the overall development process.

The capital that makes a franchise organization grow comes from the owners of the individual hotels in the form of fees. Franchisees assume the major portion of the financial risk associated with opening a new hotel, but in return receive most of the economic rewards.

### [2] Profitable Source of Revenue

The revenue generated by a hotel franchise chain typically starts with initial fees paid by franchisees when they join the franchise system, along with ongoing royalty fees. In addition, some franchisors require additional payments for services that they provide, such as marketing, advertising, reservations, frequent traveler programs, and training.

The expenses incurred by franchisors that are chargeable against these fees are generally for services provided by the franchisor and are usually minimal. Many of the services provided by franchisors generate fixed fees (e.g., centralized reservation systems, chain directories, and various administrative functions), so a franchise chain must have a sufficient number of properties under contract in order to be profitable. Once the number of franchisees reaches this level (the "critical mass"), the franchise company typically grows to become extremely profitable. Depending on the nature of the services provided by the franchisor and the fees charged the franchisees, this critical mass of properties can range in number from twenty to fifty.

Because many franchise companies also own hotels or operate properties under management contracts, franchising offers a means of spreading the fixed operating costs of the owned or managed facilities among franchised properties, thereby achieving the necessary critical mass in a shorter period of time.

## [3] Customer Recognition and Brand Loyalty

Customer recognition is an important attribute for a hotel chain. While recognition can be created through advertising and promotion, one of the best methods of developing a known hotel brand name is to have a product for people to see and use. Having hotels in both popular destinations and in the cities en route to the destinations (known as feeder cities) provides potential customers with the opportunity to see or hear about the chain before selecting their overnight accommodations. Most people are very particular in their choice of sleeping facilities; product knowledge (either first-hand or second-hand) is an important factor in the selection process.

The rapid growth potential offered by franchising accelerates the essential process of creating customer recognition. Once customers recognize a hotel product and have been satisfied after using it, brand loyalty develops, which results in repeat patronage along with positive word-of-mouth promotion.

## [4] Income From Brand Name, Trademarks, Image, and Goodwill

Most hotel companies that offer franchise affiliations started in the industry by developing or acquiring properties that they owned or managed. Over time they created a brand name and trademarks that in turn developed consumer image and goodwill. Further development of the companies included a mode of operation consisting of a home office management structure, operating systems and procedures, and in most instances, a central reservation system and marketing network.

This entire package, particularly the established consumer image and goodwill, has special value for an independent hotel in need of identity and image. Franchising converts this intrinsic value into income for the franchisor. There often is a direct relationship between a hotel chain's consumer image and goodwill and the volume of franchise fees generated on a per-property basis.

# ¶ 18.03 DISADVANTAGES FOR FRANCHISORS

## [1] Loss of Operational Control

The operating responsibility for a franchised hotel lies with either the hotel's owner or the owner's agent (i.e., a management company). The franchisor exerts very little influence over the day-to-day operation of the property. Although franchise chains attempt to control the quality and image of each individual hotel through rules and regulations and periodic property inspections, the persistent fact that the franchisor does not really have basic control over an operation can sometimes result in lower standards of quality and service than the franchisor wishes to maintain. When this occurs, the guests who experience the substandard level of quality service form an incorrect image of the entire chain, which can easily have a detrimental effect on repeat patronage or word-of-mouth promotion.

For this reason, chains such as Hyatt and Westin did not franchise until just recently, citing for years their concern with the risk of losing the operational control of a hotel. Marriott has franchised for a number of years, but has attempted to maintain only a select few management companies that Marriott believed would maintain the levels of quality and service that it requires. Generally speaking, lodging chains associated with the higher classes of facilities are less likely to franchise than those that provide a lower level of service, because they are more concerned with the need to maintain operational control. Two exceptions to this include Motel 6 and Red Roof Inns, although it appears that Motel 6 is anticipating offering franchises in the near future.

Franchise chains attempt to exert operational control by periodically inspecting each property to see that the facilities are well maintained and the hotel is operating at the prescribed standards. Backing up these inspections are extensive operating requirements contained in the franchise agreement. Objective standards set by franchisors, such as requirements that the hotel accept American Express credit cards, that the restaurant be open from 6 A.M. to 10 P.M., or that all guestrooms have a color television, are relatively simply enforced. Subjective standards are more difficult to evaluate and enforce. For example, determining whether an operator complies with regulations stating that a hotel must, at all times, be clean and well maintained or that an operation must be "first-class" can be difficult.

The ultimate penalty franchisors can wield in order to enforce their various regulations and standards is the termination of the franchise. Unfortunately, the time it takes to actually terminate a franchise, particularly if the franchisee is uncooperative, can range from several months to one or more years. The termination process becomes even more difficult if litigation is involved and the dispute involves a subjective regulation.

Perhaps the greatest loss of control for a hotel franchisor is the prevention of its expansion by franchisees concerned about the impact of new hotels being developed in their area that are affiliated with the same brand. For a hotel company that does not offer franchises, the decision to have multiple properties in a given market is made purely in-house on a corporate level. However, because the franchisee does not expect to compete either with the parent lodging company's own brand or with other brands that are owned by the company, franchisors must prove that such development would not impact the existing franchisee.

For these reasons, loss of operational control can be a significant deterrent for a hotel chain that is evaluating the potential of franchising. Not only is it difficult for a franchisor to enforce its standards, but the process of terminating a franchise can be time-consuming. The potential liability is a substandard hotel that could tarnish the image and goodwill of the entire chain.

## [2] Difficulties With Owners

A hotel franchise company generally has to work with many property owners and management companies. The hotel industry is largely ego-driven, so the chances are good that the objectives of a franchise company will not always mesh with the motivations and styles of all of the individuals with which it works. In fact, franchisees often band together and form a franchise association that represents their interests when disputes with their franchisor arise.

In any case, the end result of maintaining a number of business relationships is that hotel franchise companies often have to spend a considerable amount of time and money attending to their franchises in order to keep their system functioning in an efficient and orderly manner.

## [3] Liability Without Control

When a franchised hotel is involved in litigation, particularly in suits involving liability claims, the franchisor is often named as a defendant. Even though the hotel chain is often found to have no control over the incident and therefore to bear no liability, the cost of legal defense can often be considerable. Occasionally, franchisors are found to be liable even though they do not have direct control over the operation of a hotel. This liability exposure can be and generally is limited through insurance, which in itself can represent a considerable expense.

## [4] Quality, Service, and Cleanliness Control Problems

As described earlier, controlling the level of quality, service, and cleanliness at individual properties is not easily accomplished by franchisors. Because these subjective elements are always open to different interpretations, property owners are sometimes able to get by with lower standards than those intended by the franchisor.

Periodic property inspections followed by counseling with on-site management are the usual steps taken by franchisors seeking control of a property. Some chains offer extensive training programs and operating manuals that describe the various operating procedures that must be used to maintain the standards that they set. In any event, maintaining acceptable levels in these areas can often involve a large amount of effort and expense on the part of a franchisor.

## [5] No Control Over Pricing

Another element beyond the control of a franchisor is the establishment of uniform room rates and pricing policies for individual franchisees. For some types of lodging chains, particularly those catering to price-sensitive travelers, a uniform pricing strategy is highly desirable. Uneven pricing from one hotel to another can confuse customers and adversely affect the image of the entire chain.

## [6] Costly Start-Up

When a hotel chain first begins franchising, the company generally experiences a negative cash flow until the number of its properties reaches the necessary critical mass. Cash flow should turn around when the critical mass is reached, but the franchisor must have sufficient funds set aside to provide the necessary services to the franchises it has on board during the build-up period.

## [7] Mandatory Disclosure Document

All forms of franchising are strictly regulated by both the federal government and certain state agencies. Aimed at protecting the small investor from risking life savings on fraudulent franchise schemes, these regulations require full disclosure of many of the important business aspects of a franchise investment. This level of disclosure eliminates the possibility of franchisors creating individual agreements for each potential franchisee and adjusting terms through negotiation. As a result, most terms of a franchise agreement are fixed and are not subject to alteration.

The Federal Trade Commission (FTC) is the primary governmental overseer of franchising in the United States. In order to offer (sell) a franchise, potential franchisors must first file with the FTC a disclosure document known as a Uniform Franchise Offering Circular (UFOC). While this document does not receive either an approval or disapproval from the FTC, it must be accurate and current. The following list contains the major items that must be addressed in a UFOC.

1. *Introduction.* Brief introduction and warnings that the material should be read carefully and that a lawyer or an accountant should be consulted. Notice from the FTC that even though the offering circular has been filed with that agency, the agency has not checked it and does not know whether it is correct.
2. *The franchisor and any predecessor.* Description of the franchisor and the franchised business. Date when the franchisor started the business, its business address, any previous owners. An overview of the franchised business, its concept and strategy.
3. *Identity and business experience of the persons affiliated with the franchisor; franchise brokers.* Biographical sketches of the directors, principal officers, and other executives who have management responsibility in the franchisor's business.
4. *Litigation history.* Description of any past or present litigation involving the franchisor or the persons affiliated with the franchisor described in Item 2.
5. *Bankruptcy.* Fifteen-year bankruptcy history for the franchisor, its predecessor, or any of the persons affiliated with the franchisor described in Item 2.
6. *Franchisee's initial fee or other initial payment.* Description of the initial fee paid by franchisee to acquire the franchise. Description of the franchisor's expenses that are paid from the initial fee.
7. *Other fees and expenses.* Description of the other fees and expenses payable by the franchisee during the term of the franchise, which typically include royalty fees; accounting and auditing fees; advertising fees; expansion fees; initial leasehold construction fees; furniture, fixture, and equipment fees; insurance fees; ongoing maintenance fees; refurbishing fees; telephone reservation referral fees; transfer fees; and training fees. Statement of whether these charges and fees are to be paid to the franchisor, or expenses are to be paid to other parties (e.g., contractors, furniture and equipment dealers, and accountants).
8. *Franchisee's estimated initial expense.* A broad estimate of the major expense categories involved in developing and starting a lodging facility typical of what will be franchised.
9. *Obligations of the franchisee to purchase or lease from designated sources.* Terms of any requirement for franchisee to purchase or lease anything from either the franchisor or suppliers designated by the franchisor.
10. *Obligations of the franchisee to purchase or lease in accordance with specifications or from approved suppliers.* Terms of any requirement for franchisee to use either approved specifications or suppliers when purchasing.
11. *Financing arrangements.* Terms of any agreement by franchisor to provide any financing to the franchisee.
12. *Obligations of the franchisor.* Other supervision, assistance, or services. List of the services and obligations of the franchisor, which are generally subdivided into pre-opening obligations and continuing obligations.
13. *Exclusive area or territory.* Details of any exclusive areas or territories granted by the franchisor.

14. *Trademarks, service marks, trade names, logotypes, and commercial symbols.* Description of the various marks and trade names owned by the franchisor and available to the franchisee. Description of any known infringement or agreements limiting the use of these marks.
15. *Patents and copyrights.* Description of any patents and copyrights owned by the franchisor. Terms of issuing and maintaining operating manual supplied to franchisee, including any provisions regarding confidentiality.
16. *Obligations of the franchisee to participate in the actual operation of the franchised business.* Rules pertaining to whether the franchisee must actually operate the hotel or can hire a professional management company. Restrictions, if any, regarding the conduct of other hotel business activities and the diversion of business to other hotels are also described.
17. *Restrictions on goods and services offered by the franchisee.* Definition of what goods and services can be offered by the franchisee at the franchised premises.
18. *Renewal, termination, repurchase, modification, and assignment of the franchise agreement and related information.* Various aspects of the franchise terms including length of initial term and renewal term; termination by franchisee; termination by franchisor, with and without notice; obligations upon termination or expiration; franchisee's interest upon termination or non-renewal; transfer of interest by franchisor; transfer of interest by franchisee; transfer upon death or mental incapacity; franchisee sale of its securities; corporate transfers; non-waiver of claims; covenants not to compete; and modifications of agreement.
19. *Arrangements with public figures.* Description of any public figures involved with the franchise.
20. *Actual, average, projected, or forecasted franchise sales, profits, or earnings.* Any statement or projection of sales, profits, or earnings, made by the franchisor.
21. *Information regarding franchises of the franchisor.* Data relating to the number of franchises currently in existence and the projected franchise sales for one year.
22. *Financial statements.* Recent audited financial statements of the franchisor.
23. *Contracts.* Complete copy of franchise agreement and other contracts that must be executed by the franchisee.
24. *Statement of prospectus accuracy.* Representation by franchisor that prospectus is accurate.
25. *Acknowledgment of receipt by a prospective franchisee.* Statement by prospective franchisee noting the date of receipt of the UFOC.

The UFOC must be given to a prospective franchisee at the earlier of the first "personal meeting" or "the time for making disclosures." The FTC defines the "time for making disclosures" as ten business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement imposing a binding legal obligation or (2) the payment by a prospective franchisee of any consideration in connection with the sale or proposed sale of a franchise. In addition to the FTC disclosure requirements, several states impose additional franchise regulations, some of which are more stringent than the federal rules.

The ultimate effect of this level of disclosure is to establish uniformity in franchise structures, requirements, and fees, and thus eliminate any advantage a franchisor may have over a franchisee in terms of bargaining power.

## ¶ 18.04 ADVANTAGES FOR FRANCHISEES

### [1] Instant Recognition and Shortened Start-Up Period

The primary benefit of a franchise affiliation for a hotel is the instant name recognition that it provides. Hotel patrons traveling to new destinations often look for a lodging facility with a recognizable name and image because they want to know that the quality of the accommodations and service at the hotel they choose will meet the expectations they have that are based on prior experience with (or recommendations of) the same product. Although an independent hotel without a chain identity may well develop its own reputation and patronage, the period of time needed to penetrate the market in this fashion may extend over many years. Another decided advantage for new hotels with a recognizable affiliation is that they generally experience a faster build-up of patronage. This shortens the normal start-up period, so that a hotel with a chain affiliation will reach a stabilized occupancy level more quickly than would a new, non-affiliated hotel.

### [2] Attraction of Different Market Segments to Different Franchises

Over time, hotel chains develop specific images in various market segments. For example, Marriott Hotels, Hyatt Hotels, Westin Hotels, Sheraton Hotels, and Hilton Hotels generally achieve high penetration in the meeting and convention market segment. Courtyard by Marriott, Embassy Suites, and Doubletree Hotels have a strong following in the commercial segment, while Holiday Inns, Hampton Inns, and Comfort Inns have strong followings in the leisure market. Residence Inn by Marriott, Homewood Suites, Villager Lodges, and Studio Plus Suites are oriented toward extended-stay guests.

The market strengths of each lodging chain can directly benefit the hotels that take on their franchises, so a hotel owner looking for a franchise affiliation should thus be aware of the market strengths of each available franchisor and determine which affiliation will make the best use of both the available market and the subject property's contemplated or existing facilities.

### [3] Proven Method of Operation and Product Merchandising

Successful, established hotel chains generally allow potential franchisees access to the manuals and training programs that they have developed as internal guidelines for their mode of operation and product merchandising. By reviewing these materials, a franchisee can be certain that the franchisor has tried and proven systems and procedures that will increase the chances of franchise success.

New franchise companies typically have several company-owned hotels that serve as laboratories for developing systems and procedures. Prospective franchisees, lenders, and investors look at the operating results of these properties and use them as a means of confirming the ability of the franchisor to run viable, profitable hotels.

# ¶ 18.05 DISADVANTAGES FOR FRANCHISEES

## [1] Excessive Cost if Incorrect Franchise Is Chosen

The selection of a franchise is one of the most important decisions that a hotel owner must make. Choosing the wrong franchise almost always adversely affects operating results. For example, an affiliation with a luxury-quality, convention-oriented lodging chain will negatively affect a hotel that, based on local market conditions and characteristics, should be oriented toward the budget-rate, leisure market segment. Some of the costs that can result from selecting the incorrect franchise include:

- Operating losses during the period the ineffective affiliation is in use;
- Cost of acquiring a new franchise;
- Cost of purchasing new identity items such as signs, logos, and monogrammed items; and
- Operating losses during the initial occupancy build-up period under the new franchise.

## [2] No Guarantee of Success

Hotel franchisors typically have no financial interest in the properties they franchise and make no representation that a particular franchise will be an economic success. In fact, franchisors occasionally set operating standards that may in themselves be costly to the franchisee, such as requiring a hotel to upgrade its facilities even though such upgrades may not have a direct impact on the operating profitability of the hotel.

Even though franchise offerings are regulated by the FTC and some state agencies, franchise salespeople have occasionally resorted to unethical practices in order to sell new franchises. The compensation received by many of these salespeople is based on the number of franchises they sell, so without strict supervisory control, some salespeople may attempt to sell franchises either to unqualified owners or to projects that have no economic feasibility. Such conduct was partially responsible for the overbuilding that took place during the early 1970s.

As discussed previously, hotels spend anywhere from .75% to 9.34% of total revenues to affiliate with a national lodging franchise. This percentage is often the largest single expense incurred by a hotel after payroll and typically makes up the largest expense in the hotel's marketing budget. As with any substantial cost or investment, purchasers of a service like to see the benefit that they are receiving for their money.

With regard to the economic benefit of hotel franchise fees, we are provided only with the claims and promises provided by the franchisors themselves. Some franchise companies refuse to provide performance statistics of any kind, fearing that such claims would constitute guarantees which if not achieved would leave them open to ridicule and perhaps litigation. Other companies provide statistics such as system-wide reservation contributions, but these statistics are closely guarded and vary from chain to chain as to what is considered a reservation and/or denial. Furthermore, in comparing the gross delivery of reservations for a given period, many of which are composed of room-nights booked months and sometimes years in the future, against the actual occupied rooms in that period can be quite misleading.

Initiated by the University of Denver School of Hotel, Restaurant and Tourism Management, Richfield Hospitality, one of the largest independent hotel management companies, used this model as a basis to survey forty-three of its hotels, which operate under thirteen different franchises. The model attempted to quantify three areas of franchise performance:

1. The benefit of programs and services offered by the franchise;
2. The consumed reservation room night contribution of the reservation system; and
3. The drive-by value of the franchise name.

The findings enabled Richfield to rank the various franchises based on these three categories as shown in Exhibit 18-1.

**Exhibit 18-1 Franchise Rankings**

| Hotel Franchise Portfolio | Franchise Programs and Service | Reservation Contribution | Drive-by Value |
|---|---|---|---|
| A | 1.0 | 3.0 | 4.0 |
| B | 7.0 | 4.0 | 6.0 |
| C | 10.0 | 1.0 | 1.0 |
| D | 5.0 | 2.0 | 7.0 |
| E | 3.0 | 13.0 | 11.0 |
| F | 8.0 | 6.0 | 9.0 |
| G | 12.0 | 10.0 | 13.0 |
| H | 2.0 | 5.0 | 5.0 |
| I | 13.0 | 8.0 | 3.0 |
| J | 9.0 | 9.0 | 2.0 |
| K | 11.0 | 11.0 | 10.0 |
| L | 4.0 | 4.0 | 12.0 |
| M | 6.0 | 6.0 | 8.0 |

The franchises surveyed include Best Western, Clarion, Comfort Inn, Days Inn, Hilton, Holiday Inn, Howard Johnson's, Knights Inn, Quality Inn, Radisson, Ramada, Sheraton, and Travelodge. The survey results indicated that each franchise offered different benefits to the hotels that operate under their flag. Several of the best performing franchises in terms of their actual room night contribution were viewed by many general managers as not very effective in their programs and services provided. Similarly several franchises that did not contribute significantly to the hotel's occupied rooms through their reservation service were perceived by the general managers to provide strong benefit in terms of the flag's drive-by value.

Although it is not known whether the University of Denver model and the Richfield study adequately quantified all of the aspects of return on investment, the relative rankings of the different chains provide insight into the substantial differences in performance that can be expected on the basis of property type and location relative to the particular affiliation. HVS is currently taking this study to the next level by rolling it out on a national basis.

The goal is to quantify the benefits offered by all the major national franchises and analyze the information to see how these benefits relate to the size, type, location, and competitive situation of a particular hotel. The success of the survey is of course contingent on the contribution of the independent owners and management companies from which the survey information is polled. Although such information may be available from the franchises themselves, we believe that the owners and operators themselves will provide the most objective and pertinent information available. After all, it is not the value of a particular franchise to the franchise company itself that is being assessed; it is the value of the franchise to the franchisee that poses one of the biggest questions in the minds of hotel owners and operators in the lodging industry today.

## [3] Nontransferable Franchises

Some hotel franchisors do not allow existing owners to freely transfer a franchise to a new owner in the event of a sale. Some of the transfer restrictions typically imposed by franchisors include:

- Payment of a transfer fee;
- Approval of new owner by franchisor;
- Application for an entirely new franchise;
- Refurbishment of hotel to meet current franchise standards; and
- Right of first refusal on transfer.

Ultimately, the risk posed to the seller by these transfer restrictions is that the franchise may not be renewed or that it can be renewed only for a price. For example, a transfer may require spending hundreds of thousands of dollars in order to bring a hotel up to current standards. Anything that could inhibit the transfer of a valuable franchise could also adversely affect the market value of the property.

## [4] Short Term of Franchise

Franchisees and potential buyers face the risk that the reversionary value of an investment in a hotel will be discounted if its franchise cannot be renewed or extended. Since the economic lives of hotels generally span thirty to forty years, and franchise terms typically range from ten to twenty years, continuation of a favorable franchise affiliation is important. A change of name and image midway along a hotel's economic life can result in severe marketing and financial difficulties. For this reason, first-tier hotel management companies typically require contracts that extend beyond twenty years in order to preserve the name integrity of the chain.

## [5] Little Control Over Other Franchisor Affiliations

Most franchise agreements are not overly restrictive regarding the number of new hotels in the market area with which the franchisor can be affiliated. Occasionally, a franchise will grant a property owner an exclusive area for a specific period of time. In most cases, however, a franchisor is free to add a new product to a market whether it is another franchised hotel or a property managed or owned by the franchise company. With the recent trend in product segmentation, franchisors sometimes claim that adding a product to a market area that caters to a different market segment or price classification will not adversely affect an existing franchisee. While this may have been true during the late 1980s, when demand for accommodations was extremely high, many hotels located in the same market area that formerly targeted different segments of the traveling public found themselves competing directly for business during the lean years of the early 1990s. Proliferation of new brands virtually stalled as new development of hotels became a nearly impossible task. However, with the strong operating performance of most hotels from 1994 through 1996, many new brands targeting specific segments are set to come on line during the latter half of the 1990s.

## [6] Adherence to Chainwide Standards

The various regulations and standards developed by franchisors are designed to cover all the hotels in the chain and ensure uniform mode of operation and image. Occasionally, these standards may be inappropriate for a specific property, or unsatisfactory to a particular owner, but franchisors generally do not allow any deviation from their system. The chainwide standards that can negatively affect individual hotels include:

- Required year-round operation;
- Set operating hours for restaurants, lounges, and room service;
- Minimum staffing level requirements, such as 24-hour door attendants and bell hops;
- Participation in chain advertising and frequent traveler programs; and
- Required amenities (e.g., a swimming pool, a restaurant, room service, a lounge, or free parking).

Property owners who would be adversely affected by these standards are sometimes able to work out exemptions with franchisors before signing an agreement.

## [7] Benefits Dependent on Number of Properties in Chain

Just as a franchise chain has a critical mass for the franchisor at which franchise revenues cover the costs of licensing and maintaining franchises, so too does a franchise chain have a critical mass for the franchisee, at which the economic benefits of the franchise affiliation exceed the cost of acquiring and maintaining it. The benefits of a franchise affiliation that are directly related to the number of properties in the chain include:

- Reservation referrals from other properties;
- Word-of-mouth referrals from patrons with favorable experiences;
- Advertising and marketing assistance;
- Additional chain services; and
- Sophisticated central reservation system.

A potential franchisee should evaluate the price/value relationship of joining a hotel chain, particularly in light of the fact that some new franchisors will reduce initial and continuing franchise fees during their start-up period to reflect the reduced level of benefits that they provide compared with an established chain.

### [8] Lack of Control Over Chain Quality and Image

Individual franchises have little control over any of the operating policies of the franchisor that adversely affect the overall quality and image of the franchise chain, and so are essentially at the financial mercy of the franchisor. An analysis of the hotel franchise organizations that started during the 1950s and the 1960s yields examples of chains that faded in popularity and others that increased in strength because of their ability or inability to maintain efficient operating policies. Necessary policies for a franchise company include:

- Mechanism for terminating franchises that do not maintain an appropriate level of quality and service.
- Mechanism for removing hotels from the system that are not functionally up-to-date.
- Periodic update of marketing strategies and chainwide customer image.
- Consistent product and unified image.

A twenty-year franchise commitment will typically expose the owner of the affiliated hotel to at least one complete turnover in the management of the franchise company. New policies and management outlook evolve on a continual basis, and this may or may not be a positive influence on the entire lodging chain.

## ¶ 18.06 SERVICES OFFERED BY FRANCHISORS

Like any other long-term financial situation, a hotel franchise has certain risks and benefits. Hotel owners can minimize the possibility of an unpleasant experience by carefully reviewing the services offered by individual franchisors and dealing only with reputable franchise companies.

### [1] Site Selection and Market Analysis

Hotel franchise chains often help prospective franchisees to select a suitable hotel site and analyze the characteristics of the surrounding market area. In this regard, however, their assistance is reactionary in that franchise companies generally only comment on a potential site chosen by the franchisee; they do not actually seek out suitable locations.

Franchisors also typically recommend independent hotel appraisers who can perform market analyses for potential franchisees. Franchisors are also often able to assist appraisers by providing important data such as the room rates and occupancy levels of competitive lodging facilities, the number of fill nights at other chain properties in the market area, and reservation data regarding the amount of satisfied and unsatisfied lodging demand in the immediate area.

### [2] Provision of Plans and Specifications

Hotel chains that seek to have a uniform image or character for their properties generally provide prototypical architectural plans to the franchisee that can be modified and adjusted to fit a particular site. The benefit of these plans to the franchisee is twofold: they often reduce development cost, and they assure a well-conceived, functional property. Some franchisors also provide detailed specifications for construction and furnishings in order to maintain the quality standards of the chain. Potential hotel developers should realize that most hotel chains have strict guidelines concerning plans and specifications for constructing and furnishing their facilities. Consequently, developers should make no significant expenditures for architectural plans until a franchise has been selected and the required specifications have been obtained.

## [3] Development Assistance

Hotel franchisors are often able to provide assistance during the construction of a hotel. At the minimum, a hotel chain usually wants the opportunity to approve plans and specifications prior to construction and to inspect for compliance during development and after the project is completed. Some franchisors, however, have in-house development experts who will provide extensive support in all phases of the development process. The cost of these services is generally an additional charge over the normal franchise fees.

## [4] Assistance in Obtaining Financing

Franchisors generally do not secure financing for franchisees, but they do sometimes assist in assembling loan packages for lenders. A good hotel chain typically develops relationships with the various financial components necessary to obtain financing, which include firms that perform market studies and appraisals, mortgage bankers and brokers, construction lenders, permanent lenders, real estate investment trusts, mortage conduits, and investors. In addition, large hotel companies such as Marriott, Promus, Choice, and HFS offer potential franchisees direct financing of their own. This was a necessary vehicle created by these companies during a period in which the economics for expansion were present but the financial sources for hotel construction were not. As traditional third-party financing has returned to the market in recent years, these programs at the major hotel companies have been scaled back.

Because financing is an important aspect of a hotel development or acquisition, more franchisors can be expected to take an active role in obtaining funds in the future. A franchise package that offers not only the normal franchise benefits but some form of financing commitment is an unbeatable combination for attracting franchisees.

## [5] Publicity and Promotion Assistance

Generally, hotel chains that sell franchises have prepared professional advertising and promotional campaigns that include logos; trademarks; signs; property; billboards; and print, radio, and television ads. Franchisees can usually obtain these advertisements and promotional materials from the franchisor and immediately use them in the proper media.

## [6] Centralized Purchasing

Many franchisors offer centralized purchasing services that are able to take advantage of quantity discounts available to large volume buyers, passing these savings on to the individual franchisees. Not only can the financial benefits of centralized purchasing be substantial, but the ease of ordering, receiving, and accounting is often greatly simplified. Vendors, realizing the purchasing power of an entire organization, are also more likely to provide better service. Centralized purchasing not only reduces the cost of buying products such as furniture and operating supplies but decreases the price of such services as advertising, accounting, and legal counsel. Centralized purchasing is generally a voluntary service; in most instances, the franchisee is free to purchase supplies, furnishings, and equipment from any vendor in the market as long as the specifications of the item purchased meet the franchisor's approval.

Another advantage gained by the buying power of a lodging chain is that individual franchisees are able to receive reductions in credit card commissions.

## [7] Referrals Between Properties

One of the primary benefits of belonging to a lodging chain is the referral of business between the properties within the chain. In effect, each property in the chain functions as a marketing office that creates room-nights of demand for other hotels throughout the chain. For example, when a patron is checking out of one hotel, the front desk personnel should determine whether the traveler requires a reservation at the next destination. If so, a sale should occur, and a reservation should be made with another franchisee in the chain. Similarly, when meeting and convention groups have been satisfied with the service and accommodations they received by one hotel in a chain, they should be referred directly to other chain hotels for future meetings. Individual franchisees benefit by keeping hotel patrons "within the chain" through property level referrals.

Hotel owners who are prospective franchisees should investigate whether a franchisor actively encourages referral activity between properties, and if so, whether there is chain representation in the feeder cities where this type of reservation activity would originate.

## [8] Centralized Reservation System

Another major benefit of a franchise affiliation is the centralized reservation system that ties the entire chain together. Most hotel chains offer a reservation system consisting of a central reservation office with a toll-free telephone number. Staffed by trained personnel, the central reservation office takes all reservation requests and records the following information:

- The hotel within the chain that is the most convenient destination to the caller.
- The availability of accommodations at the requested hotel on the desired date(s).
- Available room rates.
- A reservation, if the caller so chooses.
- Guarantee of the reservation, if necessary.
- Any special request.
- Information about the caller (e.g., name, address, and telephone number).

This data is stored in the central reservation computer for future statistical analysis and, if necessary, is also transmitted to the property to confirm the reservation and identify the patron.

Hotel franchise reservation systems vary in sophistication. Potential franchisees should investigate the workings of each reservation system to determine which will work best for their particular operation. The aspects of the system that should be analyzed include the following:

- The number of reservations the central system actually generates for the properties within the chain. (The franchisee should trace this data to individual properties that have locations similar to the subject property, and then analyze the reservation data on both a monthly and weekly basis.)
- The number of reservations that represent actual room-nights and the number that result in no-shows.
- The number of reservations that are currently unaccommodated within the potential franchisee's market area, and to what properties unaccommodated reservations are currently referred.
- The identity of the properties in the chain from which the subject property can expect to receive reservation overflow. Reservation system computers are programmed to refer unaccommodatable reservations to another property within the chain, usually the closest based on travel time. This procedure should, however, be verified to ensure that the potential franchisee's hotel will receive its fair share of overflow reservations.
- The identification of the potential franchisee in the reservation system. For example, a hotel might be known as the Sleep-Inn Downtown or Sleep-Inn Convention Center or Sleep-Inn Airport or Sleep-Inn Interstate. Incorrect information conveyed by a name or description could divert reservations and patronage to other properties even if they are less well located to the traveler's final destination.

Hotel franchise companies with centralized reservation systems are generally able to provide franchisees with market analysis based on their reservation data. These reports can provide important market research information to the franchisee. The reports containing this research information that are usually available to franchisees include:

- *Reservation originations.* A listing of where reservations originate, categorized either by zip code or by telephone area code. This information is useful in planning future marketing programs.
- *Reservation denial report.* A listing of the number of potential patrons who attempted to make a reservation at a specific property but, because the property was fully booked, could not be accommodated. This information is important for quantifying unaccommodated demand, which provides an indication of the need to expand a property.
- *Occupancy comparisons.* A report showing how a specific property's occupancy percentage compares with other hotels of the same franchise in the property's market area, state, and region. This information is useful in evaluating operating performance.

A potential franchisee should request to see examples of the different reservation system reports offered by franchise chains in order to determine which offers the most useful information.

### [9] Proven Mode of Operation

A franchisor should provide the franchisee with a tried and proven mode of operation that includes all the systems and procedures that are necessary in order to operate the franchise efficiently. In most instances, the information regarding the implementation of the mode of operation is communicated either by training programs or by an operations manual offered by the franchisor.

Some chains offer extensive schools or seminar programs to familiarize management level personnel with the chain's mode of operation and general philosophies. Other franchisors have detailed operating manuals that provide recommended solutions to almost any problem that the management of the property may encounter. While the assistance provided by the franchisor will noι substitute for actual hotel operating experience, it is important to use the experience of the hotel chain in order to reduce the number of operational errors and to conform with the chainwide image and mode of operation of the franchisor as well.

### [10] Marketing Offices

Most hotel chains, particularly those with a group marketing orientation, maintain national and regional marketing offices that generate meeting, convention, and group business. This service is particularly beneficial for those hotels that anticipate heavy usage in the meeting and convention segments. The time and effort required to establish the marketing infrastructure to effectively penetrate the meeting and convention segment can be overwhelming for an individual hotel; tapping into a chain's database of group business can offer a substantial advantage. The potential franchisee should verify that such information does exist and will ultimately produce meeting and convention room-nights for the subject property.

### [11] Property Inspection and Evaluation

Quality assurance is an important activity for franchisors. A hotel chain is only as good as its poorest hotel, so constant inspection and evaluation on the part of the franchisor is necessary to maintain a consistent level of physical and service quality.

Most hotel chains typically inspect their properties two to four times per year. A score is usually awarded based on a 1,000 point system. Franchisees that do not achieve a satisfactory score are usually provided with a set time frame to correct the issues that brought them below the given standard. The purpose of these inspections is to monitor quality standards and familiarize the on-site management with the techniques used to maintain the required level of quality. Because rigid enforcement of quality standards is extemely important for the success of a franchise system, the methods of regulating property level quality should be closely evaluated by potential franchisees.

## ¶ 18.07 FRANCHISE FEES

When evaluating a possible hotel franchise, one of the most important economic considerations is the structure and amount of the franchise fee. Hotel franchise fees are the compensation paid to the franchisor for the use of the chain's name, logo, identity, image, goodwill, operating systems and procedures, marketing plans, and referral and reservation systems. Franchise fees are normally formulated using an initial fee paid upon applying for the franchise plus continuing fees paid periodically during the term of the franchise.

## [1] Initial Fee

The initial fee typically takes the form of a minimum dollar amount based on a hotel's room count. For example, the initial fee may be a minimum of $45,000 plus $300 per room for each room over 150. Therefore a hotel with 125 rooms would pay $45,000 and a hotel with 200 rooms would pay $60,000. The initial fee is paid upon submission of the franchise application. It covers the franchisor's cost of processing the application, reviewing the site and market potential, evaluating the plans or existing layout, inspecting the property during construction, and providing services over the pre-opening or conversion phases.

If the hotel is existing and the franchise represents a conversion, the initial fee structure is occasionally reduced. Some franchisors will return the initial fee if the franchise is not approved, while others will keep a portion (5% to 10%) to cover the cost of reviewing the application.

Other costs associated with the initial acquisition of a national franchise may include the cost of signage and any specialized computer software or hardware needed to interface with the franchisor's central reservation system. An existing hotel contemplating an affiliation also bears the possible burden of repurchasing towels, brochures, operating supplies, and paper items imprinted with the national franchisor's logos. It is also possible that the potential affiliate may have to undertake a property refurbishment or renovation (ranging from installing a higher grade of carpeting to enclosing a property's exterior corridors). These costs must be considered when measuring the cost/benefit of affiliation, and varies from hotel to hotel and between the various franchise organizations.

## [2] Continuing Fees

Payment of continuing franchise fees commences when the hotel assumes the new franchise affiliation; these fees are paid monthly over the term of the franchise agreement. Continuing fees generally include a royalty fee, an advertising or marketing contribution fee, and a reservation fee. In addition, continuing fees may include a frequent traveler program and other miscellaneous fees.

### [a] Royalty Fee

Almost all franchisors collect a royalty fee, which represents compensation for the use of the chain's trade name, service marks and associated logos, goodwill, and other franchise services. A significant profit is generally factored into the royalty.

### [b] Advertising or Marketing Fee

Chain-wide advertising and marketing consists of national or regional advertising in various media, the development and distribution of a chain directory, and marketing geared toward specific groups and segments. In many instances, the advertising or marketing fee goes into a fund that is administered by the franchisor on behalf of all members of the chain. In this situation, these dollars must be utilized for the purpose of promoting the chain, and do not normally represent a source of profit to the franchisor.

### [c] Reservation Fee

If the franchise chain has a reservation system, the reservation fee supports the cost of operating and paying for the central office, telephones, computers, and reservation personnel. Like advertising or marketing fees, the reservation fee is designed to cover the cost of the reservation system, and generally provides little profit to the franchisor.

### [d] Frequent Traveler Program

Some franchisors maintain incentive programs that present awards to guests for frequent stays. The programs are designed to encourage loyalty to the affiliation.

### [e] Other Miscellaneous Fees

These fees may include fees payable to the franchisor for additional systems or procedures; they are generally minimal in cost and do not represent profit. In addition, those franchisors that provide extensive training programs for their franchisees levy training fees that cover the cost of the instructional programs.

Sometimes the franchisor offers additional services for a fee. These services include consulting, purchasing assistance, computer equipment or satellite communication equipment rental, optional training programs, on-site opening assistance, or additional advertising services. The fees for these services are typically not qualified in the disclosure documents.

## [3] Continuing Fee Assessment

Continuing franchise fees are assessed on the basis of several formulas. Royalty fees are generally based on a percentage of rooms revenue (which can vary as much as 1 percent to 6.5 percent). Advertising, marketing, and training fees are generally calculated on a percentage of rooms revenue (ranging from 1 percent to 4.5 percent), but sometimes are based on a dollar amount per available room per month. Reservation fees may also be based on either a percentage of rooms revenue (1 to 8 percent) or a dollar amount per available room per month ($2 to $6) but in some instances are assessed by an amount per reservation sent to the property through the central reservation system ($1 to $5.50). These various formulas may be used by themselves or they may be combined with each other. For example, the marketing fee for a franchise may be the greater of $2.00 per available room per day or 2 percent of rooms revenue. Many also have first-month contingency fees in lieu of recorded revenues (e.g., a royalty fee of $24.00 per room for the first month and then 5% of gross revenues in the ensuing months).

Each one of these fee structures offers advantages and disadvantages for the individual property. A fee based entirely on a percentage of rooms revenue is favorable for hotels that derive significant income from food and beverage sales. Fees based on an amount per available room are fixed, and tend to benefit hotels with high volumes and penalize properties with lower results. Paying a reservation fee based on the number of reservations received is fair, as long as the reservations equate to occupied room nights and not to no-shows.

Many franchisors are now requiring franchisees to bear their fair share of the costs associated with operating a frequent traveler program. Frequent traveler program assessments are typically based on a percentage of total or rooms-only revenues generated by a member of the program at a hotel (1.0% to 6.5%), or a fixed dollar amount per room occupied by a frequent traveler member ($1.60 to $5.00). Many programs also require hotels to contribute a one-time participation fee of $5.00 to $10.00 per guestroom, while others use a combination of all three methods.

The specific fee structures required by a franchise company must be disclosed in the UFOC that it must file with the FTC, so potential franchisees can evaluate the fee structure of prospective franchise companies and determine whether the price/value relationship warrants the acquisition of a particular franchise. Exhibits 18-3, 18-4, and 18-5, developed from information contained in UFOCs, provide comparisons of the fees charged by various franchise companies. Each table deals with a different class of lodging facility (i.e., economy, mid-rate, and first-class) and the data in them is derived from the operating information in Exhibit 18-2.

**Exhibit 18-2 Lodging Facility Class Distinctions**

| | Economy Hotel | Mid-Rate Hotel | First-Class Hotel |
|---|---|---|---|
| Room Count | 100 | 200 | 300 |
| Average Room Rate (Year 1) | $35.00 | $65.00 | $95.00 |
| Room Rate Growth | 5% per Year | 5% per Year | 5% per Year |
| Occupancy | | | |
| Year 1 | 60% | 60% | 60% |
| Year 2 | 70% | 70% | 70% |
| Year 3 | 75% | 75% | 75% |
| Projection Period | 10 years | 10 years | 10 years |
| Total Room Nights | 266,450 | 532,900 | 799,350 |
| Total Rooms Revenue During 10-Year Projection Period | $11,794,243 | $43,798,356 | $96,027,117 |
| Total Food and Beverage Revenue During 10-Year Projection Period | N/A | N/A | $57,616,270 |
| Number of Reservations From Franchisor | 15% of occupied rooms | 15% of occupied rooms | 15% of occupied rooms |
| Percent of Rooms Occupied by Frequent Travelers | N/A | 8% of Occupied rooms | 8% of occupied rooms |
| Percent of Rooms Occupied By Third Party Reservation Travelers | N/A | 5% of occupied rooms | 5% of occupied rooms |
| Average Length of Stay | 2 nights | 2 nights | 2 nights |

Our model assumes that each affiliation is capable of generating the same portion of occupancy from its reservation system. In truth, some affiliations generate more demand and some contribute less.

The following three exhibits summarize the franchise fee information relating to each franchise affiliation. The first column in each table identifies the name of the franchisor. The second column shows the amount of the initial fee based on the room count assumed for each class of facility. The next five columns represent the continuing fees, which are subdivided into royalty, reservation, marketing, frequent traveler program, and miscellaneous cost. The continuing fees were calculated annually over the ten-year projection period and represent the total ten-year amount that would be paid by the franchisee. The next column represents the sum of the initial and continuing fees. The last column shows the percentage relationship of the total projected franchise fees to the total projected rooms revenue.

A total of fifty-seven franchise groups, in which twenty-six budget, eleven mid-rate, and twenty first-class franchisors participated, were included in the analysis. The trend toward continued franchise expansion and segmentation was exhibited by a 19 percent increase in the number of 1994 study participants.

The Budget Host organization lead the analysis, with only 0.75 percent of its projected ten-year revenue going toward expenses related to franchise fees. Other organizations achieving low percentages included Preferred Hotels at 1.49 percent, Best Western at 1.94 percent, Microtel at 2.70 percent, and Best Inns at 4.12 percent. The percent of rooms revenue figures ranged from 0.75 percent to 9.34 percent in the budget category, 1.94 percent to 8.99 percent in the mid-rate category, and 1.49 percent to 9.91 percent in the first-class category. Low percentage leaders in each category were Budget Host, Best Western, and Preferred Hotels, respectively. The overall range was a low of 0.75 percent to a high of 9.91 percent with a median of 6.57 percent.

Budget Host, Best Western and Preferred Hotels are, technically, not franchises, but rather associations or referral organizations. Because these groups are structured for the benefit of their member hotels, fees are oriented more toward covering operating costs rather than producing large profits. Their percentages are therefore somewhat representative of the actual cost of operating a franchise organization and provide an indication of the margin of profit realized by other chains.

A Marriott affiliation is still the most expensive; Marriott is currently the only franchisor whose continuing fees are based on a percentage of the combined rooms and food and beverage revenues. Marriott's frequent traveler award program also contributes to the above-average cost of this affiliation. However, few would argue with the success of Marriott's proven operating abilities, as well as its favorable customer image and good will. Often a direct relationship exists between a hotel's good will and its potential for asset value enhancement. Therefore, while affiliating with such a franchisor may well prove feasible and prudent, it will be comparatively costly.

As Exhibit 18-6 shows, the overall franchise class average showed steady growth over the past five years. The oudget class maintained a three-study average of 5.7 percent, the mid-rate class carried a 6.7 percent average, and the first-class group had a three-study average of 6.4 percent. The budget group exhibited the lowest averages over the past five years, while the mid-rate group logged the highest.

Most hotel lenders believe that to be competitive in today's hotel market, a strong franchise affiliation is essential. Customers want to know the level of quality for which they are paying, and would rather not take the chance of having an unpleasant surprise from a "no-name" lodging facility. Hotel lenders also typically insist on a franchise affiliation of some type because it reduces the perceived investment risk. The big question is whether to opt for a Best Western affiliation at 1.94 percent of rooms revenue or for a Days Inn affiliation at 8.97 percent.

The selection of a chain affiliation should be evaluated carefully to determine when the price/value relationship is favorable to the hotel owner and when that relationship shows promise for long-term stability. One of the tools available to compare the relative cost of a franchise chain affiliation is the preceding analysis. Armed with this information, owners can address additional costs pertinent to their particular properties and determine the overall cost of affiliation.

**Exhibit 18-3 Summary Table of Chain Franchise Fees—Budget Hotels**

| Chain | Total Initial Cost | Total Royalty Costs | Total Reservation Cost | Total Marketing Cost | Total Frequent Traveler Cost | Total Misc. Cost | 1994 Total Ten-Year Cost | 1994 Total Cost as a % of Total Room Revenue |
|---|---|---|---|---|---|---|---|---|
| AmericInn | $20,000 | $589,712 | — | $235,885 | — | — | $845,597 | 7.2% |
| Best Inns | 13,875 | 235,885 | $117,942 | 117,942 | — | — | 485,644 | 4.1 |
| Budget Host | 3,500 | 51,875 | 30,000 | — | — | $3,500 | 88,875 | 0.8 |
| Budgetel | 25,000 | 589,712 | 117,942 | 117,942 | — | 1,000 | 851,596 | 7.2 |
| Comfort Inn | 40,000 | 588,918 | 164,871 | 255,494 | — | 9,600 | 1,058,883 | 9.0 |
| Downtowner Inns | 10,000 | 471,770 | 24,000 | 117,942 | — | — | 623,712 | 5.3 |
| EconoLodge | 25,000 | 471,315 | 164,771 | 255,295 | — | 9,600 | 925,981 | 7.9 |
| Fairfield Inn by Marriott | 37,500 | 471,770 | 160,907 | 294,856 | — | 6,500 | 971,533 | 8.2 |
| Friendship Inn | 20,000 | 352,911 | 164,471 | 254,994 | — | 9,600 | 801,976 | 6.8 |
| Hampton Inn | 35,000 | 471,770 | — | 471,770 | — | 36,700 | 1,015,240 | 8.6 |
| Holiday Inn Express | 40,000 | 589,712 | 189,582 | 235,885 | 35,745 | 10,600 | 1,101,524 | 9.3 |
| Howard Johnson Inns | 35,000 | 471,770 | 294,856 | 235,885 | — | 6,650 | 1,044,161 | 8.9 |
| Master Host Inns & Resorts | 15,000 | 530,741 | 24,000 | 117,942 | — | — | 687,683 | 5.8 |
| Microtel | 25,000 | 294,856 | — | — | — | — | 319,856 | 2.7 |
| Nendels | 10,000 | 353,827 | 216,354 | 182,500 | — | — | 762,681 | 6.5 |
| Passport Inns | 10,000 | 412,799 | 24,000 | 117,942 | — | — | 564,741 | 4.8 |
| Red Carpet Inns | 15,000 | 471,770 | 24,000 | 117,942 | — | — | 628,712 | 5.3 |
| Rodeway Inns | 25,000 | 354,211 | 164,871 | 255,394 | — | 9,600 | 809,076 | 6.9 |
| Scottish Inns | 10,000 | 412,799 | 24,000 | 117,942 | — | — | 564,741 | 4.8 |
| Shoney's Inns | 25,000 | 412,799 | 117,942 | 117,942 | 55,000 | — | 728,683 | 6.2 |
| Signature Inns | 25,000 | 471,770 | 412,799 | — | — | — | 909,569 | 7.7 |
| Sleep Inn | 35,000 | 471,415 | 255,395 | 166,871 | — | 28,800 | 957,481 | 8.1 |
| Super 8 | 20,000 | 471,770 | — | 353,827 | — | — | 845,597 | 7.2 |
| Thriftlodge | 30,000 | 471,770 | — | 508,270 | — | — | 1,010,040 | 8.6 |
| Travelodge | 30,000 | 471,770 | — | 508,270 | — | — | 1,010,040 | 8.6 |
| Villager Lodge | 15,000 | 589,712 | 121,592 | 117,942 | — | — | 844,247 | 7.2 |

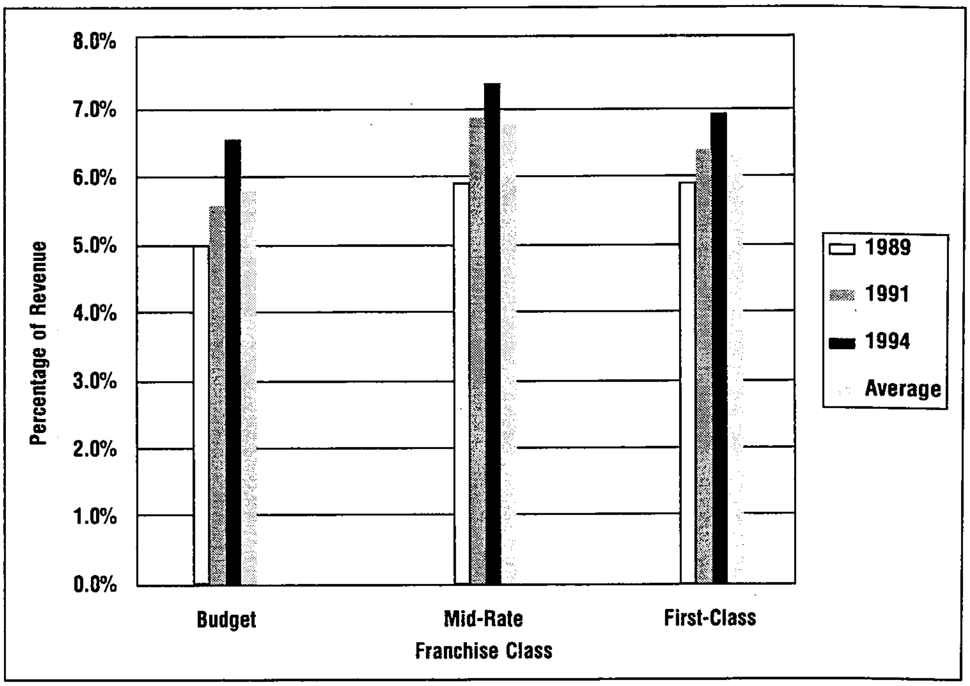
**Exhibit 18-4 Summary Table of Chain Franchise Fees—Mid-Rate Hotels**

| Chain | Total Initial Cost | Total Royalty Costs | Total Reservation Cost | Total Marketing Cost | Total Frequent Traveler Cost | Total Misc. Cost | 1994 Total Ten-Year Cost | 1994 Total Cost as a % of Total Room Revenue |
|---|---|---|---|---|---|---|---|---|
| Best Western | $42,000 | $ 46,160 | $311,593 | — | — | $449,865 | 849,618 | 1.9% |
| Comfort Suites | 60,000 | 1,751,934 | 523,746 | $772,294 | — | 9,600 | 3,117,574 | 7.1 |
| Country Lodging by Carlson | 20,000 | 1,268,043 | 439,643 | 2,144,010 | — | — | 3,871,696 | 8.8 |
| Courtyard by Marriott | 80,000 | 2,126,572 | 501,656 | 875,967 | — | 52,000 | 3,636,195 | 8.3 |
| Days Inn | 80,000 | 2,846,893 | 1,007,362 | — | — | 4,750 | 3,939,005 | 9.0 |
| Holiday Inn | 80,000 | 2,189,918 | 584,764 | 656,975 | $227,911 | 13,350 | 3,752,918 | 8.6 |
| Howard Johnson | 70,000 | 1,751,934 | 1,094,959 | 875,967 | — | 6,650 | 3,799,510 | 8.7 |
| Park Inn | 31,000 | 1,740,807 | 3,650 | 870,487 | — | — | 2,645,944 | 6.0 |
| Quality Inn | 60,000 | 1,757,734 | 523,946 | 772,694 | — | 9,600 | 3,123,974 | 7.1 |
| Quality Suites | 60,000 | 1,751,934 | 523,946 | 772,694 | — | 9,600 | 3,118,174 | 7.1 |
| Ramada | 70,000 | 1,751,934 | — | 1,970,926 | — | 6,650 | 3,799,510 | 8.7 |

**Exhibit 18-5 Summary Table of Chain Franchise Fees—First-Class Hotels**

| Chain | Total Initial Cost | Total Royalty Costs | Total Reservation Cost | Total Marketing Cost | Total Frequent Traveler Cost | Total Misc. Cost | 1994 Total Ten-Year Cost | 1994 Total Cost as a % of Total Room Revenue |
|---|---|---|---|---|---|---|---|---|
| Clarion | $90,000 | $2,866,409 | $1,084,972 | $1,552,090 | — | $9,600 | $5,603,073 | 5.8% |
| Doubletree | 30,000 | 2,880,814 | 3,360,949 | — | — | — | 6,271,763 | 6.5 |
| Doubletree Club | 30,000 | 2,880,814 | 3,360,949 | — | — | 60,000 | 6,331,763 | 6.6 |
| Doubletree Suites | 30,000 | 2,880,814 | 3,360,949 | — | — | — | 6,271,763 | 6.5 |
| Embassy Suites | 150,000 | 3,841,085 | 120,034 | 3,360,949 | — | — | 7,472,068 | 7.8 |
| Guest Quarters Suites | 30,000 | 2,880,814 | 3,360,949 | — | — | — | 6,271,763 | 6.5 |
| Hawthorn Suites | 120,000 | 3,841,085 | 2,400,678 | — | — | — | 6,361,763 | 6.6 |
| Hilton Garden Inn | 55,000 | 4,801,356 | 1,920,461 | 960,271 | 584,371 | — | 8,321,459 | 8.7 |
| Hilton Inn | 55,000 | 4,801,356 | 1,920,461 | — | 584,371 | — | 7,361,188 | 7.7 |
| Hilton Suites | 55,000 | 4,801,356 | 1,920,461 | 960,271 | 584,371 | — | 8,321,459 | 8.7 |
| Holiday Inn Crowne Plaza | 120,000 | 4,801,356 | 1,178,691 | 1,920,542 | 502,341 | 19,600 | 8,542,530 | 8.9 |
| Homewood Suites | 90,000 | 3,841,085 | — | 3,841,085 | — | 53,700 | 7,825,870 | 8.1 |
| Marriott | 90,000 | 7,487,115 | 359,708 | 960,271 | 614,574 | — | 9,511,667 | 9.9 |
| Omni | 50,000 | 2,880,814 | — | 3,360,949 | — | — | 6,291,763 | 6.6 |
| Preferred Hotels | 19,000 | 390,000 | 1,008,285 | — | — | 12,950 | 1,430,235 | 1.5 |
| Radisson | 45,000 | 3,841,085 | 419,659 | 3,760,624 | 389,683 | 139,886 | 8,595,937 | 9.0 |
| Sheraton | 60,000 | 4,801,356 | 1,199,519 | 960,271 | 385,599 | 284,768 | 7,691,514 | 8.0 |
| Sheraton Suites | 150,000 | 5,761,627 | 1,043,436 | 960,271 | 384,099 | 254,793 | 8,554,226 | 8.9 |
| Westin | 50,000 | 4,801,356 | 960,271 | 1,920,542 | 623,493 | 90,000 | 8,445,662 | 8.8 |

**Exhibit 18-6 Summary Percentages Over the Past Five Years**




# ¶ 18.08 HOTEL FRANCHISE SELECTION PROCESS

The selection of an appropriate franchise affiliation is one of the most important decisions to be made during the entire hotel development or acquisition process. The chain affiliation of a hotel affects the property's image, market orientation, ability to benefit from referral business and a central reservation system, ability to compete in the local market, potential for future competition, and ability to generate profits. A poor choice of franchise can seriously affect the competitiveness of a hotel and its ultimate profitablility and financial success.

## [1] Market Study and Appraisal

Selecting a hotel franchise is essentially a matter of first identifying what sort of hotel represents the highest and best use of a property and then determining which hotel chain affiliation would best complement the type of hotel chosen. The key to determining the highest and best use of a property is a thorough market study and appraisal. As described earlier, a market study and appraisal is an evaluation of the market potential of the subject area. Based on the locational and competitive factors determined to be influencing the subject property, recommendations are made in the study regarding market orientation, types of facilities required to cater to this orientation, and the appropriate class or level of quality for the facility. Once these characteristics have been determined and the highest and best use established, appropriate franchise affiliations can be investigated on the basis of their ability to complement and create demand for the subject property.

Developers should evaluate the important factors regarding franchises before proceeding to the next step in the selection process. The first factor that should be considered is that a hotel chain will not consider granting a franchise that will be directly competitive with another lodging facility that it owns, manages, or has franchised in the same market area unless there is sufficient existing and unaccommodated room-night demand. The presence of a competitive property within the market should not deter a potential franchisee from investigating whether the franchisor will consider a franchise application. In some cases, a franchisor may be considering the termination of a franchise, which could mean an available opening for a new property. However, the presence of another property in the same market area should alert the hotel owner to research other franchise opportunities.

The second factor to be considered is whether or not a franchisor has any properties in the feeder cities to the subject's market area. It is important from a marketing point of view that a franchisor have representation in the cities that will provide demand to the subject property's market area. Familiarity with a product often influences the selection of a lodging facility.

## [2] Analysis of Suitable Franchise Affiliations

Once several suitable franchisors have been found, the prospective franchisee should contact the appropriate franchise salespeople and request a copy of their company's UFOC. This document will contain a wealth of information, but additional investigation will probably be necessary. The following checklist contains questions that the prospective franchisee should ask in order to properly evaluate a franchise affiliation and make a suitable selection.

- ☐ How long has the chain been in business?
- ☐ Is the chain growing?
- ☐ How many properties did it have five years ago?
- ☐ How many properties does it have at present?
- ☐ How many properties is it expected to have two, five, and ten years from now?
- ☐ How many properties are owned, managed, or franchised by the chain?
- ☐ Has the product or concept been market tested?
- ☐ How many franchises were terminated over the last five years?
- ☐ What were the reasons for terminating these franchises?
- ☐ What are the names, addresses, and phone numbers of franchisees that can be contacted for references?
- ☐ What percentage of the chain's properties are up-to-date in design, and what percentage are currently being refurbished?
- ☐ How many reservations per property does it produce, on an annual, monthly, and weekly basis?
- ☐ Does it tie into airline reservation systems?
- ☐ How effective is the reservation system for other properties in the market area? For similar properties outside the market area?
- ☐ What types of reservation reports are available?
- ☐ What is the typical percentage of no-shows from the reservation system?

- ☐ What is the operating performance of other chain hotels within or near the subject's market area?
- ☐ What services are offered by the franchisor? Is there an additional charge for these services?
- ☐ What is the chain's reputation among travelers?
- ☐ Does the franchisor sell franchises only to individuals it considers qualified?

### [3] Negotiation of Final Terms

Because a franchisor is generally required to amend the UFOC whenever any important terms of a franchise agreement are changed, most hotel chains will not negotiate variances to their standard agreement. Occasionally, however, some additions and modifications such as the following can be obtained.

*Exclusive territory.* Sometimes franchisors will grant exclusive territories to franchisees who promise to develop a certain number of properties in the area within a specific period of time. Having franchise control over a geographic region often creates value for the holders of these exclusive territories, who can sometimes sell the franchise rights to others.

*Protected areas.* Franchisees are sometimes able to negotiate an agreement by which the franchisor cannot own, manage, or franchise another property within a specified geographic area for either a certain period of time or until a certain level of operating performance has been achieved at the franchisee's property (e.g., occupancy over 70 percent for two consecutive years). A protected area is an important benefit if it can be obtained from a franchisor.

In regard to the final selection of a franchise company, potential franchisees should strive to make their choice as early as possible in the development or acquisition process. Because most franchisors have specific requirements for layout, design, quality, and furnishings, it is advantageous to involve the franchisor before any architectural plans or specifications are made. The franchisee should always ask for an exclusive area, since this technique is an effective means of prohibiting new competition. If the franchise chain that is chosen is new, the franchisee should ask for reduced fees until the chain reaches a certain size. Finally, since the reservation system is one of the key elements to a franchise affiliation, the franchiser should try to obtain some guarantee that the system will be effective and generate actual room-nights for the facility.

## ¶ 18.09 FRANCHISE AGREEMENTS

Once an offer to grant a franchise has been made by the franchisor and accepted by the franchisee, a contractual agreement is drawn up that details the responsibilities of the two parties. The general provisions of franchise agreements typically provide an overview that attempts to make the franchise system and concept appear to be unique so the franchisor can consider the license it grants (the franchise) to be proprietary. Most licenses for franchises are granted for a specific location, so the franchise agreement should include a description of the exact location of the hotel. If the franchisor allows a restricted area, the details of this area should be contained in the agreement.

## [1] Term of Agreement

Hotel franchise agreements typically range from ten to twenty years. Sometimes they provide extensions at the option of the licensee. Franchisees should seek a term for as many years as possible if they have the ability to freely terminate the franchise should the benefits it generates not measure up to expectations of the franchisee. If there is a cost associated with termination, the franchisee should ask for short terms with several options to extend. Most lenders want franchise terms to extend over the life of the mortgage on the property. In addition, lenders generally want the right to either terminate or take over the franchise for the remaining term in the event of a foreclosure. Mortgagee provisions of this kind are known as "comfort letters."

## [2] Proprietary Information

Most franchisors consider all of the publications and written material that they generate for the benefit of their franchise holders to be proprietary. These include operations and training manuals, educational material, conferences and seminars, methods, techniques, formats, specifications, procedures, architectural plans, and so forth. Franchise agreements generally stipulate that this information must be treated confidentially and that its disclosure must be limited.

## [3] Relationship of Parties

All parties to a franchise agreement are considered independent and are not able to bind each other. To limit liability, most franchisors stipulate in their franchise agreements that signs be posted at the front desk stating that the hotel is independently owned and operated under a license with the franchisor. Franchisors generally require indemnification from their franchisees for any claims or actions brought against them.

## [4] Hotel Image and Operating Standards

One of the most important sections of a franchise agreement is the one containing provisions regarding the maintenance of a hotel's image and general operating standards. These provisions relate to franchisor control over not only the physical quality of a lodging facility, but also the level of service and guest satisfaction. Franchisors generally require contract provisions that allow them to monitor the condition and appearance of the hotel and to establish standards for grading compliance. Some chains insist on requirements that hotels that hold their franchises be upgraded at regular intervals so that they remain in conformance with company standards. If alterations are to be undertaken or if the hotel must be rebuilt after a casualty or condemnation, the franchisor will generally want the right to approve plans and specifications. In order to control the quality of furnishings, equipment, and supplies, franchisors also often develop strict specifications that must be followed when purchasing, including the use of approved vendors. Operational procedures are controlled by setting forth requirements in the agreement that the franchisee follow the standards established in the operating manuals provided by the franchisor. Operating standards also generally include restrictions regarding the franchisee's operating competing hotels, diverting business, employing company personnel, and working for another franchisor. Insurance coverage is another important operating standard for franchisors, so they include provisions related to the amount and types of insurance that must be carried by the franchisees in the agreement.

## [5] Training and Guidance

Hotel chains generally require some form of training or orientation for senior level management in order to familiarize personnel with the various systems, procedures, programs, and policies developed by the franchisor. The franchise agreement should specify the nature of this training, which can range from regular classes conducted by the franchisor at an educational facility to simple training manuals. A certain amount of ongoing guidance and consulting is also normally provided, but if the time involved in these activities becomes excessive, the franchisor will usually require a fee.

## [6] Reservation Systems and Advertising

Most franchised hotel chains offer some form of reservation or referral system that is paid for either by the continuing franchise (royalty) fee or by a separate reservation fee that is stipulated in the franchise agreement. A reservation fee can be assessed on the basis of a percentage of rooms revenue or on some other formula related to the number of reservations received. Some hotel chains establish advertising funds to be used for such activities as national or regional advertising and specialized marketing. Most of these funds are established and administered by the franchisor, but are funded by the individual hotels within the chain.

## [7] Fees

As noted previously, most franchises require prospective members to pay an initial license application fee. The amount and details of the fee should be set forth in the franchise agreement. The license application fee is generally payable upon application and is considered earned by the franchisor when the application is approved. The agreement should specify the procedure to be followed if the franchise is not approved. For example, a percentage of the fee may be retained by the franchisor to offset the cost involved in processing the application.

## [8] Reports, Inspections, and Audits

Most franchise agreements establish the right of the franchisor to inspect the books, records, and financial reports of the franchisee, particularly if the franchise fee is based on a formula tied to the financial operating results of the franchisee. Provisions relating to the types and timing of reports that must be submitted to the franchisor are set forth in this part of the agreement.

Franchisors periodically inspect the properties in their chains to determine whether the standards set forth in their franchise agreements are being maintained. If it is necessary to verify the accuracy of the financial data, a franchisor usually has the right to conduct an audit.

## [9] Assignment

A franchise can be assigned by either the franchisee or the franchisor, and while both parties will generally want the right to freely transfer the franchise, usually, only the franchisor has the ability to do so. The franchisee must request approval in accordance with the franchise agreement.

Naturally, the primary concern of the franchisor is to maintain the chain's level of quality, so a new franchisee must be closely reviewed. Franchise agreements generally set forth the basis for approving an assignment as well as the procedure for notification. Some franchisors require that a property be brought up to current standards before it can be assigned, which can entail a substantial expenditure and thus make the property more difficult to transfer. Most franchisors want the right of first refusal in the event they might desire to acquire the property upon a contemplated transfer.

## [10] Termination

Most franchise agreements do not permit the franchisee to terminate the agreement before the end of the term. If the agreement is terminated, the franchisee generally has to pay damages to the franchisor that usually amount to two to three times the franchise fee paid over the past year. Since the cost of terminating a franchise can be expensive, it is important for franchisees to make a good initial selection in order to reduce the chance of an early termination.

Most franchise agreements grant the franchisor extensive rights regarding franchise termination. Some of the more common termination provisions include failure to open the property; failure to operate the property; failure to have proper moral character; violation of a law or ordinance; bankruptcy; failure to maintain insurance; failure to pay franchise fees; and failure to comply with franchisee agreement. In most instances, the franchisee has a right to cure the default before the franchise is terminated.

Franchise agreements generally establish certain obligations on the part of the franchisee in the event that the franchise is terminated or expires. Some of these obligations are: payment of all monies owed to the franchisor including liquidated damages, if appropriate, and removal of signs, systems, marks, and identity items. Some franchise agreements even require that the telephone number of the hotel be returned to the franchisor.

The selection of an appropriate franchise affiliation affects a property's ability to compete in the local market, generate profits, achieve a certain image or market orientation, and benefit from referral business. Because the success of a hotel is predominantly based on the cash flow it generates, owners and lenders must quantitatively measure the benefits and services of a national affiliation against the total cost of such a commitment.

Continued brand recognition, consistency, and franchisor staying power also are important factors in an owner's or lender's decision to add or change a franchise affiliation.

# CHAPTER 19

# Property Management

## ¶ 19.01 INDIVIDUAL MANAGERS VS. MANAGEMENT COMPANIES

The financial success of any lodging facility is largely dependent on the skill and ability of on-site management. Hotel operators face a number of unique problems, ranging from booking convention business to running a high-energy lounge to installing night audit financial controls. While the skills needed to handle such problems can be acquired through college-level training and operational experience, it is the type of system used by management that usually determines how successfully personnel can apply their skills.

Historically, hotel owners have either hired individual on-site managers to operate their properties or have engaged the services of professional hotel companies through hotel operating agreements such as property leases or management contracts.

The employment of individual managers is the less expensive approach, but there are serious drawbacks to such arrangements. In terms of supervision of staff, overall management skill, and effective operational methods, management companies are frequently superior to individual managers.

### [1] Supervision

All the employees of a lodging facility should be supervised to ensure that the integrity of the facility's financial control system is maintained. An individual general manager often cannot provide the necessary level of direct supervision, whereas the structure of a hotel management company generally provides several layers of control over this aspect of the business. Furthermore, an individual general manager can be abruptly hired away by a competitor, or may quit because of a dispute. A hotel management company, on the other hand, can provide the back-up staff, logistical support, and uninterrupted supervision that is essential for a 24-hour-a-day, 365-day-a-year business. Unless ownership can assume total operational responsibility for the hotel on short notice and for extended periods, an individual general manager is often not a viable alternative for property management.

## [2] Expertise

Many professional hotel management companies offer a range of expertise and experience that individual general managers cannot match. Management companies can assist hotel owners with property development, acquisition, and operation by providing such services as national advertising and reservation systems, interior decorating, and property engineering. Management companies are often also able to provide counseling and representation for labor negotiations, permit and license applications, and zoning and property tax proceedings.

## [3] Verifiable Past Performance

A successful hotel management company should be able to document its past performance and provide references regarding its operations currently under contract. Verifiable information of this kind provides hotel operators with a basis for selecting a qualified operator. Individual managers, on the other hand, generally cannot document the effect of their management on a particular hotel. As a result, the selection of a qualified general manager usually must be made with very little assurance that the individual will be capable of successfully operating the property. At the least, poor selection results in confusion and loss of momentum until another manager is located and brought in to take over the operation. While vulnerable to the same problem, a management company is better able to handle a transition between general managers because it can provide trained interim personnel who can quickly assume necessary responsibilities within an established system, permitting continuous operation of all essential controls and procedures.

## [4] Established Methods and Procedures

The major advantage in hiring a management company is that it can provide established, functional methods and procedures that constitute a complete system capable of handling the complex job of operating a lodging facility. In instances in which a takeover must be made rapidly, established management companies can bring in top-level management staff from other properties to train local personnel and implement proper operating systems and controls. For new lodging facilities, management companies can often provide valuable advice in the layout and design of the physical plant, and once the facility is completed, can institute their mode of operation and quickly bring on-line a fully functioning lodging facility. This experience and expertise saves time and reduces costly mistakes.

Most hotel management companies have developed procedure manuals and training programs that cover all of the aspects of lodging facility operations. When nothing is left to chance and set methods are established for handling all foreseeable problems, the element of human error is greatly reduced and hotel guests receive a consistently high level of service.

The benefits of retaining a professional hotel management company usually far outweigh the alternative of employing an individual general manager, particularly when a hotel owner does not have the ability or desire to provide a high level of supervision. As a result of many investors reaching this conclusion, the number of hotel properties managed by third-party operators has grown significantly over the past twenty-five years. This trend is further substantiated by hotel lenders, underwriters, and rating agencies, who typically require that a competent hotel company be included in the project team.

## ¶ 19.02 TOTAL PROPERTY LEASES

The practice of using professional hotel companies to manage lodging facilities for property owners began in the early 1900s. During this period, hotels became larger and more complicated to operate and the benefit of chain identification became an important competitive factor as the general population gained mobility. Hotel chains such as Hilton, Statler, Manger, and Albert Pick began to expand throughout the United States, operating both their own properties and hotels owned by others.

At first, the most common method by which hotel companies furnished management services was through total property leases. Essentially, a total property lease is an agreement between a hotel company and a hotel property owner whereby the hotel company leases the hotel (land, improvements, and sometimes the furniture, fixtures, and equipment) from the property owner. The hotel company thus becomes the tenant and assumes all operating responsibilities, as well as the financial obligations of funding, working capital, operating expenses, and rent. The landlord-owner is passive with respect to all operating decisions and is not responsible for working capital or operating expenses. The hotel company receives the residual net income after all expenses, including rent, are paid.

Under a total property lease, the financial burden is placed on the hotel company, which enjoys some benefits if the property is successful, but suffers all of the losses when operating performance is not adequate. Because of the popularity of management contracts, hotel operating leases have all but disappeared. Only recently, with the resurgence of real estate investment trusts (REITs), have operating leases been reestablished.

### [1] Rental Formulas

Many types of rental formulas were devised for total property lease agreements. In a typical arrangement, known as a "25, 10, and 5 lease," the rent was based on the total of the percentages of various revenues realized by the property. See Exhibit 19-1.

Under such an arrangement, the landlord, as owner of the land and improvements, was responsible for payment of real estate taxes. The tenant owned the personal property and paid all of the operating expenses incurred by the hotel. Sometimes the rental agreement also provided the landlord with a minimum rent to cover the debt service on any mortgages on the property. If such was the case, the tenant paid the greater of the minimum rent amount or the rental formula, such as that for a 25, 10, and 5 lease.

**Exhibit 19-1 25, 10, and 5 Leases**

| | Percentage of Total |
|---|---|
| Rooms Revenue | 25 |
| Beverage Revenue | 10 |
| Food Revenue | 5 |
| Other Income | 20 |

## [2] REIT Structures

The use of real estate investment trusts (REITs) as an alternative for hotel acquisition, financing, and portfolio expansion has resulted in the increased popularity of hotel operating leases. To qualify for favorable REIT tax advantages, the owning company may not operate the properties—it must "lease" the hotels to an independent lessee. Typically, the lessee in turn contracts third-party management, in which management fees are subordinated to the minimum base fee paid to the company. Rents typically include a base and percentage fee or are the greater of the two. In these scenarios, the lessee assumes a majority of the downside risk and is often related to the chosen operator, effectively creating a total property lease.

As a result of REITs competing in the same arena as other fixed income securities, the life of a real estate investment trust fluctuates with the rise and fall of interest rates. For this reason, hotel operating leases may be limited to the few hotel-specific REITs created during periods of low interest rates.

## [3] Advantages and Disadvantages of Property Lease Agreements

A property lease agreement contains advantages and disadvantages for both parties. A property owner realizes the following advantages:

1. The owner retains title to the property, which provides possession and creates residual value when the term of the lease expires.
2. The financial risk to the owner is minimized, particularly if the hotel company is creditworthy and has guaranteed a minimum rent.
3. The owner has no operational responsibilities.

The property owner faces the following disadvantages:

1. The operator has little incentive to maintain the property in top condition as the lease term nears its expiration date. For this reason, many hotels are returned to the owners in poor physical condition, as well as with a tainted reputation. Furthermore, because much of the existing business is often diverted to other hotels managed by the operator, few reservations are on the books for the owner or new tenant.
2. A hotel lease places the owner in a passive position. Under such an agreement, the owner has no input in the operations of the hotel or control over the hotel management. Little can be done if the property is not operated

in a profitable and appropriate manner unless the terms of the lease are violated.

3. If the hotel is extremely successful, the property owner does not participate in the financial rewards to the extent of an owner/operator. Thus, the potential for profit is somewhat limited.
4. Leases are difficult to terminate. Unlike a management contract, which is an agency agreement, a lease creates an encumbrance on the real estate that gives the tenant specific rights of possession.

There are several advantages in a property lease agreement for the hotel operator:

1. The operator has total control of the hotel during the term of the lease with very few approvals required from ownership.
2. A profitable hotel creates a leasehold value that can sometimes be mortgaged by the operator. If the terms of the lease permit a transfer, the leasehold value can also be realized through a sale.
3. The upside profit created by a successful hotel will solely benefit the operator, who receives whatever money remains after operating expenses and lease rental have been paid.

The disadvantages for a hotel operator are as follows:

1. The hotel operator loses possession of the property when the lease term expires.
2. The leasehold loses its value as the term of the lease expires.
3. The financial risks of operating the hotel are borne by the hotel company, so the operator must have a net worth great enough to be able to incur the exposure.
4. Leasehold interests create contingent liabilities on corporate balance sheets that can adversely affect the value of stock in publicly traded companies. Of course, because of the requirements for real estate investment trusts, hotel operating leases are a necessity.

## ¶ 19.03 DEVELOPMENT OF HOTEL MANAGEMENT CONTRACTS

Hotel management contracts came into use between 1950 and 1960. During that time, more and more Americans started traveling abroad, and foreign governments that were interested in attracting American tourists began encouraging U.S. hotel companies to develop hotels in their countries.

The concept of a worldwide lodging chain was appealing to a number of hotel companies, but many were reluctant to expose themselves to the development and operating risks associated with owning or leasing a hotel in a foreign country. Many factors, including governmental instability, fiscal uncertainty, and a lack of skilled labor led hotel companies to develop a replacement for the property lease that would shift the financial burden from the operator to the owner. The result of the hotel companies' efforts was the hotel management contract.

A management contract is essentially an agreement between a hotel management company and a hotel property owner whereby the management company takes on the responsibility of managing the hotel and its facilities. The owner, unless stipulated otherwise, assumes a passive position with respect to operating decisions, while assuming responsibility for all working capital, operating expenses, and debt service. The management company is paid a fee for its services and the owner receives the residual net income after all expenses.

Unlike a property lease, the financial burden under a management contract is placed entirely on the owner, who enjoys the upside benefits of a successful property, but suffers the downside losses if the operation is not profitable. Under this arrangement, American hotel companies were eager to expand overseas because the foreign country assumed the financial risk for the benefit of developing tourism and the management company provided operational expertise and name recognition. Chains such as Hilton International, Hyatt, Sheraton, Western International (Westin), and Inter-Continental were among the hotel companies that used management contracts to expand their bases of operations worldwide.

Once hotel companies discovered that they could make almost as much money with a management contract as with a property lease without assuming any of the financial risks, they started to change their modes of operation.

## ¶ 19.04 PROPERTY LEASES VS. MANAGEMENT CONTRACTS

Exhibit 19-2 illustrates the shifting of financial risks between the property owner and the hotel operator, using both a property lease and management contract structure. Two scenarios are set forth for a proposed 300-room, first-class hotel: one assumes a new property (Hotel *A*) with a normal occupancy build-up and the other assumes a new property of the same description but with a lower starting occupancy and a longer and slower build-up (Hotel *B*).

**Exhibit 19-2 Assumed Occupancy and Average Room Rates**

| | Hotel *A* (Normal Occupancy Build-up) | | Hotel *B* (Low Occupancy Build-Up) | |
|---|---|---|---|---|
| Year | Occupancy | Average Rate | Occupancy | Average Rate |
| 1 | 58% | $ 95.00 | 45% | $ 95.00 |
| 2 | 65 | 101.65 | 48 | 101.65 |
| 3 | 70 | 107.75 | 50 | 107.75 |
| 4 | 73 | 113.14 | 52 | 113.14 |
| 5 | 73 | 117.66 | 53 | 117.66 |
| 6 | 73 | 122.37 | 54 | 122.37 |
| 7 | 73 | 127.26 | 55 | 127.26 |

As shown in Exhibit 19-2, Hotel *A* starts with a 58 percent occupancy in Year One and reaches a stabilized level of 73 percent in Year Four. Hotel *B* starts with an occupancy rate of 45 percent in Year One that grows slowly and stabilizes at 55 percent in Year Seven.

Seven-year projections of income and expense for each hotel based on these occupancy and average rate assumptions are shown in Exhibits 19-3 and 19-4. The data for operating ratios for controllable expenses have been adjusted to reflect differing levels of occupancy; fixed expenses such as property taxes and insurance have been held constant except for inflationary increases. A basic management fee of 3.0 percent (based on total revenue) has been deducted as well as a 4.0 percent reserve for replacement (also based on total revenue) to provide a fund for the replacement of furniture, fixtures, and equipment.

A property lease and a management contract structure is assumed for each scenario in the Exhibits. The terms for these structures are based on typical provisions found in the marketplace. It should be noted that, beyond their use in REIT structures, hotel property leases are no longer common and therefore the assumed terms are based on the historic use of these instruments.

As stated previously, the rent paid under hotel property leases has typically been determined by the "25, 10 and 5" lease. The actual dollar amounts yielded by this formula for both hotels are shown in Exhibit 19-5.

Usually, under such an agreement the landlord owns the land and improvements and is responsible for the payment of real estate taxes. The tenant owns the personal property and pays all operating expenses.

Exhibit 19-6 shows how the net income realized by Hotel A is divided between the hotel company (tenant) and the property owner (landlord) under a property lease.

The net income realized by the tenant starts with the net income from the projection of income and expense. The landlord pays the real estate taxes out of the rent, so the amount deducted for real estate taxes can be added back to the net income. The rent is deducted from the net income and is calculated using the rental formula set forth above. The result of these calculations is the net to the tenant.

The net to the landlord is based on the previously calculated rent minus the property tax obligation. Because the tenant is assumed to own the furniture, fixtures, and equipment, a reserve for replacement has not been deducted from the net to the landlord.

The terms of the management contract assume a basic management fee of 3 percent of total revenue plus an incentive fee equal to 10 percent of house profit (income before fixed charges) after deducting the 3 percent base fee. Exhibit 19-7 shows how the net income for Hotel *A* is divided between the hotel company and the property owner under a management contract.

The net to the management company is the total of the basic management fee plus the incentive fee; the net to the owner is equal to the residual net income remaining after deducting the total management fee.

A comparison of each structure is made for Hotel *A* in Exhibit 19-8 by totaling the income to each party over a seven-year period assuming both a lease and management contract.

Hotel *B* has a lower starting occupancy and a longer and slower income build-up and as a consequence produces much different results from Hotel *A*. Exhibit 19-9 shows how the net income of Hotel *B* would be divided between the hotel company (tenant) and the property owner (landlord), assuming a property lease. As can be seen, the net income realized by the tenant is actually negative for the first four years, while the landlord, on the other hand, realizes a positive cash flow.

Exhibit 19-10 assumes a management contract structure for Hotel *B* and shows how the net income is shared between the hotel company and property owner. Exhibit 19-11 compares each structure by totaling the income to each party over the seven-year period.

In this scenario, the hotel company would want to operate the hotel with a management contract, while the property owner would realize more income from a lease. In fact, if the transaction were structured as a lease, the hotel company would have a cash flow shortfall of almost $4 million during the first seven years of operation. For many of the smaller hotel companies, this degree of exposure is not acceptable.

Comparing the economic benefits to the hotel company under a lease with those under a management contract, it becomes apparent that the potential upside benefit

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**Steve Rushmore** is the Founder of HVS and the **Creator of the Hotel Valuation Methodology**. He has authored eight textbooks on hotel valuation and investing, along with over 350 articles on similar topics. In addition, Steve has taught thousands of industry professionals around the world. His online course- **"How to Value a Hotel"** is used by the leading hotel schools and consulting organizations. Contact Steve at **steve@steverushmore.com** or visit his website **www.steverushmore.com**