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HOTEL INVESTMENTS

A Guide for Lenders and Owners

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During the past 45 years, there have been several people who have had a profound impact on my life. I dedicate this book to them, with thanks for their assistance, direction, and constant encouragement.

My parents—Leon and Caroline Rushmore

My wife—Judy

My in-laws—Fred and Ruth Kellner

My children—Cindy and Stephen, Jr.

S.R.

Preface

Investing in hotels and motels is considered by many to be a high-risk use of time and capital. The investor not only acquires an interest in a volatile form of real property, but also participates in the highly specialized business of operating a service-oriented going concern. Where the lodging facility includes food, beverage, banquet, and recreational facilities, the risk and accompanying aggravation are often multiplied tenfold. Yet, despite the sometimes dire consequences associated with such investments, investors continue to be drawn to the status and glamour of hotels—as well as to the potential for lucrative gain.

Hotel Investments: A Guide for Lenders and Owners has been written as a guidebook for those who want to actively participate in the lodging industry while keeping their risk exposure to a minimum. Its coverage is equally designed for all three types of investors associated with hotel projects: (1) owners, who invest equity capital and assume the major portion of the risk; (2) lenders, who invest debt capital; and (3) hotel operators, who invest considerable time and effort. The book provides an investor with the basic tools for making a hotel investment: a complete understanding of the U.S. hotel industry; the steps for planning the investment; a procedure for determining the economic feasibility of the investment; criteria for choosing a management company and a franchise affiliation, and tips for drafting sound agreements to define these relationships; and the fundamentals of developing, acquiring, and financing a lodging facility. The book is intended to be easily usable by and useful to a first-time hotel investor, while at the same time offering valuable insights to experienced investors.

Hotel Investments brings together in one easy-to-use volume all of the information needed to make a successful hotel investment. The book is organized in a step-by-step manner that describes hotel investing from a “how-to” perspective and that follows the actual sequence of events in the development of an investment. It includes numerous charts and tables that convey information in a simple, straightforward manner, as well as a comprehensive case study that illustrates the various procedures utilized in evaluating hotel investments in a real world setting. The book also presents sample clauses, taken from actual management contracts and purchase and sale agreements, that investors can use when structuring their own agreements. Finally, *Hotel Investments* contains comprehensive directories of actual companies involved in the hotel industry, such as developers, lenders, owners and investors, franchise companies, and management companies. These directories should serve as an invaluable reference tool to anyone putting together a hotel investment.

Since hotel investing is a dynamic process and the hotel industry is constantly changing, *Hotel Investments: A Guide for Lenders and Owners* will be periodically updated with supplements in order to provide a full range of current material.

STEPHEN RUSHMORE

March 1990

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The process of writing a text of this magnitude could not possibly be accomplished by just one person. Therefore, I would like to acknowledge the efforts of some of the individuals and organizations who assisted me in making *Hotel Investments: A Guide for Lenders and Owners* a reality.

Sharon King, the Director of Marketing for Hospitality Valuation Services, Inc., researched and developed Chapter 2, which serves as an important foundation for orienting the investor to the lodging industry and identifying its current position in the various financial cycles that affect it. She also directed an army of college interns who performed much of the data collection that resulted in the various directories and statistics that appear in this volume.

Hospitality Valuation Services, a hotel appraisal organization that tracks hotel valuation trends throughout the United States, contributed a great deal of material to this book. Its databases and publications include: *The Hospitality Market Data Exchange*, a clearinghouse of sales data from over 3,000 hotels; *The Hospitality Valuation Index*, an historical index of hotel value trends for the top 25 U.S. hotel markets; and *Rushmore on Hotel Valuations*, a quarterly newsletter containing timely articles on the financial aspects of hotel investing.

The U.S. Travel Data Center provided travel data and statistics that have been utilized throughout the text. Anyone who is involved in the travel industry should belong to this organization, which is one of the most important sources available for such information.

Smith Travel Research, the most reliable source of hotel supply and demand data, as well as market area occupancies and average room rates, supplied me with a great deal of information relating to these topics. Smith Travel Research accumulates and publishes this data in its monthly newsletter, a must for every investor.

Lodging Hospitality magazine, a highly regarded monthly trade journal covering the hospitality industry, compiled many of the statistics contained in this text. This publication is an invaluable tool for hotel investors.

The American Society of Real Estate Counselors, a professional organization of counselors specializing in real estate, allowed me to utilize portions of the Spring Valley case study from a text I had previously authored for them.

Finally, I would like to thank the staff of Hospitality Valuation Services, who, over the two-year period during which this book was being assembled, provided me with assistance in many ways. The following individuals deserve recognition for their efforts: James Abe, Kent Alfano, Brenda Axelrod, Kathy Bartkus, Chris Bechtel, Elizabeth Bell, Bonny Bird, Anne Brink, Michael Cahill, Charles Cerulli, Robert Chechi, Linda Chen, Harvey Christensen, Dana Dougherty, Nancy Eschmann, Julie Falenski, Andrew Feinstein, Jill Gentile, Cynthia Gibbons, Joshua Greene, Steve Haggerty, Greg Hartmann, John Hazelton, Suzanne Heidelberger, Maggie Hernandez, Pegeen Higgins, Michael Istvanko, Craig Johnson, Carol Kieser, Daniel King, Mee Mee Kiong, Laura Kozelouzek, Glen Leitch, Kathleen L'Esperance, Daniel Lesser (MAI), Allison Levine, Robin Lewis, Ian Lien, Anne

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PART I

**Overview of the
U.S. Lodging
Industry**

CHAPTER 1

Introduction

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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, as does any investment, a certain amount of research regarding both the industry as a whole and the investment itself. *Hotel Investments: A Guide for Lenders and Owners* is divided into four main sections that present the necessary information and analytical methods in the sequence that 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. Part I (Chapters 1-4) provides an overview of the industry and discusses the forces that affect it.

The evolution of the lodging industry in the United States is 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 has often been the result of periods of increased construction

activity, which in turn has meant stagnation for the industry, even when the economy as a whole performs well, as 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 evolved to a point where it is dominated by national and international chains. Where once, however, the chains built and owned the properties on which their names were displayed, more and more such companies no longer own hotels—individuals investors do. The trend in the industry is for many of the major hotel chains to develop and manage properties for such 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.

1.02 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.

1.03 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.

Part II (Chapters 5–14) describes 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 Part II.

At the end of each Chapter in Part II is a case study based on an actual formal market study and appraisal. The case study was 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 study is 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 determining 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 the types of data and analytical techniques discussed previously 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, particularly for the first time, investors are well-advised to keep it close to home so it can be given their full attention. This recommendation is particularly appropriate when the hotel is being developed. Supervising lodging operations scattered over a wide geographic area is of course possible, but to do so requires a level of expertise that can only be gained 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. Many areas of the country are currently overbuilt, which means that even with favorable economic trends, the 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. Conversely, although the supply and demand trends within a region may indicate weak economic growth or an adversely competitive environment, an investor may sometimes find pockets of opportunity that will overshadow these negative indicators.

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, along with the competitive supply, are once again the key factors to be considered when analyzing potential market areas.

After the market area is determined, the next step is to find a market niche, which is a unique market position or a particular market for which the right kind of product may be best 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, examples of which are a restrictive zoning or license approval process, 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 based on 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 invariably 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 to 4 percent for existing hotels and 4 to 10 percent for vacant land.

Real estate brokers are agents for the seller and, as such, 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 basis, a flat fee, or some formula based on 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.

1.04 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.

In many instances, the preliminary market study and appraisal is performed by the in-house staff of the prospective buyer. In order to obtain financing, however, an independent hotel appraisal firm must ultimately be engaged to produce a formal market study and appraisal. This step is necessary because finance sources require a fully documented appraisal prepared by an accredited professional.

Chapter 6 describes the process that should be followed to select a consulting and appraisal firm and determine reasonable compensation for its services.

1.05 SITE ANALYSIS

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 7 examines all of these concerns and shows how they are to be weighed in the evaluation of a proposed site.

1.06 NEIGHBORHOOD AND MARKET AREA ANALYSIS

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, such as competition and travel patterns. Chapter 8 explains how both the neighborhood and market area can be determined and evaluated for suitability.

1.07 COMPETITIVE ANALYSIS

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 9 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.

1.08 DEMAND ANALYSIS

After the supply of hotels is 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 10 explains these two methods and shows how the data necessary to use them can be obtained.

1.09 COMPETITIVE POSITION

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 is made, the appraiser can forecast these variables for the subject property. Chapter 11 shows how this analysis is accomplished.

1.10 REVENUE AND EXPENSE FORECASTS

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 12 discusses the various categories of revenue and shows how a revenue forecast is made. Chapter 13 does the same for expenses.

1.11 PROPERTY VALUATION

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 construction. Chapter 14 explains the three basic methods for performing a property valuation: the cost approach, the sales comparison approach, and the income capitalization approach.

1.12 PROPERTY MANAGEMENT

Two of the most important steps in the hotel investment process are the selections of a hotel management company and of a franchise affiliation, as described in Part III (Chapters 15–17). Whether the project in question is a development or 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 have to 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 15 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.

1.13 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 con-

tract 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 16 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 labelled to show their orientation—owner, operator, or neutral.

1.14 **FRANCHISE AFFILIATIONS**

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 company-wide 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 17 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.

1.15 **FORMAL MARKET STUDY AND APPRAISAL**

After all of the essential elements of a hotel project are assembled and the key steps are taken, one final hurdle must be cleared: project financing. After agreements are negotiated with a management company and, if necessary, a franchise company, the property owner must estimate the total cost of the project and, if satisfied that it will be feasible, commission a formal market study and appraisal to be performed by an independent, accredited appraisal firm. The case study in Part II is an example of such a document. In the hotel industry, this document is often known as a “feasibility study,” although this term is a misnomer. A brief example will explain what often happens to first-time hotel developers.

A hotel developer finds the perfect site for a lodging facility. He goes to his bank, describes the project, and asks for a loan. The bank says, “Fine, but first we need a feasibility study.” Four to six weeks later, after spending \$25,000 to \$30,000, the developer returns to the bank with the requested study. The bank says, “Fine, we will make the loan, but now we need to have an MAI appraisal to justify our 75 percent loan-to-value ratio.” Thirty days later, after spending another \$15,000 to \$20,000, the developer has satisfied the bank with the required documentation.

Second-time hotel developers quickly realize that they should obtain a combined feasibility study and appraisal that fulfills the lender’s requirements in one package,

saving not only considerable time but also unnecessary duplication of effort and expense. This combined study is referred to in this book as an economic market study and appraisal.

1.16 PROCESS OF DEVELOPMENT OR ACQUISITION

Once the necessary planning for a hotel project is completed, the actual process of development or acquisition, as outlined in Part IV (Chapters 18–21), can begin. Chapter 18 describes the essential steps in the coordination and execution of a hotel 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.

Chapter 19 covers the acquisition of an existing property, starting with the steps involved in locating a suitable property and continuing through the entire process of contract negotiations. These negotiations involve the determination of final sale price, seller's guarantees and purchase money financing, contingencies that reduce the purchaser risk, the disposition of the existing property management and franchise affiliation (if necessary), and a number of other issues, such as tax planning, property inventory, and the proration of revenues and expenses. Appendix 2 provides sample clauses, taken from actual purchase and sale agreements, that illustrate the approaches used to address these matters.

1.17 MORTGAGE FINANCING

All efforts in both the acquisition and development processes should be directed toward the goal of obtaining mortgage financing. Mortgage lenders, by nature, tend to be very conservative and many will not even consider making hotel loans. Industry overbuilding, along with negative publicity in recent years surrounding foreclosures and bankruptcies, has put a number of hotel lenders on the sidelines looking at other lending alternatives.

In today's economic climate, lenders look carefully at track records. In order to approve a loan they require a developer to be able to show a list of successful hotel developments, a lodging concept that has proven successful in the hotel marketplace, a franchise affiliation that produces room-nights, and an operator who is capable of making profits. Essentially, they want to reduce all areas of potential risks.

Chapter 20 identifies the major sources of mortgage financing for hotel projects and describes the factors of risk that are analyzed by lenders when considering issuing a mortgage for a particular project. The chapter also covers the types of loans that hotel investors use and the process by which they are obtained.

1.18 EQUITY INVESTMENT STRUCTURES

If a hotel developer or someone acquiring an existing facility is able to secure sufficient mortgage financing, they usually find that equity capital is fairly easy to obtain. Essentially, when a lender determines that a transaction can provide a satisfactory financial return, there should be a sufficient cushion of cash flow to satisfy equity investors. Further, mortgage lenders are likely to perform a high degree of due dili-

gence, which indirectly benefits the positions of the equity interests. Like mortgage lenders, equity investors look for a track record of success. If the structure is a limited partnership, for example, lenders want to be sure that the general partner has the financial strength to cover operating deficits should the project not generate a sufficient cash flow. Equity investors look for a fair distribution of cash flow and tax benefits based on the various types of risks they face during the investment period.

Structuring the equity portion of a hotel investment is the topic of Chapter 21. In addition to describing the economic positions of the various parties involved in a hotel investment (e.g., owner, lender, seller, management and franchise companies, and real estate, mortgage, and equity brokers, among others), the common types of investment structures are analyzed and a detailed example is provided that illustrates a typical transaction. Partnerships and the distributions of sales proceeds are also closely examined.

1.19 **INDUSTRY SOURCES AND CONTACTS**

The directories at the back of *Hotel Investments: A Guide for Lenders and Owners* 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; the person to contact; and some basic information regarding the properties with which the firm has recently been involved. 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 and Dynamics of the Lodging Industry

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2.01 EVOLUTION OF THE INDUSTRY

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

The first lodging facilities developed in the United States were coaching inns and taverns. Patterned after the English inns, these facilities were situated primarily in seaport towns and along coaching routes.

As the new colonies began to prosper and the country expanded westward, some lodging facilities were developed with a new degree of opulence. Reflecting the richness of their European counterparts, these grand hotels were situated in both resort and urban settings.

In time, the growth of the U.S. railroad system created a need for overnight accommodations for rail travelers. In response to this new demand, small rooming houses were often built near train stations. These facilities generally had much lower standards of service and cleanliness than did the luxury hotels found in the cities. Transients in many cities then had a choice between high-quality downtown hotels and inexpensive accommodations in railroad rooming houses. Since many travelers

were unable to afford first-class accommodations, the railroad rooming houses were their only real alternative.

[2] Turn of the Century Expansion

The turn of the century in the United States saw an economic expansion that, in conjunction with improvements in transportation and lower travel costs, opened up travel to the middle class. This in turn created a new, large, and growing market. The economic expansion also brought about increased commercial activity and ever larger numbers of business travelers. However, neither of the two classes of hotels then available were acceptable to the growing mid-rate commercial market.

Ellsworth M. Statler answered the needs of this expanding market in 1908 by opening the Buffalo Statler in Buffalo, New York—the first modern commercial hotel. 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.

The early 1900s saw vigorous growth in hotel construction in America as large luxury hotels (such as the Plaza, built in New York City in 1907) continued to be built in major cities, and the commercial hotel segment continued to emerge. World War I brought on a period of relatively low construction activity as the country focused its efforts on the war, but this lull was followed by a tremendous surge in building activity in the 1920s.

[3] Overdevelopment in the 1920s

As the economy expanded after the war, the middle class continued to grow and had more disposable income to invest. 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 participate as they listened to hotel promoters who set up shop in their towns and cities. Many times their arguments for investment were based not on economic feasibility but on civic pride, improving a neighborhood, or personal prestige. In some cases, local merchants were promised patronage by the hotel when it opened if they invested in the project. In these "community-financed" hotel projects, real estate bonds for first and second mortgages were sold to local residents. In many cases the financing structures thus created involved high leverage and an inordinate amount of risk.

Despite these conditions, investors were convinced, money was available, and hotels were financed, resulting in a boom in hotel construction throughout the decade. By the middle of the decade, *Hotel Management* (a trade publication that later became *Hotel and Motel Management*) began to print articles by several industry spokespersons warning against "over-hoteling" and urging professional hoteliers to release to the public the "real facts" about their hotel's occupancy level and financial condition to offset the larger-than-life stories that had circulated earlier and contributed to the overbuilt situation. In order to illustrate the extent of the overbuilding

problems a nationwide survey was conducted in 1928–1929 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 over the period 1919–1928. They found that nationwide hotel occupancy dropped from 85.5 percent in 1920 to 67.6 percent in 1928.

Room rates appeared to remain nominally constant between 1921 and 1928, but the Foundation determined that the addition of services for guests over this time effectively lowered the rate achieved by hotels. Hotel failures increased between 1924 and 1928 at an average annual rate of 15 percent.

[4] Depression Years

The real status of the lodging industry quickly became apparent after the stock market crash of 1929. Hotel rate wars became common, leading one industry spokesman to suggest mergers of hotels within cities in order to hold prices firm. However, even low rates could not induce demand when there was none. 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, over 80 percent of the hotels in the nation were in foreclosure or in some form of liquidation. Many properties closed entirely.

A major opportunity arose from the collapse of the hotel industry for investors that had available cash, because they were able to buy troubled properties with only a small cash outlay and reasonable financing. It was at this time that some of the most well-known hotel chains had their beginnings.

Conrad Hilton had entered the lodging industry in 1919 with the purchase of the 40-room Mobley Hotel in Cisco, Texas. During the 1920s Hilton had 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 as a result of the crash. Despite cutting costs to the bone—including removing guestroom telephones and shutting off entire floors—he was only able to retain control of five hotels in his chain. By 1935, however, profits from oil leases provided Hilton with cash to satisfy his creditors and to fund new purchases. Hilton then bought control of the Sir Francis Drake in San Francisco, the Town House in Los Angeles, the Stevens in Chicago, and the Roosevelt and Plaza in New York.

Ernest Henderson founded what was to become the Sheraton hotel chain in 1937 with the purchase of the Stonehaven Hotel in Springfield, Massachusetts. By 1941, his 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 companies, such as Hilton and Sheraton, were able to overcome the fears of bankers and other lenders who were wary of independent developers and hotel investments in general. By taking advantage of low selling prices, the strong hotel companies were able to continue their expansion.

Representatives of the hotel industry warned investors during the depression years not to value hotels based on their present income streams, which were, of course, very low. They stressed rather that hotels should be valued on the expectation of future earnings, which would turn around. Trade writers, looking back at previous recessionary times, optimistically forecast three years of darkness before the industry would recover. However, the depression years were different because of the overbuilding that had preceded them.

[5] World War II Era

The hotel industry did not begin to recover until the early 1940s, after both the general economy improved and the hotel room supply had been significantly reduced by closures. With the onset of World War II, the industry experienced an 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 commercial travelers swelled in number to meet the huge need for goods and services. Despite the large increase in demand, supply remained constant because construction materials and labor were devoted to the war effort. Financing was generally unavailable for new construction because lenders and investors were still wary after experiencing the downswing of the depression. In some areas, hotel room supply was actually significantly reduced when the armed forces required that hotels such as the Hotel Stevens in Chicago and the Greenbrier in White Sulphur Springs, Virginia be converted to housing for troops. The combination of excessive demand and constant or diminishing supply created occupancy levels over 90 percent and unmatched profits.

The labor and material shortages made it difficult to maintain high service standards during this time, but guests waiting hours in hotel lobbies for accommodations had no alternatives. In fact, at one point New York City hotels had to limit the stay of guests to three days.

[6] Postwar Development

The years immediately following World War II did not see a construction boom such as the one that followed the First World War, in large part because hotel lenders were concerned about the risk of repeating the financial disaster of the 1930s. Though averse to lending on new hotel projects, mortgage lenders did grant refinancing to existing hotels. 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. Hilton purchased the Statler chain of 10 hotels in 1954 for \$111 million from Statler's widow, and Sheraton expanded in 1956 by acquiring 22 hotels from Eugene Eppley.

The 1950s were marked by the development and growth of motel chains. With their beginnings in the tourist courts of the 1930s, motels in the early years were usually 20–50 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. The war activity of the 1940s caused tourist court business to decline because there was little free time for vacation travel and gasoline and food were rationed. It was not until after the war that the situation improved for this segment of the industry.

Travel had become an accepted part of American life during the war. Travel came to be seen as recreational, and the new-found pastime was fueled by the increasing use of the automobile and the expanding economy, which provided many families with more disposable income. It was easy and inexpensive to take a family vacation by driving and staying at motor courts, where the car could be parked by the guestroom door. In addition to vacation travelers, the motel market included business travelers (especially salespersons, middle-managers, and small business owners) and per diem government employees.

The first motels were distinctly different from hotels of the same period in terms of size, construction costs, land values, and management requirements. They were also distinctive in the benefits they offered—convenient highway locations, ample free parking, and low rates.

[a] **Emergence of Chains and Franchises**

While motels began to flourish throughout the U.S., their potential guests had no idea what service and quality levels to expect when pulling off the highway. Standards were at best unpredictable and frequently disappointing. Recognizing an opportunity when traveling with his own family, Kemmons Wilson started a new era in the lodging industry in 1952 by founding Holiday Inns, one of the earliest motel chains. Holiday Inns offered its guests a modern motel with standardized service and a recognizable name at a moderate price. The growth of the Holiday Inn chain from Kemmons Wilson's original four motels in and near Memphis, Tennessee in the early 1950s to over 100 motels nationally by 1960 was driven by the sale of franchises to investors who then operated the properties as their own businesses. The first Holiday Inn franchise was sold in Clarksdale, Mississippi for \$500 and a flat fee of \$0.05 per occupied room. In return, the franchisee received the Holiday Inn name, architectural plans, and national advertising. In 1964, when Holiday Inns launched its Holidex I reservation system, a major benefit was added to the franchise package and Kemmons Wilson was overwhelmed with franchise applications.

[b] **Expansion of Supply**

On a nationwide basis, motel room supply increased from 600,000 to 1.5 million rooms during the 1950s. Three major factors contributed significantly to this increase. The first was the passing of the Interstate Highway Act in 1956, which defined the future growth of interstate highways and allowed planning for roadside motel sites throughout the nation. The second was a change in income tax laws in 1954 that permitted real property owners to use an accelerated depreciation method. This led to a period of readily available cash from "tax-based" hotel deals in which syndicators offered investors participation in hotels that benefited from the large depreciation and interest expense that offset income in the early years of the investments. The drawback to this type of investing was that in order to keep up the high depreciation and interest deductions, new properties had to be added continuously to an investor's portfolio, which led on occasion to poor investment choices. The third factor was the use of franchising as an expansion tool for motel and hotel chains.

[7] **Changes in the Marketplace in the 1960s**

Hotel owners were at first reluctant to accept the fact that they were competing with motels for the same market. However, steady declines in their own occupancy rates as motel rooms came on the market, coupled with the fact that motel occupancy levels remained stable, told them differently. Nationwide occupancy, performing in the upper-70 percent range during the early 1950s, dropped to the mid-60 percent range by 1960, and fell further to low-60 percent figures overall by 1962 as more motel rooms came on the market. In order to compete for the same market as hotels, motels began to offer more amenities and to develop properties in metropolitan loca-

tions. Hotels, in turn, started to offer parking facilities and lowered their room rates in order to stay competitive. The distinction between hotels and motels continued to diminish and resulted in a hybrid lodging facility known as the motor hotel, which combined the services and facilities of a hotel with the convenience of a motel.

Marketing achieved recognition as a profession during the 1950s and 1960s, and "market segmentation" gained acceptance as an industry precept. As a result, the market for lodging accommodations was no longer thought of as one homogenous mass. Marketers began to research and understand their customers more clearly, to define specific segments with varying characteristics, and to focus on the segments more effectively by carefully selecting the services, amenities, and prices that were offered.

The late 1950s and early 1960s saw the rise of several new lodging chains in addition to Holiday Inn that relied on innovative marketing strategies for their initial success. Ramada Inns, Howard Johnson Inns, Marriott, Hyatt, and Radisson all successfully won significant market shares in their early years through inventive, aggressive marketing.

International activity on the part of U.S. hotel companies became common during the decade of the 1960s. Pan American Airways' subsidiary, Inter-Continental Hotels Corporation, which had begun 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 their Hilton International division, and began expanding their operations in Europe and South America.

A move toward vertical integration within the airline and lodging industry also 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.

The convention and meeting market became a focus of interest during the 1960s as hotel chains sought new opportunities for growth. The New York Hilton, which opened in 1963, was designed and built specifically to cater to the growing convention market, which favored major cities as destinations.

[8] Expansion and Contraction in the 1970s

The large hotel companies that were formed in the 1950s and 1960s matured in the 1970s, becoming more professional and more sophisticated in their management systems. The disciplines of hotel operations, finance, accounting, and marketing were developed into a science. Emphasis was placed on making operations more efficient, monitoring operating statements, and comparing financial ratios to prior years and national averages. University degree training in hotel administration became common for management personnel.

The concept of "market segmentation," which gained respect in the 1960s, became the guiding force behind the growth of many of the major chains throughout the 1970s and into the present. As market segments became better defined and hotel companies selected the segments their hotels could best target, the appropriate sales skills for the chosen segment also improved.

During the late 1960s and early 1970s, hotel companies actively expanded through franchising. In a franchise agreement, the hotel owner pays an initial franchise fee plus monthly royalty fees for the use of a hotel chain's name, logo, reservation system, national advertising, operation and training manuals and, in some cases, centralized accounting systems.

The late 1970s and early 1980s saw a trend by hotel chains toward selling ownership of their hotels to investment groups and taking back management contracts to operate the properties, thereby freeing capital for further expansion while still retaining a high degree of control. (See Chapter 16 for further discussion of the role of management contracts in the industry.) Professional hotel management companies proliferated as it became apparent that the industry was moving in this direction.

Aggressive expansion of hotel chains and the creation of budget motels during the late 1960s and 1970s caused the start of a construction boom and overbuilding cycle reminiscent of the 1920s. While many factors contributed to this period of expansion, the ready availability of capital, in several forms, may be seen as one of the driving factors.

High-leverage finance organizations known as real estate investment trusts (REITs) were created to allow small investors to participate in real estate mortgages and equities. They were greeted with a great deal of enthusiasm and as a result provided an enormous amount of funds for hotel financing during the early 1970s. The concept was just as eagerly accepted by Wall Street and funds became available for investment that had not existed before. Many lenders became so overwhelmed with new money that their underwriting qualification procedures broke down, resulting in a number of marginal and speculative developments being approved.

Franchising itself was an indirect source of new capital for hotel companies because the franchisee's investment could, essentially, be used to finance corporate growth. In some cases, franchises were sold and hotel properties developed in markets that were not strong enough to support them. On one intersection in Selma, North Carolina, eight nationally franchised properties were built, though demand existed for one at best. The combination of readily available financing and aggressive hotel chains eager to sell franchises resulted in overbuilding and the development of a number of undercapitalized properties managed by inexperienced owners in poor locations.

The frenzied growth in hotel supply in the early 1970s led to a crisis for the lodging industry. High inflation caused construction costs and interest rates to escalate. In addition, the oil embargo in 1974 and the resulting energy crisis drastically reduced travel. The recession that followed curtailed even further business trips, conferences, and conventions. The marginal properties built during the boom earlier in the decade could not survive this downturn and as a result were taken back in foreclosure by the lending institutions that had financed them. The lenders then either established workout departments headed by experienced hoteliers or engaged professional management companies to assume operational responsibility for the properties, the primary objective being to improve profits so that the hotels could be sold at satisfactory prices. Over the short term, very few properties were able to meet this objective, however, and lenders frequently had to either take substantial all-cash write-downs or provide purchase-money financing with extremely favorable terms. Over the long term, many of these hotels recovered during the early 1980s and became successful lodging facilities.

By the late 1970s, a rough equilibrium between lodging supply and demand was reached because of the scarcity of capital, the downturn in new construction, the retirement of older lodging facilities from the market, and the closure of unprofitable

hotels developed during the construction boom. High occupancy rates were once again recorded.

[9] Overbuilding and Recovery in the 1980s

In the early 1980s, the prime rate was at a record high, with the result that construction financing became too costly and many projects were rendered infeasible. In addition, lenders were still wary of hotel investment after the downturn of the mid-1970s and were thus resistant to extending credit. Hotel supply did not increase during this time, so hotel occupancy continued to remain at high levels.

After 1983, interest rates dropped as a result of declining inflation and falling energy prices, and hotel development resurged. As had been the case in the early 1970s, the ready availability of capital contributed to a period of excessive hotel construction. At this time, however, it was the entry of savings and loan (S&L) institutions into the commercial lending market that provided new capital for hotel development. In many ways, the overall scenario was the same as it was in the 1970s: So much capital became available for real estate transactions that review processes broke down and many marginal and speculative investments were approved.

Another major contributing force to overbuilding in the first half of the 1980s was the favorable treatment offered by U.S. income tax regulations. Many real estate syndications were structured using "tax-based" real estate deals for investors, which took advantage of rules that allowed losses from one investment to offset other types of income from different investments. In addition, a favorable capital gains tax rate enhanced the value of real estate investments. These "non-economic" deals (i.e., generally non-cash flow generating) provided equity capital that would not have otherwise existed. In addition, in anticipation of the changes in the tax laws, a large number of hotel construction deals that might well have been delayed until market conditions were more favorable were pushed through before midnight on December 31, 1985. Because of the considerable lead time needed to plan and build a hotel, this led to an extended period of overbuilding and a glut of hotel rooms coming on the market at the same time.

The industry recovery that has taken place in recent years is similar to that which occurred after the period of overbuilding in the mid-1970s: Lenders holding distressed properties have contracted professional management companies to turn around their hotels and avoid losses; most lenders are now extremely wary of making new hotel loans; and demand in many markets is beginning to catch up to supply. As a result, occupancy rates appear to be on the way to recovery.

Although overall new construction has slowed, hotel chains have still been active in development as "product segmentation" became the watch word of the 1980s. In 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. The 1980s saw this concept 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 over the last 30 years has been to deliver what is appropriate to each market segment and product type, based on 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. Con-

ciere 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 the most important factor to this segment.

A new market segment was defined and addressed during the 1980s. Known as the extended-stay market, it comprises guests who need 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 has previously been met chiefly by short-term lease apartments.

The all-suite hotel is a product that also became active during the 1980s, as several hotel chains brought their all-suite designs to the market. The guest accommodations in these facilities usually includes a living area as well as a sleeping area, a room layout that is favored by many guests.

There has also been a revival of bed and breakfast inns and country inns since the 1980s as a significant number of vacationers have sought quaint, older-style accommodations.

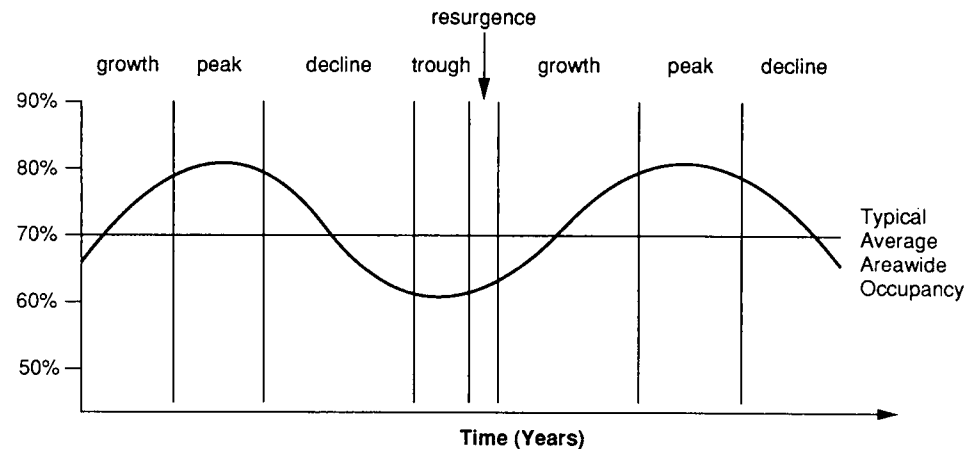
On a national basis, lodging demand gained strength in the second half of the 1980s (as had not been the case after the energy crisis and recession in the mid-1970s) and major influences continue to appear healthy. Trends of increased leisure time and the changing structure of the American family have contributed to both growth in travel and overnight lodging stays, although not at the rates seen in the 1940s and 1950s. The population as a whole is aging, which means more Americans are in the higher age brackets known for greater disposable income, more free time, and a propensity to use both for travel. Predictions by industry experts have been made for a 20-year period of slow to moderate growth for the lodging industry in the United States.

2.02 INDUSTRY DYNAMICS

The evolution of the hotel industry is driven by the interaction of the demand for lodging accommodations and the supply of hotel rooms. At its equilibrium point, the demand and supply in a market area are exactly equal. Every guest needing a room is accommodated and every room is filled. However, since demand changes daily and room supply cannot be added to or removed from the market nightly, it is more realistic to define the equilibrium level in terms of the level of occupancy at which, all else being equal, the supply of rooms would remain constant. Although this equilibrium level does not frequently occur, it is useful to recognize that there may be typical area-wide conditions characteristic of each market where supply and demand and all the forces affecting them are in balance. Being able to recognize this stabilized level helps hotel investors determine where in the hotel industry cycle a particular market is situated.

The hotel supply and demand relationship in a given area does not, of course, exist without outside influence. It is both directly and indirectly affected by the interaction of many factors that tend to shift the balance and contribute to upward and downward swings of the cycle. Factors affecting demand include the general state of the national economy, the economic vitality of the specific market, and changing travel patterns. Factors that affect supply include the availability of capital and government policies and programs.

FIGURE 2.1
Typical Hotel Industry Cycle



This section examines the forces responsible for change in the lodging industry. Where possible, the actual experience of the hotel industry in the United States is used to illustrate these factors.

[1] Industry Cycle

Most industries experience periodic cycles that reflect changes in the economic forces that affect a specific type of business. Movement in the hotel cycle is typically measured by changes in occupancy levels in a specific area or in the nation as a whole. The typical cycle that the hotel industry follows has a pattern of five characteristic phases (see Figure 2.1). Each phase is marked by specific conditions in the local marketplace.

In the growth phase, hotel occupancy rates increase, as do average room rates (usually over and above the rate of inflation). Individual properties, therefore, generate increasingly strong cash flows. This phase is also marked by the availability of capital at feasible rates for hotel development. In addition, debt sources are actively interested in lending on hotel properties. Overall, the market value of hotel properties increases.

During the peak phase, hotel occupancy and room rates remain strong and cash flows from operations maintain a high level. Both equity and debt funds are readily available and hotel market values, while still on the rise, tend to grow at a slower rate as they move toward a stabilized peak level.

The decline phase marks the beginning of a decrease in the overall occupancy level. Average room rates may increase, but only in step with inflation, and the interaction of these factors will mean either stable or slowly decreasing cash flow from operations. Equity investors generally sense higher risks in hotel investment during this phase and may increase their return requirements. The combination of decreasing cash flows and higher return rates causes the market value of hotels to decrease.

During the trough phase, hotel occupancy, room rates, and cash flow from operations reach their lowest levels. Average room rates may drop because of the need for competitive pricing. In response to the perceived high risk, equity investors may raise their return requirements still further. Debt financing for proposed hotels may be nearly impossible to find, and refinancing dollars almost as hard to locate. Hotel market values continue to decrease and eventually bottom out.

The resurgent phase is characterized by the rebounding of hotel occupancy, room rates, and cash flow from operations. As the market begins to show signs of recovery, equity sources begin to lower their return requirements. Hotel lenders, however, may still be wary and debt financing may still be hard to obtain.

[2] Economic Life of Individual Properties

A key element in the economic life of a hotel is the length of time over which improvements to the property contribute to its value. As hotel improvements age, they may suffer physical, functional, and external obsolescence, causing income productivity to decline. The economic life of a hotel can vary considerably, and the risk factor associated with an unknown economic life must always be evaluated by hotel investors before developing or purchasing a lodging facility.

Physical deterioration is evidenced by wear and tear, decay, or structural defects in a building, such as cracking in the building foundation. The physical deterioration of a hotel can be minimized by ongoing maintenance and remedied by periodic extensive renovations and so does not typically influence the economic life of a hotel.

Functional obsolescence may be caused by a deficiency in the size, style, or mechanical equipment of a building. For example, after the advent of the elevator in 1852, hotels higher than three stories that did not have elevators quickly became functionally obsolete. Other examples of functional obsolescence include hotels with exterior corridors rather than interior hallways, outdoor pools rather than enclosed facilities, and ballrooms rather than conference facilities. Sometimes the cost of redesigning and replacing the outmoded elements is not economically justified, and the property gradually becomes less competitive. However, correcting functional obsolescence in a hotel property is frequently possible and does not necessarily reduce economic life.

External obsolescence is caused by negative outside influences over which the hotel operator and investor have no control. Examples include a declining neighborhood, adverse changes in the local economy, overbuilding, and new highway or travel patterns. External obsolescence can radically affect the economic viability of lodging facilities and immediately diminish bottom line profits.

In 1978, the Internal Revenue Service conducted a study that showed that hotels and motels have the following average economic lives:

	<i>Life (in years)</i>	<i>Standard deviation</i>
Hotels	40.91	20.63
Motels	31.00	6.87

Source: The Appraiser, June 1978

The large standard deviation found in this survey indicates that a hotel may have a useful life as short as 20 years or as long as 60 years. This variable element contributes greatly to the risk of hotel investments.

A shorter economic life means an income flow of shorter duration and the possibility that a property may only reach a lower stabilized net income level, thus necessitating more market recapture. In analyzing the project, investors may use higher mortgage constants and may require higher equity dividends and yields.

[3] Demand Trends

Various broad factors contribute to shifts in hotel demand. In some cases, these factors can work to decrease demand. As discussed previously, the stock market crash of 1929 and the subsequent depression directly reduced demand for lodging accommodations. The economy contracted, disposable income was reduced, and both commercial and leisure travel dropped significantly. The oil embargo of 1974 and subsequent recession also sent lodging demand plummeting for many of the same reasons. Conversely, wartime activity generated extensive lodging demand in the United States because of the tremendous increases in travel created by troop movements and the relocation of workers to essential industries. During World War II, the nationwide occupancy rate reached an historic high of 94 percent.

Changes in the local economy specific to the market area of a hotel also directly affect lodging demand. Population shifts (e.g., from the Northeast to the Sunbelt) have reduced market growth rates, especially if they are followed by movement of commercial activity. Changes in the health of the individual industries that make up the local economy also affect lodging demand. For example, the "oil patch" markets, which include much of Texas, Oklahoma, Louisiana, Colorado, and Wyoming, have been dramatically affected by reductions in the price of oil in the mid-1980s. In general, developers now look for market areas with diversified economies in order to mitigate the risk of changes in individual industries.

Changing travel patterns have been a major factor affecting developments in lodging demand throughout the history of the industry. As discussed earlier, lodging facilities were often opened in response to new innovations in transportation. As each new innovation was introduced, the industry adapted to meet the needs of a new sort of traveler. Those lodging facilities that could not adapt, such as a motel located away from the route of a new interstate highway, often suffered a precipitous drop in demand and a dramatic shortening of their economic lives.

[4] Supply Trends

The hotel supply cycle generally follows the same course as the overall industry cycle. Changes in building activity are sometimes a result of changes in occupancy level, while in other cases they may precede and be the reason for the occupancy shift. The actual circumstances usually depend on contributing factors such as increased demand from newly accommodated markets or a surge in building that is fueled by readily available funds.

[a] **Effects of Increased Supply**

Hotel development usually occurs when the need for a greater supply of hotel rooms becomes apparent, either by overly high occupancy rates achieved by existing hotels or by customer dissatisfaction with the available hotels.

There have been many instances, however, when the need was apparent but development did not occur. Other factors, such as the lack of materials for construction or the lack of available and cost-justified financing, inhibited new hotel development. During World War II, occupancies ran in the 90 percent range, but no construction took place because materials were rationed and labor was unavailable because of wartime activity. In the late 1970s and early 1980s, occupancy levels were high but the cost of capital prohibited new construction.

[b] Development Without Demand

Hotel development also occurs occasionally when demand for additional rooms does not exist, simply because it is sometimes difficult to accurately quantify and project hotel demand over extended periods. Even when existing demand is properly quantified, the interaction of other factors may cause future demand levels to change. For example, new supply may be added to the market in the time it takes to develop a particular hotel. The decision to build may make economic sense for an individual hotel or chain but not to the overall market. A new hotel may be expected to capture demand from older properties, effectively shortening their economic lives. In some cases, a chain may build a hotel in a particular market in order to have its name or "flag" represented. In order to keep up a predetermined level of growth or to reach a critical mass, a hotel chain may lower its development requirements and allow marginal properties to be built. Hotels may also be introduced into a market as loss leaders in order to attract other development. This occurs presently when hotels are built in mixed-use developments in order to generate interest in the project. Finally, hotels may sometimes be erected to bring economic revitalization or civic pride to an area.

The decision to build may even be justified by individual profit motives. For example, personnel working for franchisors, developers, and hotel lenders may receive compensation dependent on the number of deals closed. Incentives may exist for such people to go forward with marginal projects, especially if they expect to change positions and will not be held accountable for the subsequent poor performance of the projects. All of these motivations for pushing through marginal deals should cause potential investors to be very careful to make sure that the project they are examining is economically sound for their own interests.

[c] Availability of Capital

One of the most prevalent reasons for hotel development is that "the money was there." This factor contributed significantly to periods of overbuilding in the 1920s, 1970s, and 1980s. In each case, a new source of investment funds (respectively, real estate bonds, REITs, and S&L loans) attracted large amounts of money that was utilized for the construction of new hotels.

[d] Government Intervention

Government actions and policies have affected hotel development throughout its history. For example, in colonial times Massachusetts required its towns to build inns for travelers.

The government may intervene in the hotel market by providing funds that would otherwise not be available. On the federal level, the Urban Development

Action Grant (UDAG) program of the U.S. Department of Housing and Urban Development has provided funds for hotel projects as well as other types of development. Local city and state governments also provide funds in the same manner. In the case of a downtown metropolitan area that is trying to revitalize by building, for example, a convention center and hotel, the standard industry sources of funds may not be available because of the current lack of demand in that area and the high risk of the project. Monies provided by the government in this situation contribute to the hotel market directly, by the addition to room supply, and indirectly, by funding the convention center, which, if successful, will generate lodging demand that would not otherwise have existed.

Local governments may provide outright bonuses or inducements, in the form of tax incentives, for development they would like to see take place. In 1927 the city of Waco, Texas gave Conrad Hilton a bonus of \$50,000 as inducement to build a hotel in that town. Government agencies may offer favorable leases for government-owned property, effectively providing funds and incentive for development. Government agencies may also effect hotel development by helping with the assemblage of parcels.

Changes in tax law have had profound effects on the lodging industry. In 1954, such changes enabled hotels to use an accelerated method of depreciation, thus increasing the depreciation expense in the properties' early years and lowering their tax liabilities. Anticipation of the Tax Reform Act of 1986 generated a rush of hotel development at the end of 1985 that might otherwise have been delayed until market conditions improved.

[5] Financing Trends

[a] **Development Costs**

Hotel development costs include the costs of land, labor, construction materials, furniture, fixtures, and equipment, financing, professional fees, and preopening expenses. The cost of each of these goods and services operates on a separate market cycle, which may be dependent on the general economy, the availability of raw materials, and alternate or more profitable uses. Table 2.1 lists the results of eight surveys taken between 1976 and 1988 regarding development costs.

As illustrated in the table, construction costs between 1986 and 1987 rose at a 1-2 percent rate, one of the slowest increases in recent years. This modest rise compares to the rapid 7-8 percent escalation in prices that took place between 1983 and 1984. Several factors contributed to the more recent favorable trend in construction costs. Inflation decreased significantly between 1986 and 1987, resulting in lower material costs and wage expenses. At the same time, interest rates declined 300 to 400 basis points, making the cost of construction financing much less expensive. However, as was the case in the 1930s, relatively low construction costs in the late 1980s have been coupled with limited opportunities for developers to take advantage of this condition. Not only is new construction difficult to justify in already overbuilt markets, but lenders who have had their fill of hotel investments (and who may be holding distressed properties themselves) are reluctant to initiate new hotel mortgage loans.

Table 2.1 also shows that preopening expenses have increased over this period as hotel management companies have put increased emphasis on establishing adequate preopening budgets in order to have sufficient funds for marketing and training

TABLE 2.1
Hotel Development Costs (in dollars per available room)

	Improvements	Furniture, fixtures and equipment	Land	Preopening	Operating capital	Total
1976						
Luxury	32,000– 55,000	5,000–10,000	4,000–12,000	1,000–2,000	1,000–1,500	43,000– 80,500
Standard	20,000– 32,000	3,000– 6,000	2,500– 7,000	750–1,500	750–1,000	27,000– 47,500
Economy	8,000– 15,000	2,000– 4,000	1,000– 3,500	500–1,000	500– 750	12,000– 24,250
1979						
Luxury	36,000– 65,000	8,000–15,000	5,000–20,000	1,500–3,000	1,500–2,000	52,000–105,000
Standard	25,000– 36,000	5,000–10,000	3,000–11,000	1,000–2,000	1,000–1,500	35,000– 60,500
Economy	10,000– 20,000	3,000– 5,000	1,500– 6,000	750–1,000	750–1,000	15,750– 33,000
1981						
Luxury	45,000– 80,000	10,000–20,000	8,000–22,000	2,000–3,500	2,000–2,500	67,000–128,000
Standard	25,000– 40,000	7,000–13,000	4,000–12,000	1,200–2,500	1,200–2,000	38,400– 70,000
Economy	13,000– 25,000	4,000– 7,000	2,000– 7,000	700–1,200	900–1,200	20,600– 41,400
1983						
Luxury	55,000–100,000	12,500–20,000	10,000–24,000	2,300–4,000	2,000–2,800	81,800–151,000
Standard	35,000– 50,000	9,000–15,000	5,000–13,000	1,400–3,000	1,300–2,200	51,700– 83,200
Economy	18,000– 32,000	5,000– 8,000	3,000– 8,000	800–1,500	900–1,300	27,700– 50,800
1984						
Luxury	58,000–110,000	13,000–21,000	10,500–25,500	2,500–4,200	2,000–2,900	86,000–163,600
Standard	37,000– 55,000	9,000–16,000	5,300–14,000	1,500–3,100	1,300–2,300	54,100– 90,400
Economy	19,000– 35,000	5,000– 8,500	3,200– 9,000	900–1,600	900–1,400	29,000– 55,800
1985						
Luxury	60,000–115,000	13,400–30,000	11,000–26,500	3,000–5,000	2,100–3,000	89,500–179,500
Standard	38,000– 57,000	9,500–16,500	5,500–14,700	1,900–3,600	1,400–2,400	56,300– 94,200
Economy	20,000– 36,000	5,000– 8,800	3,300– 9,500	1,000–1,700	1,000–1,400	30,300– 57,400
1986						
Luxury	62,000–120,000	13,700–30,600	11,500–27,800	3,100–5,200	2,200–3,100	92,500–186,700
Standard	39,000– 60,000	9,700–16,800	5,800–15,400	2,000–3,800	1,500–2,500	58,000– 98,500
Economy	21,000– 37,000	5,100– 9,000	3,500–10,000	1,000–1,800	1,000–1,500	31,600– 59,300
1987						
Luxury	63,000–122,000	13,800–30,900	11,900–28,600	3,300–5,500	2,300–3,200	94,300–190,200
Standard	40,000– 61,000	9,800–17,000	6,000–15,900	2,100–3,900	1,500–2,600	59,400–100,400
Economy	21,000– 39,000	5,200– 9,100	3,600–10,200	1,100–1,800	1,100–1,500	32,000– 61,600
1988						
Luxury	65,000–125,000	14,000–31,000	11,900–28,600	3,300–5,500	2,300–3,200	96,500–193,300
Standard	41,000– 63,000	10,000–17,100	6,000–15,900	2,100–3,900	1,500–2,600	60,600–102,500
Economy	22,000– 40,000	5,200– 9,200	3,600–10,200	1,100–1,800	1,100–1,500	33,000– 62,700

during the initial start-up period. The current competitive environment makes this strategy essential to financial survival.

[b] Amenity Creep

A phenomenon associated with the growth of hotel development costs is “amenity creep.” This process begins when a new lodging product is introduced with a basic package of amenities. As the lodging product matures, it is upgraded with additional amenities, such as swimming pools, restaurants, meeting rooms, and health clubs. These changes are justified under the premise of keeping up with the competition. Inevitably, the room rate is increased to cover the cost of the new amenities package. As this process occurs over time, lodging chains that started as budget level properties begin to “creep” into higher priced markets, and a gap develops at the economy end of the scale.

The process of amenity creep is illustrated by the case of the motor hotel. As discussed previously, the 1930s saw the establishment of motels as an inexpensive alternative to hotels. As the motels developed, a new lodging product, the motor hotel, gradually emerged as a hybrid of these two types of lodging facilities. Like motels, motor hotels provided an informal atmosphere that catered to motorists, with free parking and, in some cases, drive-up check-ins. However, in the manner of hotels, motor hotels also offered more amenities and a higher level of service and charged a higher price than most motels of the time. As motels upgraded themselves to become motor hotels, an opening was created for new motels.

The phenomenon of amenity creep can also be seen in the data contained in Table 2.1. In the data for 1988 economy hotel construction costs, the low end of total project cost is \$32,000 per room. However, hotel developers can actually build a no-frills budget motel that would be attractive to a sizable portion of the economy travel market for \$18,000–\$22,000 per room. This opportunity at the low end of the economic scale is the direct result of amenity creep.

[c] **Methods of Financing**

Over the past 60 years, the use of leasing arrangements (both land and total property leases), hotel management contracts, franchising, and depreciation methods have all had significant effects on hotel financing. Banks and other lending institutions have become more or less involved in the hotel industry depending on overall economic conditions of the time and their perceptions of the risk and return of hotel activity. Mirroring the hotel industry cycle, lenders have a higher degree of confidence making hotel loans when the cycle is in its growth and peak stages, and show a hesitancy to make loans during the downturn and trough phases. Lenders generally lag behind the rest of the lodging industry in renewing their activity after a downturn because they remain wary of the conditions.

[i] **Franchises.** 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.

As franchising proliferated, however, drawbacks such as lack of control by the franchisor became apparent. By the 1960s, and continuing through the 1980s, hotel and motel chains moved toward the increased use of management contracts. This arrangement allows hotel chains to expand the number of properties bearing their name without using their own capital to fund their growth while still retaining a high degree of control over the property. Depending on the management agreement negotiated between the hotel chain and the hotel owner, this arrangement may also put the chain in a position of lower risk than would be the case if it owned the property.

[ii] **Public Corporations.** In 1946, stocks from both Sheraton (United States Realty–Sheraton Corporation) and Hilton (Hilton Hotels Corporation) were listed for the first time on the New York Stock Exchange and traded on the open market. Raising equity by selling stock is a strategy that has been actively used since the mid-

1960s, and it continues to be seen as a viable means of generating capital for growth by hotel and restaurant chains.

[iii] **Leasing.** The use of total property leases was common in the early part of the 20th century, but since the 1950s the general practice has tended toward leasing of only the land. The leasing of a hotel's furniture, fixtures, and equipment (FF&E) has also been used as a source of capital in the early stages of hotel development. When capital is short and the developers feel that the hotel will generate enough income to cover F,F&E as a fixed expense, they may negotiate a lease arrangement in order to get the hotel open.

[iv] **Leverage.** Although the use of leverage in hotel financing structures is not unique to this century, it has become an important component of modern deal structures. As discussed earlier in this chapter, an over-dependence on leverage in the 1920s brought about the failure of a number of hotels during the Great Depression because their high debt service could not be supported. For a long while after the experiences of those crisis years, lenders, when they did make hotel loans, would not allow the debt level to exceed more than 50 percent of fair market value. Larger chains were, however, able to borrow up to 60 to 70 percent of fair market value by using the entire hotel chain as collateral. Current industry patterns indicate that 75 percent of fair market value is now standard for most hotel loans.

[v] **Syndications.** Syndications, which are usually thought of in terms of "tax-driven deals," became a common form of hotel financing in the 1950s when a change in the income tax laws allowed real property owners to use an accelerated method of depreciation. Hotels benefited from this method because of large depreciation and interest expenses that offset income in the early years of the investments. Syndications soon became known for tax-sheltered investments that provided tax losses to be used against tax liability generated by other income-producing investments. Tax-based syndications were common until the Tax Reform Act of 1986 eliminated many of their benefits.

[vi] **Innovative Techniques.** During the history of the hotel industry, a number of innovative and imaginative techniques have been used to raise money to finance hotel investments. As discussed earlier, the REIT and the savings and loan industry played important roles in hotel development in the 1970s and 1980s.

Throughout the 1980s, the Wall Street community played an increasingly important role in hotel financing as innovative financing techniques were introduced and accepted by investors. Master limited partnerships (MLPs) have been used by many hotel companies to dispose of their real estate assets while maintaining operating control of the hotels through management agreements. A large number of MLPs are traded publicly, and investors have found that they provide more liquidity than the usual kinds of hotel investments.

Of late, large financing deals have been structured by the Wall Street investment houses that include the pooling of hotel properties to reduce risk. Generally, several lenders participate in this sort of cross-collateralized transaction, which usually includes a number of hotels (anywhere from 5 to 75 properties) chosen for their diversity in terms of geographic location, condition, and target market.

Wall Street investment houses have also been successful in marketing hotel deals to foreign investors, who were one of the most active sources of hotel money in the latter half of the 1980s. Owing to the decline of the dollar in world markets, foreign investors, many of whom are Japanese, have found profitable investment opportunities in the United States. During this period, foreign investors acquired many hotel properties, including Omni Hotels, Intercontinental Hotels, Westin Hotels, and Ramada Inns.

CHAPTER 3

National Supply

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3.01 QUANTIFICATION OF SUPPLY

Various attempts to quantify the national supply of transient lodging facilities have, over the years, produced a wide range of estimates of both the number of facilities and the rooms they contain. Defining “transient” and determining what qualifies as a “lodging facility” can be difficult. Some of the issues that must be considered include:

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

One of the best sources of data on the supply of lodging facilities in the United States comes from Smith Travel Research. Anyone who is active in the hotel industry should subscribe to *Lodging Outlook*, published monthly by Smith Travel Research. This publication provides data related to both the supply and demand for hotels and motels, along with estimated occupancies and average rates for most major hotel markets and other valuable hotel investment information.

TABLE 3.1
Census of Hotels, Motels, and Other Lodging Facilities

Sources: 1977, 1982: U.S. Bureau of the Census; 1985: Smith Travel Research

	1977	1982	1985
Properties	51,860	47,570	45,000
Rooms	2,333,000	2,471,000	2,609,000

Another source of supply data is the Bureau of the Census, which periodically surveys all of the hotels, motels, and other lodging facilities in the United States. The bureau then issues a detailed listing of the number of properties and rooms in the country by state and metropolitan statistical area. The results of the most recent surveys, updated by Smith Travel Research, are shown in Table 3.1.

According to the census data, the number of properties declined by 13.2 percent between 1972 and 1982. At the same time, however, the number of rooms increased by 4.4 percent. Smith Travel Research estimates that in 1986, 115,000 rooms were added to the supply while approximately 30,000 rooms were removed through closures, resulting in a net gain of about 85,000 rooms, or an increase of 3.3 percent.

In 1987 Smith Travel Research investigated the supply of hotels and motels in the United States and determined percentages of market share based on both locational characteristics (Table 3.2) and class, as determined by room rates (Table 3.3).

3.02 CLASSIFICATION OF LODGING FACILITIES

In order to analyze the varied supply of lodging facilities in the United States, a system that classifies facilities according to type, class, and locational characteristics must be used.

[1] Type

The type of facility refers to the actual physical property and the primary amenities offered to guests. The types of facilities range from commercial, convention, and leisure to microtels, casinos, and bed and breakfast inns.

TABLE 3.2
Market Share by Location

Source: Smith Travel Research

Location	Market share
Highway	33%
Suburban	31
Urban	17
Resort	12
Airport	7

TABLE 3.3
Market Share by Class

Source: Smith Travel Research

Class	Market share
Luxury	30%
Upscale	19
Basic (mid-rate)	25
Limited (budget) upper	14
Limited (budget) moderate	12

[a] Commercial

Commercial facilities cater primarily to the individual business traveler. These hotels are generally situated in downtown or commercial districts near the businesses that they serve. Their amenities normally include a restaurant, lounge, small meeting rooms, recreational facilities, and shops. The services offered by many commercial hotels include: room service, secretarial services, computer terminal rentals, concierge and valet services, airport pickup, and local transportation.

[b] Convention

Convention hotels characteristically have meeting spaces with enough capacity to handle large groups of people. Generally, hotels with more than 30 square feet of meeting space per guestroom are considered convention hotels. Most convention hotels provide large ballrooms and additional break-out rooms for meetings and conferences. In some hotels, exhibit space and special sample rooms have become popular features. Convention properties also typically offer extensive restaurant and cocktail lounge facilities.

[c] Resort

Resort hotels provide facilities and equipment so that their guests can enjoy activities such as swimming, golf, tennis, boating, skiing, skating, sailing, riding, and hiking. These hotels are usually situated in locations that provide a recreational environment, such as the seashore or the mountains. Resort hotels sometimes use the American or modified American plan for meals, which means that certain meals are included in the price of the rooms. Extensive restaurant facilities are necessary in order to offer these plans.

[d] Suite

Suite hotels feature guest quarters that contain both a sleeping area and a separate living area. In some suite hotels, the suites are actually two normal size guestrooms (12' × 26') situated side-by-side, with one room devoted to sleeping accommodations while the other is used as the living room. Most suite hotels, however, use a single room (13' × 36') with the sleeping area to the rear and the living area in the front. Guest suites generally offer rudimentary kitchen facilities such as a small sink, microwave oven, and refrigerator, but they are not designed for involved food preparation or extended stays. The public space in suite hotels is generally limited, with a minimal amount of meeting space and food and beverage facilities. Guests are generally provided with a complimentary breakfast and access to an open bar in the evening. By increasing the size of guestrooms and decreasing the size of meeting and public spaces, suite hotel companies are able to hold total cost per room to approximately that of a commercial or convention hotel. Guests who do not need a meeting room or extensive restaurant and lounge space are then attracted by the value of larger guestroom accommodations offered at a rate usually similar to a commercial or convention hotel.

[e] Extended Stay

Extended stay hotels, which are a fairly new lodging product, provide a residential atmosphere by offering larger, apartment-type guestrooms with separate living and sleeping areas, full kitchens, exterior entrances, and recreational amenities. Residence hotels generally resemble garden apartment complexes and usually have a small administrative building that houses the front desk and breakfast and lounge areas. Residence 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 approximately 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. Up until recently, such extended-stay customers generally had to use either hotels that did not provide necessary facilities or furnished rooms 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 turnover requires fewer people to staff the front desk, the longer stay enables the property to achieve high levels of occupancies (over 80 percent) because the normal commercial demand dropoff during weekends does not occur, and the facilities are so unlike a traditional hotel that there is usually very little competition.

[f] Conference Center

Conference centers combine lodging and extensive meeting and conference facilities with an environment that is conducive to learning. This last characteristic is important because it 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. These gatherings can at times become noisy, and can have a disturbing effect on a business conference taking place at the same time. As a result, conventions and conferences do not always go well together, so a planner organizing an important learning experience will usually opt for a conference center rather than a convention hotel. Typically, conference centers provide meals, conference planning, support services, meeting rooms, and recreational amenities in one all-inclusive package.

[g] Microtel

Although microtels are a recent development in the lodging industry, they actually represent the reintroduction of an old idea: the budget lodging concept. Over the past 40 years, the U.S. lodging industry has seen many hotel chains that began by offering budget prices slowly evolve into mid-rate products. Holiday Inns, Ramada Inns, and Days Inns all began with the premise that there was an unanswered need in the hotel industry for a low-priced product. However, after a period of time these chains succumbed to "amenity creep"—the gradual addition of amenities such as food and beverage facilities, meeting rooms, and swimming pools, and ultimately raised their room rates. The microtel concept is the most recent attempt to return to a basic, economical lodging product. Generally, these facilities offer guestrooms with only 190 square feet of space but with a full-size bath, color television, telephone, desk, and small closet. Designed to compete with current so-called budget hotel chains such as Super 8, Red Roof Inns, Comfort Inns, and Econolodges, microtels offer

room rates that are approximately 15 to 25 percent lower than those offered by their competition.

[h] **Casino**

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 specialty restaurants and night-clubs.

[i] **Bed and Breakfast Inn**

These inns generally offer quaint accommodations along with breakfast. Historic areas in the United States—Annapolis, Maryland; Charleston, South Carolina; and Savannah, Georgia, for example—have numerous bed and breakfast inns that mainly cater to leisure travelers.

[j] **Ma-and-Pa Motel**

“Ma and Pa” is the name given to old-style motel-type lodging facilities that generally have fewer than 50 units and offer few amenities. Tourist cabins and camps are usually included as part of this category.

[k] **Boutique Hotel**

A boutique hotel is a small lodging facility that caters to upscale patrons looking for intimate, quiet surroundings. These properties usually offer a high-quality restaurant and extensive room service, among other luxury amenities.

[l] **Health Spa**

A health spa is a hotel dedicated to providing various health-oriented services and activities, such as special diets and dining plans, exercise programs, medical supervision, and health education and training. Many resort hotels offer spa programs but true health spas are generally solely dedicated to such activities.

[m] **Boatel**

“Boatels” are lodging facilities that are associated with a marina development. They generally accommodate leisure travelers who wish to enjoy the nearby water, along with boat owners who seek guestrooms and other amenities on shore. The amenities typically offered by a boatel include a restaurant, lounge, ship’s store, laundry, parking, and marine equipment repair.

[2] **Class**

Describing the class of a hotel is a way of categorizing both the quality of the property and the service provided by its staff. Room rates generally reflect the class of a

property, as indicated by the following list of typical ranges for room rates for most areas of the United States.

Luxury	\$110+
First-class	\$60-110
Standard (mid-rate)	\$45- 60
Economy (budget)	\$25- 45
Microbudget	\$15- 25

The class of a hotel is relative to its own market area. The facilities and level of service offered by what might be classified as a first-class hotel in Utica, New York could be very different from those expected at a first-class hotel in New York City. Determining the class of a hotel often involves a subjective ranking. Generally, the best hotel in a particular market would be classified as the area's first-class luxury property and other lodging facilities in the same area that offer a lower level of quality or service would have a lower ranking.

[3] **Location**

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

[a] **Airport**

Generally 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 delayed passengers. Airline crews can provide a constant flow of business on a year-round basis, but this segment of the lodging market can be very price-sensitive. As a result, average room rates may have to be kept low by such a property in order to ensure continued patronage.

Airport hotels often have pick-up and delivery 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 with no charge.

Small meeting rooms are also generally necessary in order for airport hotels to attract the meeting business of out-of-town travelers who wish to use the airport as a gathering spot for meetings. Appraisers must be careful, however, when evaluating an airport hotel to determine how much actual lodging demand the airport generates. Some airports are merely regional hubs where the majority of the passengers change planes rather than leave the airport facilities; as a result, they are less likely to generate lodging demand than an airport that serves as a terminus.

[b] **Highway**

A hotel with a highway orientation caters to travelers passing by in their vehicles. Properties with these locations typically attract both commercial and leisure travelers. Proximity to a major highway (usually an interstate) and visibility are the major attributes required for this type of location.

Highway hotels do not often need to provide much meeting space—several small meeting rooms are usually sufficient. A restaurant and lounge on the property

or within walking distance is desirable. Amenities that attract children, such as a swimming pool and playground, are also important if the family leisure market represents potential lodging demand.

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 improve or devastate a hotel's location almost overnight.

[c] **Downtown**

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 only need to have minimal restaurant facilities.

Adequate parking is a primary consideration when designing a downtown lodging facility. On-site parking is the best solution, but can add considerable cost to the overall project. Valet parking is an important amenity for upscale hotels.

[d] **Suburban**

Suburban hotels are generally located near office, retail, and industrial areas. These locations typically allow for low-rise rather than high-rise construction, more recreational facilities, and better parking facilities than do urban sites. Development costs are typically lower for suburban hotels than for downtown properties.

[e] **Convention Center**

A hotel located near a convention center will draw patronage from the events held at the center, but it must be remembered that most convention centers generate transient visitation only 100 to 130 days per year—which, by itself, is insufficient to justify a lodging facility. As a result, a convention center hotel should be able to attract other market segments, such as commercial travelers and in-house meetings and conventions. To this end, convention center hotels should incorporate enough meeting space within their facilities so that they are not totally dependent on the convention center for them.

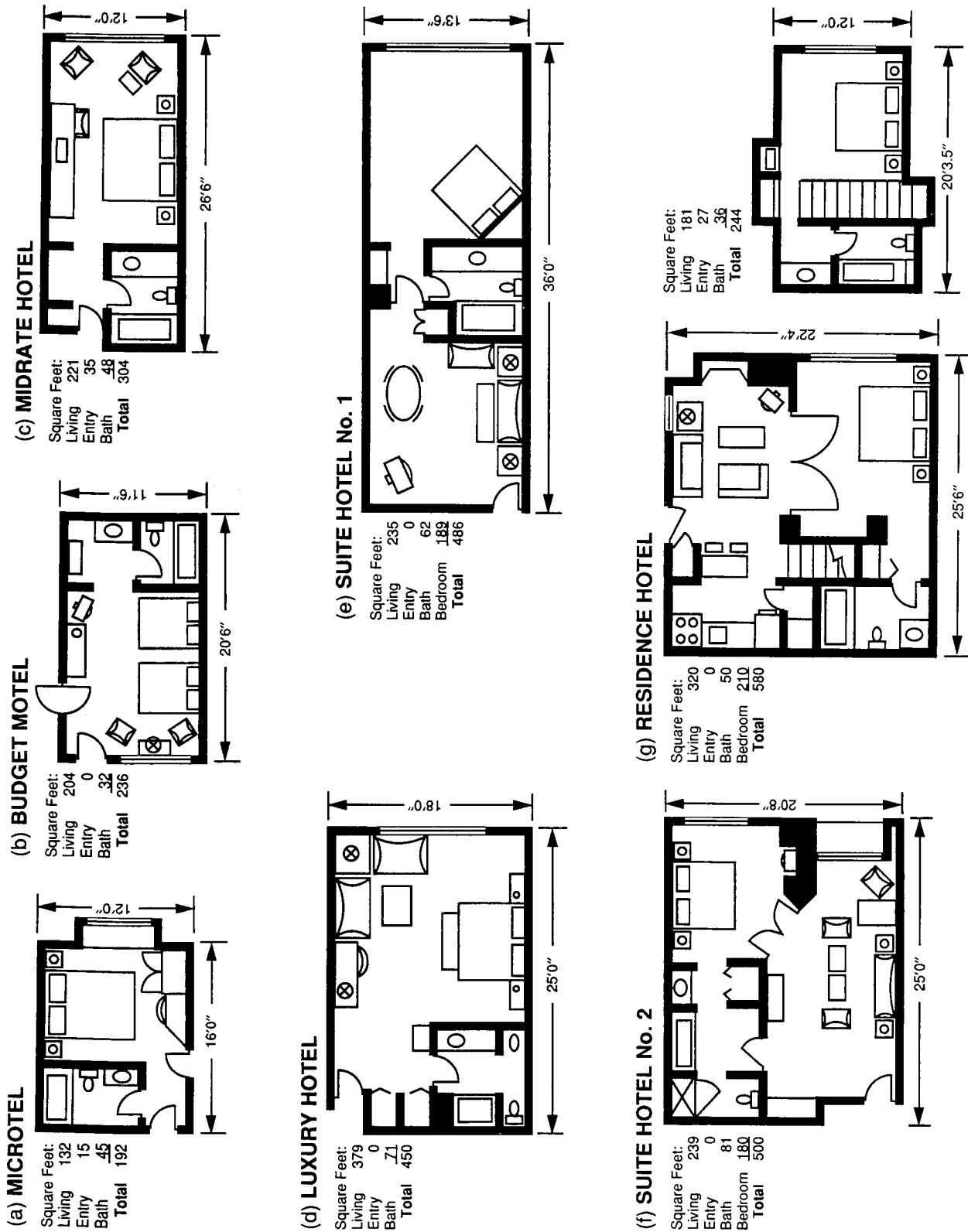
[f] **Resort**

Resort hotels attract primarily the leisure segment of the lodging market and sometimes leisure-oriented meetings and conventions. The facilities of a resort hotel offer leisure activities, such as swimming, jogging, tennis, billiards, bicycling, fishing, riding, and boating.

[g] **Mixed-Use**

Some hotels are situated in mixed-use developments that contain non-hotel elements such as office space, retail, and residential property. The synergy between the various components of the development is often beneficial for the whole project.

FIGURE 3.1
Typical Guestroom Sizes and Layouts, Various Hotel Types



3.03 GUESTROOM DESIGN

Hotel guestroom design is influenced more by facility orientation and class than by locational attributes. The floor plans in Figure 3.1 illustrate typical sizes and guestroom layouts for various types and classes of hotels.

Figure 3.1(a) is the floor plan of a microtel room. The total area is 190 square feet. Although the guestroom is comparatively quite small, it has all of the normal amenities found in conventional guestrooms.

Figure 3.1(b) is 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.

Figure 3.1(c) is a floor plan typical of a mid-rate facility. The 300 square foot room includes an entry area with closet and a king-sized double bed. The corridor to which the room has access is interior.

Figure 3.1(d) is 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 hotels of lower class, it is 18 feet wide, which creates a greater feeling of open space. The bathroom is above average in size and the sleeping area has room for two small couches.

The accommodations offered by suite hotels come in many sizes and shapes, but by definition contain separate sleeping and sitting areas. Figures 3.1(e) and 3.1(f) illustrate the layout of two typical hotel suites. Figure 3.1(e) shows a long, narrow space in which the living area is in the front and the sleeping area is to the rear. The suite in Figure 3.1(f) is more square, which results in a side-by-side placement of the living and sleeping areas. Both of these suite layouts have approximately 400 to 500 square feet of space, which is not significantly larger than normal luxury guestrooms.

A residence-type hotel typically provides the greatest amount of space of any type of lodging facility, consisting of a full living room, kitchen, and bedroom. Figure 3.1(g) shows a residence layout that makes use 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. A recent survey of frequent travelers examined what amenities and services travelers expect to find at the three basic classes of lodging facilities (economy, mid-price, and luxury). Table 3.4 shows the results of this survey.

The information obtained by the survey is particularly interesting when contrasted with the results of another recent survey (see Table 3.5) that quantified the use of various services and amenities by guests in lodging facilities. The data in Table 3.5 show, among other things, that while a swimming pool is frequently an expected feature of a lodging facility, it is used only by an average of 29 percent of the guests. This creates an obvious problem for hotel developers: Should an expensive amenity such as a swimming pool that many guests expect but very few will actually use be included in the property? The answer generally lies in the local competitive environment and what amenities are necessary in order to attract the desired market segments and classes of travelers.

TABLE 3.4
Amenities and Services Expected by Frequent Travelers

Source: Dial Corporation, Michigan State University

Amenity or Service	Economy	Mid-priced	Luxury
Personal care items	13%	61%	95%
Room service	11	73	93
Free morning 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

TABLE 3.5
Usage of Amenities and Services

Source: American Hotel and Motel Association

	Guest usage
TV	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 TV	20
Exercise equipment	15
Check cashing	10
Room service	10
Valet dry cleaning	4
Video games	3
Coin laundry	2

3.05 FINANCIAL OPERATING CHARACTERISTICS

Hotels generally have financial operating data that is typical of their classification. Income and expense statements for several types of hotels are contained in Table 3.6, illustrating the usual differences between them.

The income and expense statement for the economy motel shows that the property, as is typical, has no food and beverage revenue. Its rooms department expense is an efficient 18.7 percent of gross expenses and the net income ratio to total revenue is 44.2 percent.

In contrast, the statement for the mid-rate convention hotel with average operating ratios shows that rooms department expense is 24.9 percent and food and beverage expense is 82.1 percent of gross expenses. The net income ratio to total revenue is 20.3 percent.

The higher rate convention hotel shows a strong food and beverage business and exceptional operating ratios. Rooms expense is 18.9 percent, while food and beverage expense is 68 percent. The net income ratio is 29.4 percent.

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 good operating ratios, which result in a net income ratio of 32.7 percent.

The residence hotel statement shows that this type of property generally achieves a higher occupancy than a suite hotel (81 percent vs. 74 percent in this example) at a similar average room rate. As a result of the higher occupancy, the residence hotel is able to realize a net income ratio of 40.3 percent. Comparing the net income on a per-room basis, the suite hotel earned \$9,311 per room and the residence property earned \$11,634 per room.

While the operating data shown in Table 3.6 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.

TABLE 3.6
Hotel Financial Operating Characteristics, by Type

	Economy Hotel		Mid-rate Convention Hotel		High-Rate Convention Hotel		Suite Hotel		Residence Hotel	
	Number of Rooms: 62	Average Rate: \$30.00	Number of Rooms: 350	Average Rate: \$69.00	Number of Rooms: 290	Average Rate: \$113.00	Number of Rooms: 240	Average Rate: \$92.00	Number of Rooms: 80	Average Rate: \$92.00
	Percent of gross	Amount per room	Percent of gross	Amount per room	Percent of gross	Amount per room	Percent of gross	Amount per room	Percent of gross	Amount per room
Revenues										
Rooms	97.3%	\$8,097	56.4%	\$18,889	57.5%	\$8,971,000	93.3%	\$5,964,000	94.3%	\$2,176,000
Food	0.0	0	24.9	8,346	29.3	4,581,000	Leased	135,000	0	0
Beverage	0.0	0	13.4	4,491	8.2	1,277,000	0.0	0	0	0
Telephone	2.3	194	2.1	700	2.2	343,000	2.8	178,000	3.7	1,075
Other income	0.4	32	3.2	1,057	2.8	440,000	1.8	113,000	2.0	575
Total	100.0	8,323	100.0	33,483	100.0	15,612,000	100.0	6,390,000	100.0	2,308,000
Departmental Expenses										
Rooms	18.7*	1,516	24.9*	4,697	18.9*	1,699,000	21.5*	1,285,000	18.4*	401,000
Food & beverage	0.0*	0	82.1*	10,537	68.0*	3,984,000	0.0*	0	0.0*	0
Telephone	133.3*	258	108.2*	757	100.0*	343,000	69.7*	124,000	72.1*	775
Other income expense	0.0*	0	0.0*	0	79.1*	348,000	0.0*	0	0.0*	0
Total	21.3	1,774	47.8	15,991	40.8	6,374,000	22.1	1,409,000	20.1	463,000
Departmental Income	78.7	6,549	52.2	17,492	59.2	9,238,000	75.8	4,981,000	79.9	1,845,000
Undistributed Operating Expenses										
Administrative and general	6.8	565	9.3	3,117	8.5	1,325,000	8.8	582,000	9.0	208,000
Management fee	3.0	250	4.9	1,634	3.0	467,000	4.0	256,000	4.0	93,000
Marketing	7.4	613	4.9	1,629	4.7	736,000	9.4	599,000	9.5	219,000
Property operations and maintenance	2.9	242	4.2	1,391	4.1	636,000	5.8	368,000	3.8	87,000
Energy	4.3	355	4.6	1,540	3.2	502,000	5.1	323,000	4.7	109,000
Total	24.4	2,025	27.9	9,311	23.5	1,421,000	33.1	2,108,000	31.0	716,000
House Profit	54.3	4,524	24.3	8,181	35.7	7,817,000	42.7	2,873,000	48.9	1,129,000
Fixed Expenses										
Property taxes	5.4	452	2.0	671	3.4	532,000	5.2	334,000	4.3	99,000
Insurance	1.7	145	0.3	109	0.2	27,000	1.8	113,000	1.3	29,000
Reserve for replacement	3.0	250	1.7	557	2.7	428,000	3.0	192,000	3.0	70,000
Total	10.1	847	4.0	1,337	6.3	987,000	10.0	639,000	8.6	198,000
Net Income	44.2%	\$3,677	20.3%	\$6,844	29.4%	\$6,830,000	32.7%	\$2,234,000	40.3%	\$931,000

* Expressed as a percentage of departmental revenue

CHAPTER 4

National Demand

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4.01 INTRODUCTION

The constantly changing 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 that affect lodging demand are

- Changes in the 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.
- Changes in 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.
- More families with two wage-earners.* An increase in the last decade of families with two wage-earners has meant, for these families, an increase in disposable income that can be devoted to leisure travel.
- Advances in telecommunications.* Increasingly sophisticated technology has begun to allow meetings and conferences to take place with participants in many separate locations, thus causing a decline in business travel.
- Implementation of frequent flyer programs.* In recent years, airlines have established and maintained programs that encourage travel by awarding free or reduced-cost transportation.

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 provide the clearest indications of the current status of lodging demand because the data require little extrapolation or hypothesization. Categories 2 and 3 comprise information that does not directly reflect demand for transient accommodations, but from which useful inferences can be drawn nonetheless. Category 4 data concern elements of demand such 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 types of amenities offered by lodging facilities. This sort of information does not indicate overall levels of demand, but rather characteristics of demand segments, and is useful for the proper planning, design, operation, and marketing of individual lodging facilities. Each of these categories of data is discussed in turn in the sections that follow.

4.03 USE OF TRANSIENT ACCOMMODATIONS

The U.S. Travel Data Center is the primary source of Category 1 data, regarding the use of transient accommodations and the actual dollar receipts of lodging facilities.¹ 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 The U.S. Travel Data Center, established in 1973, is a national nonprofit center for travel research. Its primary purpose is to advance the common interests of the travel industry and the public by encouraging, sponsoring, and conducting statistical, economic, and scientific research concerning travel, the travel industry, and travel-related industries. In pursuit of this objective, the Data Center gathers, analyzes, publishes, and disseminates the results of its research and cooperates with government agencies, private industry, and academic institutions with similar goals. As a result, the Data Center has become the premier source for national travel research.

Members of the U.S. Travel Data Center keep abreast of the latest trends through fourteen reports published throughout the year and *Travel Printout*, the monthly travel research newsletter. Membership also provides discounts on custom research and other Data Center services. The U.S. Travel Data Center is an affiliate of the Travel Industry Association of America, the national, nonprofit association representing all components of the U.S. travel industry. For more information contact: Membership Department, U.S. Travel Data Center, Two Lafayette Centre, 1133 21st Street, NW, Washington, DC 20036.

TABLE 4.1
Distribution of the Overnight Travel Market by Mode of Accommodation (in current thousands of dollars)

Source: U.S. Travel Data Center

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
Commercial	410,663	345,987	529,920	502,571	401,964	404,800	441,816	482,245	524,084	529,975
Homes of friends and relatives	512,653	420,795	449,280	406,334	454,854	445,280	474,144	459,815	464,529	480,675
Other	177,584	168,318	172,800	160,395	200,982	161,920	161,640	179,440	202,487	221,850
Total	1,100,900	935,100	1,152,000	1,069,300	1,057,800	1,012,000	1,077,600	1,121,500	1,191,000	1,232,500

[1] Trends in Distribution

The U.S. Travel Data Center conducts monthly travelers' surveys from which a wide range of statistics are developed, including the distribution of this overnight travel market by type of accommodation. Table 4.1 shows the distribution of the market among the three basic types of accommodations: commercial, homes of friends and relatives, and "other," which includes second homes, travel trailers, and so forth. The unit of measurement for this kind of data is the person-trip, which represents one person making one trip (e.g., a family of four traveling together would total four person-trips). Table 4.1 shows that between 1979 and 1988 the use of accommodations remained fairly level, but as a percentage of the total, commercial accommodations gained market share at the expense of homes of friends and relatives while the use of "other" accommodations remained level.

[2] Industry Receipts

Another direct indicator of transient demand is the annual national total of lodging facility receipts, which are tallied by the U.S. Travel Data Center and several federal agencies. In order to accurately quantify the trends indicated by the annual changes in these receipts, the data are adjusted for inflation so that all dollar amounts are expressed in constant dollars as of a specific year. Tables 4.2 and 4.3 contain some of the most useful available data related to lodging receipts.

As shown in Table 4.2, between 1975 and 1988 lodging receipts increased in real terms at a compounded annual rate of 2.3 percent. Between 1980 and 1988, the growth slowed to a rate of 1.7 percent per year. These figures are reinforced by similar receipt information published by the U.S. Bureau of the Census, which is shown in Table 4.3. This table shows that between 1980 and 1987, the annual sales

TABLE 4.2
United States Travel Industry Receipts (constant 1982 dollars—values given in billions)

Source: U.S. Travel Data Center

1975	1980	1985	1987	1988	Compounded annual % change 1975-1988	Compounded annual % change 1980-1988
28.4	33.3	34.5	37.2	38.2	2.3%	1.7%

TABLE 4.3
Estimated Annual Receipts for Hotels, Motels, and Tourist Courts (in current millions of dollars)

Source: Stat Abstract 1989; Table 409, p. 237, U.S. Bureau of the Census

1980	1981	1982	1983	1984	1985	1986	1987	In constant 1987 dollars		Compounded annual % change 1980-1987
								1980	1987	
26,832	31,572	32,749	35,897	38,917	41,837	45,881	49,612	36,992	49,612	4.3

TABLE 4.4
Gross National Product by Industry (in current billions of dollars)

Source: Stat Abstract 1988; Table 1322, U.S. Bureau of Labor Statistics

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Lodging facilities	6.3	6.8	7.6	8.4	9.0	10.1	11.5	12.7	15.4	17.4	18.9	20.4	21.7	24.3	27.0	30.4	32.7	35.8
Amusement and recreational facilities	4.8	5.1	5.5	6.4	6.9	7.7	8.6	9.8	10.4	11.5	12.4	14.0	15.1	16.8	17.8	19.9	21.8	24.0

	In constant 1987 dollars						Compounded annual percent change	
	1970	1975	1980	1985	1986	1987	1970-1987	1980-1987
Lodging facilities	18.4	21.3	26.1	32.1	33.9	35.8	3.99%	4.61%
Amusement and recreational facilities	14.1	16.3	17.1	21.0	22.6	24.0	3.18%	4.96%

receipts for hotels, motels, and tourist courts experienced progressive increases and had an estimated real compounded annual growth of 4.3 percent.

The Bureau of Labor Statistics breaks down the gross national product (GNP) into amounts contributed by all major industries, including lodging, amusement, and recreational facilities. Table 4.4 shows this information expressed in current dollars. Between 1970 and 1987, the portion of the GNP generated by lodging facilities had a real growth of 3.99 percent per year. For the years 1980 through 1986, this rate of increase was 4.61 percent. In the same two periods, the amount of the GNP generated by the amusement and recreation industry grew at compounded annual rates of 3.18 and 4.96 percent, respectively.

Hotel revenue on a worldwide basis is projected to reach \$149.6 billion in 1990—an annual compounded increase of 4 percent from the 1985 level of \$123 billion. Hotel revenue in the United States is projected to reach \$51.1 billion in 1990, which is also an annual compounded increase of 4 percent from the 1985 level (\$42 billion). These projected growth rates are considered to be favorable indicators of future lodging demand by industry experts.

On a national basis, commercial lodging demand has been increasing over the past 20 to 30 years at an annual compounded rate of growth of 1.5 to 2.5 percent per year. Industry analysts believe that growth will probably continue at the same rate into the long-term future.

4.04 TRAVEL INDUSTRY STATISTICS

Travel statistics, Category 2 data, are in general much more readily available than information concerning the actual utilization of hotels and motels. Category 2 data

TABLE 4.5
U.S. Travel Industry Sales (in current billions of dollars)

Source: U.S. Travel Data Center, *Economic Review of Travel in America*

Year	Sales	Year	Sales	Year	Sales	Year	Sales
1972	68.936	1976	107.510	1980	171.785	1984	231.961
1973	75.778	1977	118.778	1981	190.671	1985	245.363
1974	85.085	1978	133.499	1982	199.774	1986	263.033
1975	94.539	1979	155.091	1983	215.523	1987	287.257
						1988	309.855

In constant 1988 dollars			
1973	1978	1983	1988
193.88	232.51	245.82	297.54

do not provide a direct indication of trends in lodging demand, but they do reflect the overall health of the travel industry, which ultimately affects lodging demand. Table 4.5 lists annual total sales for the travel industry in recent years.

When the sales figures are converted to a constant (1988) dollar basis, the compounded annual growth rates can be calculated with the following results:

1973 to 1978	3.7%
1978 to 1983	1.1
1983 to 1988	3.9
1973 to 1988	2.9

These growth rates reflect changes in the health of the lodging industry during the 1970s and 1980s. For example, between 1973 and 1978, the surge in building fueled by real estate investment trusts (REITs) was winding down, but the industry still enjoyed a healthy rate of growth (3.7 percent). During the latter part of the 1970s, hotel industry supply exceeded demand by a wide margin and the industry as a whole was depressed (1.1 percent). Between 1983 and 1988, however, a recovery took place and the industry once again grew at a fast pace (3.9 percent).

[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. While not a direct indicator of lodging demand, this information does provide an indication of lodging activity. The data for the period from 1970 to 1987 are contained in Table 4.6.

In constant dollars, food and drink sales at lodging facilities had a compounded annual growth of 2.9 percent between 1970 and 1987. This increased to 4 percent between 1980 and 1987. Hotel restaurants showed growth rates of 4.9 percent and 5.9 percent for the same respective years. Motel restaurants actually experienced lower volumes each year, with a 2.3 percent decline between 1970 and 1987 and a 3.1 percent decline between 1980 and 1987.

TABLE 4.6
Estimated Food and Drink Sales (in current millions of dollars)

Source: Stat Abstract 1987; Table 1364; Stat Abstract 1988; Table 1309, National Restaurant Association

	1970	1977	1980	1982	1983	1984	1985	1986	1987
Lodging places	2,585	5,030	6,768	8,286	9,165	10,026	10,699	11,480	12,271
Hotel restaurants	1,554	3,268	4,964	6,412	7,302	8,110	8,748	9,468	10,203
Motel restaurants	643	1,133	1,151	1,196	1,159	1,190	1,209	1,244	1,275

	In constant 1987 dollars				Compounded annual percent change	
	1970	1980	1985	1987	1970-1987	1980-1987
Lodging places	7,568	9,330	11,296	12,271	2.9%	4.0%
Hotel restaurants	4,550	6,844	9,236	10,203	4.9	5.9
Motel restaurants	1,883	1,587	1,276	1,275	(2.3)	(3.1)

TABLE 4.7
Passenger-Miles (in billions)

Source: Transportation Policy Associates

	1970	1973	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987
Total	1,181	1,341	1,354	1,460	1,529	1,602	1,590	1,558	1,574	1,609	1,647	1,739	1,812	1,807	1,870
Private cars	1,026	1,163	1,171	1,260	1,316	1,362	1,322	1,300	1,319	1,344	1,364	1,473	1,484	1,418	1,494
Domestic airlines	119	143	148	164	177	203	228	219	216	227	245	263	290	320	342
Buses	25	26	25	25	26	26	28	27	27	27	27	27	26	24	23
Railroads	11	9	10	11	10	11	12	11	11	11	11	12	12	12	12

	Compounded annual percent change			
	1970-1987	1980-1987	1983-1987	1986-1987
Total	2.7	2.6	3.2	3.5
Private cars	2.2	2.0	2.3	5.4
Domestic airlines	6.4	6.6	8.7	6.9
Buses	(.5)	(2.3)	(3.9)	(4.2)
Railroads	.5	1.3	2.2	0.0

[2] Passenger-Miles

Passenger-mile statistics for private cars, and domestic airlines, buses, and railroads also provide indirect indicators of transient lodging demand. Table 4.7 shows these data for the period 1970 to 1987.

As can be seen, during most years the greatest growth rate took place in domestic air travel, which had a 6.4 percent annual increase between 1970 and 1987. In more recent years this growth rate increased to 8.7 percent. Air travel tends to generate a high level of lodging demand, so these trends are very favorable for hotels and motels, and particularly those located at major airport destinations.

[3] Travel Price Index

Price increases are an indication of the general good health of an industry. Generally, during periods of increasing demand or decreasing supply, prices can be raised faster than the rate of inflation, which is not true during periods of decreased demand or

TABLE 4.8
United States Travel Price Index

Source: U.S. Travel Data Center

Category	1980	1985	1986	1987	1988	Compounded annual
						percent change
						1980-1988
Travel price index	81.2	108.4	109.0	114.9	119.5	4.95
Lodging while out of town	75.8	114.2	118.4	125.7	132.9	7.27
Food and beverage away from home	83.4	108.4	112.8	117.3	122.2	4.89
Airline fares	68.0	112.5	117.1	122.8	124.2	7.82
CPI	82.4	107.6	109.6	113.6	118.3	4.62

increased supply. Table 4.8 shows the travel price index for certain segments of the U.S. travel industry with comparisons to the consumer price index (CPI), which is an indicator of inflation. Between 1980 and 1986, prices for all of the segments increased at a faster rate than the CPI.

[4] Foreign and U.S. Travelers

Foreign travel is largely dependent on the strength of the dollar. When the value of the dollar relative to other currencies is high, U.S. citizens are able to travel abroad more frequently, while foreign visitors are less likely to come to the United States; the reverse occurs when the value the dollar is low. Table 4.9 shows the number of arrivals of foreign travelers to the United States. Table 4.10 shows the number of departures of U.S. citizens to other countries.

Foreign travel to and from the United States has a definite effect on the overall demand for lodging accommodations. The "gateway" cities, Boston, New York, Washington, D.C., Miami, Los Angeles, and San Francisco, benefit the most from foreign travel to the United States because most overseas visitors arrive at these cities and spend at least some of their time in and around them.

4.05 ECONOMIC AND DEMOGRAPHIC TRENDS

Category 3 data, which indicate general economic health and broad-based demographic trends that can indirectly affect lodging demand, are readily available to

TABLE 4.9
Visitor Arrivals in the United States (in thousands)

Origin	1980	1981	1982	1983	1984	1985	1986	1987
Canada	11,385	10,930	10,430	11,956	10,982	10,880	10,943	12,418
Mexico	3,200	3,800	2,600	1,900	2,300	2,542	5,556	6,705
United Kingdom	1,130	1,225	1,298	1,017	928	861	1,134	1,362
West Germany	680	700	668	563	545	509	670	952
France	320	330	426	305	331	336	440	544
South America	1,190	1,255	1,308	1,032	771	782	944	935
Japan	1,125	1,170	1,447	1,283	1,415	1,469	1,681	2,128
Others	7,915	8,350	8,886	7,851	7,528	7,538	8,860	10,534

TABLE 4.10
U.S. Travelers Abroad (in thousands)

Destination	1980	1981	1982	1983	1984	1985	1986	1987
Canada	11,171	11,374	10,974	11,237	11,706	12,100	14,134	13,306
Mexico	3,807	3,432	3,580	3,900	4,100	3,541	11,437	13,074
Europe	3,868	3,839	4,122	4,707	5,755	6,425	5,171	6,173
South America	489	482	461	488	559	556	629	788
Central America ¹	—	—	—	—	—	392	444	470
Caribbean ¹	2,541	2,449	2,607	2,910	3,384	3,175	3,483	3,714
Others	8,107	8,070	8,594	9,716	11,690	12,696	12,038	13,616

¹ Central America and Caribbean combined until 1984; separated thereafter

TABLE 4.11
Gross National Product by Industry (in current billions of dollars)

Source: Stat Abstract 1988; Table 1298, The Office Network

	1970	1975	1980	1981	1982	1983	1984	1985	1986
GNP	1,015.5	1,598.4	2,732.0	3,052.6	3,166.0	3,405.7	3,765.0	3,998.1	4,235.0
Wholesale and retail trade	168.7	273.7	438.9	483.1	506.5	542.9	610.4	652.5	702.5
Services	120.2	199.8	374.0	422.6	463.3	515.5	581.6	639.4	700.2
	In constant 1986 dollars					Compounded annual percent change			
	1970	1975	1980	1985	1986	1970-1986	1980-1986		
GNP	2,868.5	3,256.2	3,633.8	4,072.4	4,235.0	2.5	2.6		
Wholesale and retail trade	476.5	557.6	583.8	664.6	702.5	2.5	3.1		
Services	339.5	407.0	497.5	651.3	700.2	4.6	5.9		

analysts and investors. The most useful data of this type pertain to the GNP and the contributions made to it by wholesale and retail trade and the service industries (see Table 4.11).

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 GNP had a compounded annual growth rate of 2.5 percent between 1970 and 1987. During this same period, wholesale and retail trade also grew at 2.41 percent and services increased by 4.9 percent annually. Much of the increase took place between 1980 and 1987 when the growth rates were well above the average.

In addition, several other important economic indicators showed strong compounded annual growth between 1980 and 1986: Total personal income rose 2.8 percent, disposable personal income rose 2.0 percent, and corporate profits grew by 3.2 percent.

4.06 CHARACTERISTICS OF TRAVEL DEMAND

Category 4 data are quite different from the first three categories of data in that they do not assist in quantifying lodging demand, but rather provide information about the characteristics of the demand, such as

TABLE 4.12
Characteristics of an Average Trip

Source: U.S. Travel Data Center

	1967	1972	1975	1976	1979	1980	1983	1984	1985	1986	1987	1988
Persons per trip	1.80	1.94	2.01	2.00	2.16	2.09	1.96	1.92	1.93	1.89	1.87	1.88
Nights per trip	5.04	3.88	3.97	4.06	3.97	4.60	5.10	5.20	5.1	4.8	4.6	4.3

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

Although Category 4 data do 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.

Table 4.12 contains data regarding the characteristics of an average trip along with the number of nights per trip for the period from 1967 to 1986. The data in the table show that the number of persons per trip ranges from a low of 1.8 to a high of 2.16. Other than the fact that the increase and decrease in the number of persons per trip is cyclical, the trend does not seem to be tied to any particular economic or demographic factor. The number of nights per trip appears to vary at random from 3.88 to 5.4.

Category 4 data, such as that shown in Table 4.12, relate to the entire travel market within the United States. Taken as a whole, this information is of some interest, but it is often too general or broad in scope to provide a meaningful base from which to make specific investment or operational decisions. In order for such data to be truly useful, they must be broken down into individual segments based on the unique characteristics of the travelers comprised in a particular segment. The most logical method for performing this operation is to use the purpose of the trip as a distinguishing characteristic. Using this method, lodging demand can be divided into many different categories, but the three primary segments are commercial demand, which consists of individual business people traveling for a business purpose; meeting and convention demand, which comprises groups of people (more than three) traveling for the purpose of having a meeting of some type; and 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 tend to have a longer average stay than commercial patrons; and growth rates in commercial travel are often very dependent on the local economy, while 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.

TABLE 4.13
Business Trips Taken per Year

Source: U.S. Travel Data Center

Business trips per year	Percentage of commercial travelers
1-2	59%
3-9	31
10+	10

TABLE 4.14
Nights Spent per Business Trip

Source: Mastercard International Frequent Business Traveler Study

Number of nights	Percentage of commercial travelers
1	32%
2-4	58
5-10	8
10+	2

[1] Commercial Demand Segment

As shown in Table 4.13, well over half of all business travelers take between one and two business trips per year, while only 10 percent travel more frequently than ten times in one year. Hotel chains develop marketing plans aimed at these frequent travelers in an effort to develop brand loyalty. Various traveler incentive programs instituted by hotel chains are used to capture the 41 percent of the commercial segment that is on the road on a frequent basis. The average length of a business trip is 2.8 nights at a hotel. Table 4.14 shows a breakdown of business trips based on the number of nights away from home.

The demographics of the typical business traveler are always of interest to hotel investors and operators. Table 4.15 shows some of the most important characteristics of the commercial segment. The data indicate that the typical business traveler generally travels more than 1,100 miles in a single trip, stays at a hotel, and is between 25 and 44 years of age. It is interesting to note that the majority of commercial travelers are not college graduates, do not hold a professional or managerial position, and do not use the services of a travel agent.

Private cars are the primary means of transportation for most business trips, followed by commercial airlines. Table 4.16 shows the types of transportation used by commercial travelers.

One of the most important characteristics of commercial travelers is the nature of the business that causes them to travel. Table 4.17 shows the top ten businesses that

TABLE 4.15
Demographics of Business Travelers

Source: U.S. Travel Data Center

Men	61%
Age 25-44	57%
College graduate	45%
Professional or managerial	26%
Household income \$40,000+	39%
Two-wage earner family	52%
Average miles per trip	1,180
Average nights per trip	4.2
Average household members per trip	1.4
Use airline for trip	42%
Use rental car for trip	15%
Stay in hotel	71%
Use travel agent for trip	26%

TABLE 4.16
Types of Transportation Used on Business Trips

Source: U.S. Travel Data Center

	Primary type used
Own car	45%
Airline	36
Rental car	6
Taxi	1
Bus	2
Train	1
Other	9

TABLE 4.17
Top Ten Purchasers of Lodging (Commercial Segment)

Source: U.S. Department of Commerce

1. Wholesale trade	14.4%
2. Finance, insurance, real estate	7.2
3. Miscellaneous	7.0
4. New construction	4.7
5. Retail trade	3.8
6. Health care services	3.4
7. Food industry	3.2
8. Motion picture production, amusement / recreation services, and commercial sports	2.7
9. Nonprofit organizations	2.6
10. Miscellaneous business services	<u>2.6</u>
Total	51.6%

generate commercial lodging demand. This type of information is helpful when evaluating a market area for potential commercial lodging demand. For example, if many of the local businesses are engaged in wholesale trade, then the likelihood is good that these firms will generate strong lodging demand. Businesses that perform various financial, insurance, and real estate services are also good prospects for commercial hotel demand.

The process of selecting a hotel from the point of view of a typical commercial traveler is important to owners and operators of lodging facilities. Table 4.18 shows the top ten factors that commercial travelers consider when selecting a hotel. 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 fairly evenly distributed throughout the year. The months of December, January, and February do, however, see somewhat less activity. Table 4.19 lists the distribution of business travel by month throughout the year.

TABLE 4.18
Top Ten Factors in Hotel Selection (Commercial Travelers)

Source: U.S. Travel Data Center

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

TABLE 4.19
Distribution of Business Trips by Month

Source: U.S. Travel Data Center's National Travel Survey

	Percentage of total
January	6.8%
February	5.9
March	8.3
April	9.0
May	8.3
June	9.0
July	9.8
August	9.0
September	9.0
October	9.8
November	8.3
December	<u>6.8</u>
Total	100.0%

TABLE 4.20
Characteristics of Corporate Meetings

Source: 1987 Meetings Market

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	2.3	154,200	19%	3.1
Regional sales meetings	44	2.5	137,600	17	3.5
Training seminars	38	2.6	207,500	26	3.4
National sales meetings	128	3.5	70,700	9	6.2
Incentive trips	81	5.2	66,600	8	7.7
Professional/technical meetings	58	2.4	75,800	9	4.5
New product introductions	68	2.0	48,500	6	3.6
Stockholder meetings	82	2.5	21,600	3	4.7
Other meetings	<u>116</u>	<u>3.1</u>	<u>24,700</u>	<u>3</u>	<u>3.1</u>
Average/Total	59	2.8	807,200	100%	4.4

Business travelers are somewhat less price-sensitive than most other travelers, 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*.

Meetings Market divides the meetings and convention market into three segments: corporate meetings, conventions, and association meetings. Table 4.20 shows the important characteristics of corporate meetings.

Corporate meetings tend to have a fairly small attendance (the average is approximately 59 people) and range in duration from 2 to 5.2 days, with an average length of 2.8 days. Training seminars make up the largest number of corporate meetings, followed by management meetings and regional sales meetings. The planning lead time for corporate meetings ranges from a low of 3.1 months to a high of 7.7 months for incentive trips. 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 that they are booked in advance. Table 4.21 shows that as the size of a meeting increases, the number of months lead time required for booking arrangements also increases up to the point where 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.

Association meetings comprise smaller groups who meet periodically to conduct the business of the association. These events consist of work sessions similar to

TABLE 4.21
Advance Time Required to Book Meetings

Source: Meeting Planners Survey

Number of people attending	Months
10 – 50	10
51 – 150	13
151 – 300	25
301 – 500	33
500 +	55

TABLE 4.22
Characteristics of Association Meetings

Source: 1987 Meetings Market

Type of meeting	Average attendance	Average number of days' duration	Number of months' lead time
Board meetings	34	2.0	5.2
Educational seminars	96	2.0	5.6
Professional/technical meetings	106	2.2	6.2
Regional/local chapter meetings	102	2.0	5.0
Other meetings	<u>153</u>	<u>2.6</u>	<u>8.1</u>
Average	90	2.1	6.0

corporate meetings but also generally involve some leisure-oriented and socially oriented activities. Table 4.22 provides basic information about such meetings.

Association meetings include functions such as board meetings, seminars, and local chapter meetings. They typically attract an average of 90 people, which is larger than the average corporate meeting, but the duration is somewhat shorter, with an average of 2.1 days. Planning lead time for association meetings tends to be somewhat longer than corporate meetings, ranging from 5 months to 8.1 months.

The seasonality 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. Table 4.23 shows the percentage of major conventions held by month.

The process by which meeting planners select a hotel is important information for owners and operators of lodging facilities. Table 4.24 shows the top ten factors that a meeting planner considers when selecting a hotel.

TABLE 4.23
Distribution of Conventions by Month

Source: U.S. Travel Data Center

	Percentage of meetings
January	1%
February	7
March	5
April	13
May	15
June	13
July	10
August	8
September	9
October	11
November	6
December	<u>2</u>
Total	100%

TABLE 4.24
Top Ten Factors in Hotel Selection (Meetings and Conventions)

Source: U.S. Travel Data Center

1. Food service
2. Meetings 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

TABLE 4.25
Distribution of
Leisure Trips by Month

Source: U.S. Travel Data Center

January	5.5%
February	4.7
March	6.0
April	6.8
May	9.6
June	10.7
July	12.8
August	10.7
September	9.1
October	8.3
November	7.8
December	8.0

TABLE 4.26
Demographics of
Leisure Travelers

Source: U.S. Travel Data Center

	Percentage of total
Men	48%
Age 25-44	48%
College graduate	34%
Professional or managerial	15%
Household Income \$40,000 +	27%
Two-wage earner family	46%
Use airline for trip	21%
Use rental car for trip	6%
Stay in hotel	39%
Use travel agent for trip	13%
Average miles per trip	1,010
Average nights per trip	5.9
Average household members per trip	2.1

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 to the full use of facilities, this market also offers several other benefits. For example, 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 attended meetings.

[3] Leisure Demand Segment

Leisure travel is important to the lodging industry because it creates lodging 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, and during periods when commercial demand is strong, leisure travel is generally at a low level. (Table 4.25 illustrates the seasonality of leisure trips.) 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 only cater to one segment of demand.

Table 4.26 contains demographic data pertaining to leisure travelers. As can be seen, this segment is family-oriented, with an average of 2.1 people per trip, and the average trip is fairly extensive, lasting 5.9 nights and covering more than 1,000 miles.

As the average American family becomes more affluent (largely through the increase in the number of families with two wage earners), leisure travel should increase and the lodging industry will benefit as a result.

TABLE 4.27
Customer Preference

Demand Segment	Class of Hotel		
	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

[4] Comparison of Demand Characteristics

Category 4 data are useful as an insight to the nature of the main segments of lodging demand, but the real value of this kind of information is revealed when it is used to compare one market segment with another. To illustrate, Table 4.27 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.

Table 4.27 shows that for the commercial-economy traveler, price is the most important consideration, while the image of the hotel is the least important. For commercial travelers who seek luxury accommodations, the reverse is true: image is of primary importance and price is not a pressing concern. This table is an example of one of the ways in which operators and investors evaluate the characteristics of lodging demand in order to orient their property toward the market with the greatest potential or utilize the existing characteristics to their fullest extent.

PART II

**Hotel Development
or Acquisition**

CHAPTER 5

Market, Product, and Site Selection

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5.01 INTRODUCTION

The first step in a hotel development or acquisition is to identify market areas that show long-term potential for hotel investment. The next step is to choose a lodging product that will take best advantage of the local supply and demand characteristics. This step is then followed by a search for an appropriate site.

5.02 MARKET AREA EVALUATION

When looking at market areas in which to develop or acquire a lodging facility, the investor should first focus on long-term, rather than short-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 future survival and success of a new hotel (whether recently constructed or acquired and renovated) depends on the future, long-term supply and demand conditions in the market area.

Hotel investors must understand that the economic life of a lodging facility typically ranges from 20 to 60 years, with a median of 35 to 40 years. When the positive aspects and risks of a given market area are under consideration, a long-term evaluation is necessary in order to determine if the current economic characteristics of the market are likely to continue or if 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 econo-

mies of many of the major manufacturing centers in the United States. 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.

Some of the other long-term trends that may have a significant effect on both the lodging industry as a whole and individual market areas over the next 30 to 40 years are as follows.

- Decline in the manufacturing and production industries may have a negative affect on market areas that are dependent on this type of business activity.
- Increase in the service and technology industries will benefit market areas that attract these types of 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. In addition, the trend toward more leisure time will also encourage people to travel. Resort, leisure, and tourist markets should prosper over the long term 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. Future technology should further increase the speed and range of travel, thus making it easier for people to reach their destinations. For example, the travel time from New York to Hawaii is currently 10 to 12 hours, but someday it will be possible to travel on a supersonic transport that will significantly decrease the time and effort necessary to make the trip, and as a result, many more people will do so.
- Faster transportation will, however, in some ways reduce lodging demand. New technology will enable commercial travelers to reach their destinations more rapidly, and thus to conduct their business and to return in less time. At present, for example, most commercial travelers from New York with a business meeting in Chicago leave New York in the morning, conduct the meeting in Chicago, and return to New York in the late afternoon. A trip to Los Angeles, on the other hand, 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, so that lodging facilities in markets served by this form of high-speed transportation will lose commercial demand.
- Advancing video communication technology is rapidly approaching the point at which businesses will be able to eliminate many of their face-to-face meetings by substituting live video communications. There will then be little need for people to travel either short or long distances to hold meetings, conferences, seminars, and conventions when the same activities can be accomplished from each party's individual office. Needless to say,

this development might have a significant negative impact on both business and meeting travel, with a resultant decrease in the demand for transient accommodations in markets oriented toward these types of travelers.

- It is likely that an increasingly greater 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.

5.03 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.

When looking for hotel development or acquisition opportunities, investors should seek out:

- 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 settlement 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 after 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 that represented a higher and better use of the land.
- 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, so this period should have been a good time to either acquire an existing hotel or start developing a new one in these markets. This strategy is theoretically sound, but it takes both personal determination and strong financial staying power to actually follow such a course.
- 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 concede to a different use of the property. Zoning can also reduce the feasibility of a hotel project by limiting the number of rooms or requiring such unnecessary facilities 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, such as 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 where 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.

- 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 in significance 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**

The process of identifying a market area with the necessary long-term characteristics to support a lodging facility is accomplished by conducting a market overview study. Market overview studies are performed either directly by the hotel investor or indirectly 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 future, 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 like over 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.* The study sometimes contains data regarding historic occupancy cycles over the past 10 to 20 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. 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 back 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 must then 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 in order 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.

[1] **Long-Term Trends**

Like market areas, hotel products tend to go through definite cycles. Over the past 40 years, there has been a recurring phenomenon in the lodging industry that is known as "amenity creep." Amenity creep has occurred in several major hotel chains. Holiday Inns provides a prime example. When Kemmons Wilson started this lodging 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 Statler, 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. Franchise fees are generally computed as a percentage of rooms revenue, so when amenity creep drives room rates upward, franchisors benefit directly by collecting

more 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' recent strategy of moving up from the economy segment into the mid-rate market has left fewer products available for the economy traveler. This void is presently waiting to be filled by a lodging chain that is willing to offer no-frills accommodations. The last time there was such a gap in the low-end economy segment was during the 1970s, and there are currently very few options for travelers who desire inexpensive accommodations that offer only the basics: a clean room, a private bath, a television, a telephone, and a referral-type reservation system. The very-low-price segment of the hotel market therefore appears ripe for new products to replace the chains that have risen in class as a result of amenity creep. Progressive hotel chains will undoubtedly move quickly to recognize and meet market needs and desires.

[2] Product Niches

Occasionally, a new product appears in the hotel industry that creates its own market niche and, by doing so, 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 further 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.
- Microtel.* A microtel room is actually a down-sized motel unit that is usually no larger than 190 square feet in area. A microtel facility is designed to offer accommodations at prices 15 to 25 percent lower than the traditional economy-type motel. A microtel is able to offer this low price by eliminating all such unnecessary amenities as a restaurant, a lounge, meeting rooms, a lobby area, and a swimming pool. This concept has created new hotel demand by providing price-conscious travelers with a lodging product that meets their particular needs. Microtels attract patronage from rooming houses, ma-and-pa motels, and campgrounds.
- Mega-resort.* 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 Hyatt Regency Waikoloa 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.

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 actually generates new hotel demand, such as residence hotels.
- Price/value relationship.* Hotel products that achieve the greatest success in the marketplace are generally those that 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 amenities such as meeting rooms, entertainment lounges, or room service. With a pricing structure that is similar to 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 or reviewing the inventory of existing properties, a preliminary product selection should be made to determine what 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
- The primary characteristics of the area's existing lodging supply:
 - 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
- 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:
 - Superior location
 - Superior management
 - Superior affiliation
 - Superior product (facilities and amenities)
 - Lack of competition

If the success factors cited above can be duplicated, the presence of sufficient demand to justify another product of this type and the likelihood that other, similar products will enter the market over the short- and long-term, given expected barriers to entry, should be determined. If there are any market segments that are not currently adequately served by area lodging facilities, the depths of these market segments, projections of their expected growth, and the probability of future competition for these segments should be explored.

Based on an analysis of the factors described above, the following criteria for a preliminary product selection describe, in descending order, the relative desirability of certain product traits and market conditions.

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 type of 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 type of 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 above are rarely found, but, nevertheless, are worth looking for. 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 and a different conclusion might be rendered if the project were located on a different site.

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

There are three basic location types that are considered suitable for 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, theatre, 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, such as 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 above also apply to the selection process for existing lodging facilities.

5.08 CONCLUSION

The process of finding a potential market, identifying a suitable product, and locating either a desirable site or existing facility is 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 in selecting a consulting and appraisal firm are discussed in the next chapter.

CHAPTER 6

Selecting a Consulting and Appraisal Firm

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6.01 INTRODUCTION

Over the past several years, innovative hotel consulting and appraisal firms have developed a new valuation product that is superior to the traditional hotel feasibility study, or market study with financial projections. This new type of study, known as an economic market study and appraisal, combines into one all-encompassing report the market evaluation and financial projections with the valuational findings that show whether the economic value of a proposed or existing facility exceeds its total cost. Developers and lenders have been particularly receptive to this new approach because it presents all essential investment information in one comprehensive study.

In the past, hotel developers interested in obtaining mortgage financing would approach a lender with a proposal. The lender's usual response was to request that the developer have a feasibility study prepared by one of the major accounting firms with an active hotel accounting practice. After 30 to 60 days, and \$20,000 to \$30,000 later, the developer would deliver this study to the lender. If, after reviewing the study, the lender wanted to proceed, the developer would be told that an appraisal performed by a member of the American Institute of Real Estate Appraisers

(an MAI) was required to justify the amount of the loan. Only after another 20 to 30 days and an additional \$15,000 to \$20,000 would the developer have finally satisfied the lender's requests for market and financial analysis and valuation.

The fieldwork and analysis process is similar for hotel market studies and appraisals, so combining the two into one all-encompassing report saves both time and money. In fact, hotel consulting and appraisal firms with in-house MAI expertise in both hotel market study and hotel appraisal can often render a market study and appraisal within the same time frame and at about the same cost as one of the outmoded feasibility studies prepared by an accounting firm.

6.02 **BASIC REQUIREMENTS**

The key to obtaining a report that will fulfill the lender's requirements for both feasibility analysis and appraisal is twofold: to select a qualified hotel consulting and appraisal firm, and to provide that firm with detailed instructions regarding the specific issues that must be addressed in the study and the format that the final report should take.

Choosing the wrong consulting and appraisal firm to perform a market study and appraisal can be a costly mistake. Unfortunately, it can be difficult to find knowledgeable hotel people who are also qualified real estate appraisers. Conversely, it is unusual to find an expert real estate appraiser who also has the necessary actual hotel experience. A market study and appraisal of a lodging facility requires in-depth knowledge of hotel markets and operations, so the consulting firm that is chosen should be staffed by either hotel management school graduates or consultants with extensive on-the-job hotel operating experience. Likewise, the MAI appraiser who works on the project should have a hotel management background in order to ensure that he or she thoroughly understands the unique dynamics of hotel market studies and appraisals.

Some consulting firms try to integrate the work of market consultants trained by hotel schools with that of MAI appraisers with general real estate backgrounds. In such cases, the market study portion is usually performed by the hotel expert, who also prepares the financial projections. The appraiser then capitalizes the resulting net income and renders an opinion of value. This division of responsibility does enable these firms to perform hotel market studies and appraisals, but difficulties frequently arise with the coordination of professionals possessing divergent areas of expertise, and the final product is too often a compromise of conclusions. The lodging industry is complex and constantly changing, which means that specialists who concentrate all their efforts within the field are best suited to conduct market studies and appraisals for this market.

6.03 **INITIAL SELECTION PROCESS**

A well-prepared hotel economic market study and appraisal can cost from \$20,000 to \$50,000, depending on the scope of the assignment. This expense is generally well worth the price if the findings and recommendations are accurate and well-founded. The key to choosing the best company to undertake a study is to look beyond the prestige of the firm and concentrate instead on the abilities of the personnel that will actually produce the study.

When first assembling a list of candidates to perform a market study and appraisal, the developer must make sure that limiting conditions are clearly understood. Many firms will not allow their reports to be used in any form of public or private offering, which can seriously impair the utility of a study. The developer should also beware of firms that isolate or limit interaction with any of the personnel working on the study. Starting with the first meeting and with every meeting thereafter, all members involved with the project should be in attendance. This personal interaction is necessary in order for everyone to be as familiar as possible with the concepts behind the project and to fully share the combined knowledge, experience, and insights of the team.

6.04 FIRM QUALIFICATIONS CHECKLIST

The selection of a consulting and appraisal firm requires a thorough evaluation of each prospective firm's expertise and credibility. The following checklist is a useful means of determining if a company is qualified and able to conduct a proper market study and appraisal.

- Does the firm operate on a national level?* Exposure to many types of markets enhances the level of expertise.
- Does the firm use hotel-trained personnel for both the market study and appraisal portions of the study?* A study of this type should not be divided between market study consultants and appraisers, particularly if the appraisers have no specific expertise in hotel operations.
- Does the firm specialize in hotel-related studies?*
- Can the firm conduct the appraisal with a staff from one office?* If not, it is better to find another firm, because the coordination of personnel between offices is usually impossible. Make sure that the people who will be performing the study can be contacted directly.
- Do the financial projections the firm will use in the study take into account every category of expense?* Some firms omit fixed expenses such as property taxes, insurance, reserve for replacement, and management fees. Estimates for these real costs are critical when evaluating the economic potential of a lodging facility, so it is important to confirm that the financial projections in the study are complete.
- Who will be working on the assignment?* Obtain copies of the appraisers' qualifications, background, and experience. Since a hotel is a highly specialized business venture, meet with the appraisers, including the MAI member who will be working on the assignment, to determine if each individual has the following minimum qualifications:
 - A degree from an accredited hotel management school;
 - Actual operating experience in the hospitality industry;
 - Postgraduate courses in real estate principles and practices, real estate appraisal, and real estate finance; and
 - Experience in evaluating a wide range of different types of lodging facilities, both proposed and existing.
- Does the firm have the high level of credibility necessary to defend its conclusions in the event they are questioned?* This issue is especially important. Generalists who devote time to other types of real estate have

difficulty staying current with industry data, statistics, and trends. True experts tend to publish widely in professional journals and to be active as lecturers in the field. By seeking out the most qualified expert to perform a hotel market study and appraisal, the client will be assured of receiving a high-quality, reputable product.

6.05 **SAMPLE MARKET STUDY AND APPRAISAL CHECKLIST**

Before retaining a firm to perform a market study and appraisal, ask for a sample report and evaluate its approach, content, and comprehensiveness. Compare studies from several different firms in order to properly judge quality and completeness. The following checklist can be used to determine if the sample report is satisfactory.

- Does the study document every number and conclusion with a logical rationale, or are recommendations seemingly pulled out of thin air?
- Are forecasts of income and expenses made properly?
 - Are they made in accordance with the Uniform System of Accounts for Hotels?¹
 - Do they contain a complete accounting of all normal expenses, including management fees, property taxes, insurance, and reserve for replacement?
 - Are they made in inflated dollars?
- Are the construction costs and financial requirements quantified?
- Does the study support occupancy and average rate estimates by citing actual operating data from nearby competitive hostleries?
- Is the study a cookie-cutter-type report, or does it contain unique approaches that set it apart from the ordinary mass-produced varieties? Areas that demonstrate specialized competence include:
 - Break-even analysis
 - Use of full supporting schedules
 - Mortgage interest rate regression evaluations
 - Ten-year internal rate of return (IRR) analysis of debt, equity, and total property components
 - Spatial allocations on a square footage basis
 - Use of restaurant growth index (RGI) and restaurant activity index (RAI) indicators.
- Are the descriptions of the site, proposed improvements, neighborhood, and competition highly descriptive and augmented with a variety of graphics and photographs?
- Does the study have a professional appearance? Are the printing and binding well done? Both the form and content of the study must be of the highest quality, because it will be scrutinized by sophisticated investors.

¹ The hotel industry generally uses a standardized format for forecasts of income and expenses. For an explanation of this format, see Hotel Association of New York City, Inc. *Uniform System of Accounts for Hotels* (8th ed.). New York, NY: HANYC, 1986.

6.06 PRELIMINARY NEGOTIATIONS

After a qualified hotel consulting and appraisal firm is selected, the next step should be to ascertain the fee the firm will charge and the time it will need to complete the study. The right approach at this early stage can often save money. Usually, the officer or partner in charge of the appraisal practice is contacted by phone to discuss the potential assignment. At this point, the developer should discuss the nature and scope of the project in somewhat general terms, so that it will not appear to be overly involved or complicated. Difficult-sounding assignments and clients often result in higher fee quotes. The developer should push to establish the fee early in the conversation and then attempt to have it reduced by providing more information. Negotiating stances that sometimes produce lower fee quotes include:

- We have already performed our own market study, which we will submit to you, so much of the work is done.
- We will be developing many hotels over the next several years and would like to establish a good working relationship with a firm like yours (i.e., explore the possibility of a quantity discount).
- We are in no hurry—fit our assignment in when you have a chance.
- What other studies have you performed in the area? That many? Then you should already have much of the information for doing ours.

Bear in mind, however, that as with any product or service, quality generally corresponds to price. It is worthwhile to make an effort to reduce costs, but not at the expense of the careful selection of the most qualified firm possible. The time and money spent to secure a capable firm that will produce an accurate study will be recouped in the future when the myriad decisions involved in the development or acquisition of a lodging facility are based on a thoroughly researched and soundly reasoned study.

The developer should ask for an all-inclusive fee that comprises professional and computer time charged, report production costs, and miscellaneous expenses such as for telephone, postage, and photocopying. It is best, however, to reimburse out-of-pocket travel expenses based on actual receipted invoices rather than a lump-sum estimate. Beware of firms that bill travel expenses at a rate higher than their actual cost. Finally, expect to pay a sizable retainer fee before work commences.

6.07 REQUEST FOR PROPOSAL

Once the fee and schedule for the study have been established, the consultant should be provided with a full set of instructions detailing the scope and content of the study. While it is not a prerequisite for developers to put together a formal request for proposal (RFP) containing specifications for the assignment, an RFP is useful for several reasons:

- It forms an outline of what should be specifically addressed in the report. The consultant thus cannot omit or gloss over areas in an attempt to save time.
- It directs the consultant's attention to the most important issues.
- It assures a report that meets the requirements of lenders and investors.

- It shows that the client has taken a reasoned professional approach to retaining a hotel consulting and appraisal firm; this will serve as notice to the firm that a similar level of sophistication will be expected of it.

Each RFP should, of course, be adapted to the particular project as well as the specific needs of the developer and the ultimate use of the report. However, an RFP for a proposed hotel should clearly set forth, as described in the following sections, the overall objectives of the market study and appraisal, the services deemed necessary to meet the stated objectives (including outlines that detail the requisite elements of fieldwork and project analysis), an economic valuation of the project with supporting data and calculations, and, finally, any additional information that the investor thinks necessary for a complete report. The specifications set forth herein have been developed to accommodate a wide range of assignments. Since it would generally be inappropriate and probably impossible for an appraiser to include each of them in a particular assignment, the appraiser should be given a wide latitude to perform the requested tasks in a manner that will create the best study possible within the client's budget.

[1] **Objectives**

The market study and appraisal should evaluate the local market demand, the area's economic and demographic characteristics, the locational attributes of the site, and the surrounding competitive environment to determine the characteristics of an optimal lodging facility. Based on this profile, the study should then furnish estimates of future occupancy levels and average room rates for the proposed facility in order to project income and expenses over a three- to ten-year period.

[a] **Services Required**

The services that are required for the market study and appraisal include fieldwork data collection, project analysis, and economic valuation. During the fieldwork data collection phase of the study, some of the specific area characteristics on which the appraiser should focus include the site and surrounding land uses, accessibility to transportation systems, the economic and demographic base, and competitive lodging facilities.

After the fieldwork is complete, the appraiser is to perform a project analysis, which consists of organizing the fieldwork data and stating conclusions regarding the most appropriate type of facility (if the project involves a development rather than an acquisition); franchise or management contract affiliation; occupancy and use projections for guestrooms; food and beverage facilities and related amenities; and a ten-year projection of income and expenses.

The last step is an economic valuation that compares the value of the project cash flow with the estimated total project cost to determine economic feasibility.

[b] **Written Report**

The written report embodies the findings obtained during the fieldwork, the analysis performed by the appraiser on the findings, and the final conclusions and recommendations of the appraiser. In most instances, the appraiser issues the written report in

draft form first, so that it can be reviewed by the developer and any necessary changes made before it is finalized.

[2] Fieldwork Analysis

[a] **Site Analysis**

The analysis should include an evaluation of the site's suitability for the intended use; a review of the general area with respect to future growth trends; the location of the site in relation to local amenities such as shops, offices, and entertainment; and a comparison of the site to existing and planned hotel, recreational, and conference facilities and major demand generators. Approximate travel times to major demand generators and competitive hotels may also be provided. A site location map may be included that can be used to identify the following:

- The site of the proposed development
- Existing and planned hotel facilities
- Major industries and demand generators that would have an effect on the project
- Primary transportation routes and facilities
- Central business district

The following areas may be discussed in terms of the site suitability for the intended development:

- Location
- Visibility
- Ingress and egress
- Accessibility to market sources of demand
- Area attractions
- Market demand generators
- Competitive supply of hotels
- Future developments

[b] **Transportation Systems**

A thorough examination of the transportation systems in the market area and region may be provided. This examination should determine the degree to which transportation access may affect the marketability of the intended development.

As part of this examination, significant travel trends should be identified and some indication given of any expansion or rerouting planned or under construction. This section may also include:

1. Historical enplanements and terminal forecasts provided by the U.S. Department of Transportation or obtained from managers of area airports.
2. A list of carriers serving the market and the number of flights available on a daily basis.

3. A description of the network of roads and highways serving the market area and average daily traffic counts.
4. A description of anticipated improvements to the transportation network and an indication of how they might affect demand or market penetration and performance.

[c] Market Area Analysis

The analysis in this section should cover the economic and demographic factors of the general area that determine the suitability of the area for the development intended. The main points of this analysis may include:

1. Economic and demographic trends (summarized in tabular form) in the market area in comparison with the applicable metropolitan statistical area (MSA), state, and nation. Historical and projected statistics should be provided and any discernible trends noted and explained.
2. A general statement regarding long-term economic development of the market area.
3. Historical and projected trends in population.
4. Total effective buying income of the population.
5. Trends in retail, bar, and restaurant sales. The extent to which these statistics reflect the trends in the specific market area should be evaluated.
6. Changes and trends in both total employment and the distribution of employment in the major industrial classifications. Historical unemployment rates may also be provided along with a list of the major employers in the area, including the number of employees for each and the product manufactured or service provided.
7. A conclusion regarding the market stability and growth potential of the area.
8. Descriptions of the size, function, and stability of growth of any major commerce or industries in the area.
9. A description of other significant developments in local commerce.
10. A description of any proposed developments in the local lodging market and their potential impact on the market.

[d] Competition

Existing hotels in the area should be listed. Those considered to be primary or secondary competition should be identified and the rationale for their selection discussed, emphasizing any unique marketing feature and overall strength of market penetration. The following elements may also be included:

1. A review of the locations of existing hotels in relation to major demand generators and the site of the subject property.
2. A determination of the annual and seasonal occupancies in the market area, along with annual average room rates and the annual and seasonal

market mix of demand for lodging accommodations on the basis of room nights of demand.

3. Miscellaneous information for each competitive facility, including:
 - Name and affiliation
 - Owner
 - Management company
 - Number of rooms
 - Quality of facility, based on location and general category (e.g., luxury, first-class, economy)
 - Estimate of age
 - Estimate of annual and seasonal occupancy and average room rate
 - Market mix
 - Published rates
4. A discussion of the fill pattern generally experienced among the competitive hotel facilities and an estimate of the amount of room-nights turned away on a weekly basis by season for each facility identified as competitive.
5. Descriptions of existing food, beverage, and meeting facilities, as well as any other facilities that accommodate guests, such as a pool or a golf course, or ski, tennis, or equestrian centers. An analysis of the effect on the competitiveness of the subject property that these facilities have may also be included.
6. Identification of planned additions to existing properties and new properties that are under construction or in the planning stages. Information provided should include the probability of development or completion of a given project, the schedule for each project, the number of new rooms that will result, the type and class of each new facility, and any new or changed affiliations with lodging chains, organizations, or management companies.
7. An analysis of convention and conference activity, including:
 - An historical analysis of the number of conventions and conferences held in the area.
 - An estimate of the percentage distribution of the market in terms of the origin of convention and conference attendees (i.e., international, national, regional, or state) and the size of each category.
 - A description of existing and planned convention and conference facilities in the market area.
 - A discussion of the advantages and disadvantages of the immediate area as a market, relative to other competitive convention and conference locations.

[3] Project Analysis

[a] Specific Recommendations

A recommendation based on the market review and analysis that contains the following specific elements should be provided:

1. Type of facility (e.g., commercial, convention, or suite)
2. Class (e.g., luxury, first-class, or economy)
3. Number of rooms, broken down by types (e.g., single, double, or suite)
4. Restaurant and lounge capacity, including the area and seating requirements of each such facility
5. Function rooms, including the number of banquet seats in the main ballroom and other function rooms, with a recommendation as to their divisibility and overall area requirements
6. Meeting rooms, including number, area requirements, and capacity of each
7. Rental area, including number of square feet categorized as internal or external, with analyses of existing rental areas in competitive or comparable facilities along with their rental rates
8. Other guest facilities, such as for tennis, golf, sauna, pool, or parking.

[b] Affiliation

A recommendation of the best affiliation for the facility based on the market review and analysis should be provided. The recommendation should include an analysis of the comparative advantages and disadvantages of the affiliations considered that includes:

1. Strength of corporate management organization
2. Representation in the MSA understudy
3. Strength of reservation system
4. Fit of the recommended affiliation's marketing image with local market needs

[c] Lodging Demand

In respect of current lodging demand and to support projections of occupancy and use, the study should indicate the long-term level of demand in the area, including the amount of growth expected over the next five years. The analysis of demand should also include:

1. Discussions of the following categories by market segment:
 - Primary market sources of demand by season
 - Accommodated demand
 - Unaccommodated (turnaway) demand
 - Induced demand
2. Discussions of monthly, seasonal, weekday, and weekend demand patterns
3. Anticipated growth in demand by market segment
4. Future market conditions, five-year projection of market occupancy, and anticipated impact on room rates
5. Projections of occupancy and use for the proposed facility and related amenities, prepared in view of the following:
 - Occupancy rates, derived from market analyses presented in the study, and broken down by type of user (e.g., conference, transient, resort, or

- tourist), as well as an estimate of the expected double occupancy rate and rationale for it
- The statistical basis for occupancy projections
 - The effects of new competition coming into the marketplace in the next five years
6. Analyses of the extent to which the subject property's restaurant will compete with area restaurants and conclusions regarding:
- The potential of the subject to capture food and beverage demand
 - The extent of potential banquet business
7. Projections of average room rates, including:
- Consideration of seasonal fluctuations, with seasonal breakdowns that support the projection of the overall average rate
 - Projection of average rates for the first five years of operation, using the present year as the base year, with data indicating the effect of inflation on the rate attainable at the present time and the rate attainable at the time the subject property will open, compared with the average rates of similar existing hotels, and a discussion of the reasoning behind these conclusions
 - A rationale for the rate of inflation used in the report, which can be based on historical trends and other data received from similar hotels

[d] Ten-Year Projection of Income and Expense

The format of the projection of income and expense should be in accordance with the Uniform System of Accounts for Hotels,² and may be carried down to cash flow before debt service, depreciation, and income taxes. In addition, the following specific points may be covered:

1. Computation of food and beverage revenue, based on the recommended facilities. Food revenue might also be broken down to indicate daily average covers and estimated average checks for the proposed facilities. These projections should be based on comparable statistics from existing facilities in the area where possible. Revenue and profit percentages for similar hotels in the area should also be presented when available.
2. The methods used to project revenues from telephone, shop rentals, and other sources of income. Regarding shop rentals, annual per square foot rental income may be supplied for various categories (e.g., internal, external, or second class). Any comparative data from similar facilities in existing area hotels used to make these projections should be included.
3. All undistributed operating expenses, supported by data from existing hotels and other sources.
4. The property tax calculations, including:
 - All applicable tax rates (e.g., property, land, improvements)
 - Methods of assessment and the frequency of assessments
 - Tax or mil rate
 - An estimate of property taxes based on comparable taxes for existing hotels that are similar to the subject property

² Id.

5. Documentation of data used as the basis for projecting insurance costs and other fixed charges.
6. A break-even analysis.

[4] Economic Valuation

The market value of the property as of the date the hotel is completed and operational should be estimated by an MAI appraiser using the income capitalization approach, which should utilize specific supportable mortgage and equity rates rather than unsupported discount rates. The appraiser should carefully select the valuation procedures to be used so as to ensure an accurate valuation.³

[5] Additional Requirements

The hotel valuation company should furnish biographical sketches and qualifications for all personnel assigned to the project. The company should also provide a list of any prior hotel-related feasibility studies that it has conducted in the MSA from the past three years. The list should indicate the completion date of the report, its present status, and the present status of the development.

The developer should also ask for a summary of the valuation company's national involvement in performing market studies and appraisals of hotels and motels that details (1) the length of time the valuation firm has been making MAI appraisals; (2) the specific hotel-related employment and education of the MAI; (3) the degree of responsibility that the MAI will have for each area of the study; (4) whether more than one office will be involved in the study, and, if so, why; and (5) the percentage of total work that hotel valuations represents for the valuation firm.

The valuation company should provide fee quotes for all aspects of the study, including the printing of the final report. It should be agreed that the only additional charge will be for actual out-of-pocket travel expenses on the part of employees of the valuation company. It is essential that the report be suitable for use in syndications and other public offerings, so the valuation company should furnish a list of any assumptions or limiting conditions pertaining to the use of the report.

[6] Proposal Letter

After receiving an RFP, a valuation firm will issue a proposal, which is actually a contract in letter form, outlining the services to be rendered and fees charged. Once the contract is signed and returned by the developer, the valuation company is usually given 45 to 50 days to complete the assignment. The case study at the end of this chapter contains an example of a typical proposal letter made in response to an RFP.

³ For examples of such procedures, see Rushmore, Stephen. *Hotels, Motels, and Restaurants: Valuations and Market Studies*. Chicago, Ill.: American Institute of Real Estate Appraisers, 1983.

CASE STUDY Proposal for a Market Study and Appraisal

December 1, 1989

Mr. John Smith
Hospitality, Inc.
Main Street
Spring Valley, New York

Re: Proposed Hotel
Spring Valley, New York

Dear Mr. Smith,

Pursuant to your request for proposal, we are pleased to submit this proposal for services of our firm in connection with the above-captioned project. This letter sets forth a description of the objectives and scope of the assignment, along with the methodology to be employed, an estimate of the time requirements, and a schedule of professional fees.

ECONOMIC MARKET STUDY AND APPRAISAL REPORT

The objective of this assignment is to perform an economic market study and appraisal for the purpose of evaluating the market demand, analyzing the economics, developing the parameters for an optimal lodging facility, projecting income and expenses, and estimating the market value of a proposed hotel on your site. Our valuation will be as of the date specified by you and will consist of one overall value incorporating the land, improvements, and personal property components. In addition to the economic study and appraisal report, we would be available to provide counseling assistance in the development and opening of a hotel on this site.

In order to accomplish the objective described above, our work will be conducted in four phases, which typically include the following steps:

Phase One: Fieldwork

1. We will meet with you and/or your representatives to discuss our study in more detail and formulate a schedule for performing the fieldwork. At this time, we will gather any information from you that may assist us in performing this assignment (a list of necessary information is set forth in this proposal). Any introductions to local hotel operators, governmental officials, and business lenders would increase the effectiveness of our research and expedite the performance of our fieldwork.
2. An on-site inspection of the subject site will be made.
3. The physical orientation of the subject site with respect to access and visibility to highways, other forms of transportation, and the local demand for accommodations will be analyzed. We will also review the supportive nature of surrounding land uses as they relate to the subject property.
4. The demand for transient accommodations will be investigated to identify the various generators of visitation operating within the local market. The current and anticipated potential of each of these market segments will be evaluated to

determine the extent of existing and future demand. Interviews with officials of business and government, as well as statistical data collected during the fieldwork, are useful in locating and quantifying transient demand. In conjunction with the identification of potential demand, an investigation will be made of the respective strengths of these markets in terms of seasonality, weekly demand fluctuations, vulnerability to economic trends and changes in travel patterns, and other related factors. Similar market research procedures are utilized in estimating the demand for food, beverage and banquet facilities.

5. The market orientation of nearby lodging facilities will be evaluated to determine their competitive position with respect to the subject. Those properties displaying similar market attributes will receive a physical inspection, along with selective management interviews, to estimate levels of occupancy, room rates, market penetrations, and other pertinent operational characteristics. Some of the competitive factors that will be specifically reviewed include: location, type and quality of facilities, physical condition, management expertise, and chain affiliation.
6. Statistical data relating to general economic and demographic trends often foreshadow future potential for market areas and neighborhoods. Interviews with local Chambers of Commerce, economic development agencies, and other related organizations, along with an investigation of the subject's primary market area, will reveal patterns reflecting growth, stability, or decline.
7. Expense factors relating to local conditions such as labor, food and beverage costs, energy rates, assessed values, and taxes will be researched. In most instances, we will attempt to utilize actual expense experience from comparable properties in the economic portion of our appraisal.
8. Through interviews with hotel operators, developers, governmental officials, and others, we will ascertain the status of projects, under construction, proposed, or rumored, that might be competitive with the subject property.
9. Depending on the nature of the assignment and the individual characteristics of the subject's market, our fieldwork may also include:
 - Interviews with zoning and building officials;
 - Meetings with local planners, highway officials, and property assessors;
 - Discussions with other appraisers, counselors, real estate and mortgage brokers, bankers, architects, builders, and developers.

Phase Two: Analysis

1. Based on the data and information gathered during the fieldwork phase, along with our extensive library of actual hotel operating statements, financial statistics, area hotel trends, and investor requirements, we will first perform a supply and demand analysis for the subject property to determine its market orientation and competitive penetration with respect to other lodging facilities. This analysis will result in a quantification and documentation of probable future trends in the subject's occupancy, average rate, and overall rooms revenue. A similar procedure will be utilized in projecting food, beverage, and other revenues. Based on this information, we will develop a recommendation as to the optimum number of guestrooms, size and type of restaurants, and other necessary amenities and facilities.
2. Using actual income and expense statements from comparable lodging facilities, we will develop expense estimates corresponding to the level of activity and quality of operations indicated by the projected occupancy and average rate.

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3. A ten-year projection of income and expense representing future expectations of income potential will be made. Our projected income statements are in accordance with the Uniform System of Accounts for Hotels and include a detailed line-by-line account of all revenue sources and expenses.
4. The current market for hotel/motel transfers, mortgage rates, and hostelry equity investment requirements will be researched. Using these market indicators as a base and adjusting for potential investment benefits and risks displayed by the subject property, we will formulate an appropriate capitalization rate.
5. Following the recommended procedures set forth in the text books *The Valuation of Hotels and Motels* and *Hotels, Motels, and Restaurants: Valuations and Market Studies* published by the American Institute of Real Estate Appraisers, an estimate of market value will be developed by the Income Capitalization Approach. Where relevant, and where comparable data are available, either the Cost Approach and/or the Sales Comparison Approach will be utilized as a valuation cross-check.

Phase Three: Written Report

Complete documentation of our fieldwork, analyses, and value conclusions will be set forth in our written report. Conforming to the standards of the American Institute of Real Estate Appraisers, the appraisal report will contain the following sections:

1. Purpose of the appraisal and definition of value
2. Description of the site and recommended physical improvements and amenities
3. Review of the area and neighborhood
4. Analysis of the market for transient accommodations
5. Examination of existing and proposed competition
6. Projection of income and expenses based on recommended optimal facilities
7. Development of an appropriate capitalization rate
8. Value conclusion
9. Signed MAI certificate.

When appropriate, we will include graphics such as photographs, maps, surveys, plans, and charts to assist in visualizing our findings.

Phase Four: Consultation Services

Members of this firm will be available to meet with you and your associates, along with your architects and any other appropriate parties, for the purpose of developing and implementing the construction of a hotel located on your site.

Among some of the services we would perform under this agreement are: assistance in developing an overall plan for developing a hotel on your site; assistance in planning floor layouts and space utilization of all areas of the hotel in order to create a functional environment that is marketable to the eventual users of this property; meeting with your architects, attorneys, accountants, and any other professionals to develop an overall program for the full utilization of this property; assistance in reviewing potential operators and joint venture partners, managing agents, and franchise organizations for the facilities; working with your accountant to structure the debt and equity capital components; assistance in acquiring necessary capital; and any other appropriate counseling services.

REQUESTED INFORMATION

To aid us in performing this assignment, we request that you provide us with the following information (where applicable):

1. Any leases, management contracts, franchise agreements, mortgages, title reports, stock or partnership agreements, union agreements, service contracts, etc.;
2. Architectural/floor plans and plot plans, survey and legal description;
3. Operating budgets, projections, marketing plans, etc.;
4. Past appraisals, market and feasibility studies, impact studies, prospectuses;
5. The latest real and personal property tax bills and name of legal owner;
6. Terms of purchase or sale of the subject property including options and listings. Terms required: price, date, and financing. Include a copy of the contract and closing statement.

TIMING

We anticipate that our fieldwork and analysis can be completed within approximately 20 to 30 days of your execution of this agreement and receipt of all requested information. At this time, we will provide you with a summary of findings and recommendations. After your review of our findings and upon your authorization, we will then prepare the economic study and appraisal report, which will take an additional 20 to 30 days.

FEES

Our fee for the fieldwork, analysis, and the preparation of a summary of our findings will be \$15,000, payable upon execution of this agreement. An additional fee of \$10,000 will be payable upon your request for the economic study and appraisal report (Phases One through Three). This fee covers all report preparation costs, such as graphics, photographs, typing, proofreading, printing, and binding and includes five copies of the final report, which will be delivered to you.

Our fee for the consultation services (Phase Four) will be determined once the full scope of this continuing service is established by you.

In the event that after completing the fieldwork phase (Phase One) of the economic study and appraisal it becomes necessary to alter the assumptions on which the study is based, such as the property description, date of value, financial, management or ownership structure, or any other factor that could change the final estimate of value, our firm will be entitled to charge an additional fee based on our current per diem rates and the time required to incorporate the necessary changes into our analysis and report. In addition, the estimate of timing will be extended by an amount equal to the added work.

Notwithstanding the fee payment schedule set forth above, if, at any time while performing this assignment, it becomes necessary to suspend work for a period of 30 days or more, then our firm will be entitled to bill for the portion of the assignment completed up to the suspension (less any retainer paid) at its current per diem rates.

In addition to our professional fees, you agree to reimburse us for out-of-pocket travel and related expenses incurred while traveling on your behalf. You will be billed periodically for these expenses, which will be due and payable upon presentation of our bills.

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If payment for professional fees and out-of-pocket travel and related expenses is not received within thirty (30) days of the billing date, our firm reserves the right to suspend all work until payment is made and apply a service charge of 1.5 percent per month or fraction thereof to the total unpaid sum. It is further agreed that in the event legal action becomes necessary to enforce collection of bills rendered, you will be responsible for all collection costs, including, but not limited to, court costs and reasonable legal fees. It is understood that our firm may extend the time for payment on any part of billings rendered without affecting the understanding outlined above.

It is agreed that the liability of our firm, its employees, and anyone else associated with this assignment is limited to the amount of the fee paid as liquidated damages. Any responsibility of our firm is limited to the client, and use of our product by third parties shall be solely at risk of the client and/or third parties.

The report described in this proposal cannot be used by a syndication without first obtaining written permission from our firm.

If the foregoing proposal meets with your acceptance, please sign and return one copy of this agreement, together with your retainer check in the amount of \$15,000. Your signature beneath the words "Agreed to and Accepted," together with your remittance, signify your agreement to employ our firm for these services.

In order to schedule our assignments and perform your economic study and appraisal in accordance with the timing set forth above, we ask that you return an executed copy of this agreement, together with your retainer check, on or before January 1, 1990.

We appreciate the opportunity of submitting this proposal and look forward to working with you on this assignment.

Very truly yours,

AGREED TO AND ACCEPTED:

By: _____

Date: _____

SR: wm

CHAPTER **7**

Site Analysis

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7.01 INTRODUCTION

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 back of this chapter examines all of these considerations in a real-world setting.

7.02 PHYSICAL SUITABILITY

The suitability of a parcel of land for the development and operation of a lodging facility affects both the economic viability of the facility as well as its overall value. Factors such as the size, shape, and topography of a site all 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 size of the facility that can be built. 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 and 300 rooms if the hotel will cater to groups and conventions.

Height limitations and parking space requirements also affect the utilization of a site. For example, if there were a six-story restriction on the site described above, 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 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 overall 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 existing conditions that affect the site.

7.03 ACCESS AND VISIBILITY

Access and visibility are qualitative factors that either add to or detract from the marketability of a particular hotel site. While the adequacy of a hotel's access and visibility is to an extent 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. That is to say, at one extreme 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 highly 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. At the other extreme is a convention-oriented destination resort hotel, where most of the guests travel by air, are pre-booked, and have guaranteed their arrival with substantial deposits. Such a facility does not require—and probably does not even want—a great deal of visibility, and while access must of course be available, it need not be quick or easy.

TABLE 7.1
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 a convention facility

The location of the proposed property in relation to demand generators is as important a consideration as the access factor. A commercial traveler, for example, 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 up to 20 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.

The rating system in Table 7.1 illustrates the relative importance of access and visibility for several different segments of demand along with various modes of transportation. The scale ranges from -5, which means that access and visibility is not important, to +5, which indicates a high degree of importance. When the scale number for the appropriate market segment is added to the scale number for the primary mode of transportation, the result indicates 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 ($-3 + -4 = -7$).

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 image, 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 less desirable and 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 produce a competitive disadvantage. The long-term competitive environment must be considered, however, and with it the probability that at some point in the future new hotels with better access and visibility may well be developed that will have an immediate negative impact.

In a market study and appraisal, the access and visibility of the proposed property should be thoroughly analyzed and a determination 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.¹

7.04 **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, 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. For example, in some areas of the country municipalities have imposed sewer moratoriums that prohibit any new sewer connections until the capacity of the system is enlarged. These 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, and thus could detract from the overall feasibility of the project.

7.05 **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 facil-

¹ See 11.03 infra.

ities, 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 conformity 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 existing zoning codes, unless there is a reasonable expectation that the zoning will be modified or a variance obtained. Some of the provisions that should be investigated include:

1. Is a transient hotel a permitted use?
2. Are a restaurant and cocktail lounge also permitted?
3. How many hotel rooms can be developed?
 - What constitutes a room?
 - Is a unit considered to be one or two rooms?
 - Are kitchens permitted?
4. What are the parking requirements?
5. 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 normally at a competitive disadvantage without a liquor license, so the inability to obtain one could have a detrimental effect on the overall feasibility of a project. Other permits and licenses typically required for a hotel operation include:

- Health certificates
- Food service license
- Occupancy permits
- Fire safety permits
- Sign permits
- 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.

7.06 EXCESS LAND

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.

Land surrounding a hotel is classified as excess if it is not utilized by the current hotel operation. 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 utilized in some manner. Favorable uses of 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.

7.07 CONCLUSION

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 ± 8.74 -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-87/I-287). The municipal jurisdictions governing the property are the City of Spring Valley, the Town of Clarks-town, 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, 1986, the subject parcel contains approximately 380,714 square feet (± 8.74 acres) of land. The site is an irregular rectangle, with 826.3 feet of frontage and access on Central Avenue to the east and 478.2 feet abutting the New York State Thruway to the south. The northern and western property lines face adjoining parcels and measure 877.4 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, 1987, indicates no unusual rock formations or other adverse site conditions, and sug-

gests that a mid-rise structure would pose no major engineering problems. The property does not appear to be in a flood zone.

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 up to 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 17 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-87/I-287 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 and west through Utica, Syracuse and Rochester, and terminating in Buffalo, New York. At Albany, I-87 departs from the Thruway system and heads northward to the U.S.-Canadian border, where it becomes Quebec Highway 15 leading to Montreal. Several miles east of the subject property, I-287 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. I-87 continues south from the Tappan Zee Bridge, becoming 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 importantly, 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 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 17 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 17 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 rooms 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 high-

way. 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 emerged 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.

SITE ANALYSIS

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. The intersection of the westbound Thruway exit ramp and Central Avenue is situated directly across from the subject parcel, so 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 utilized 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 14 feet in order to reach grade level. The subject property is completely obscured by the elevated Thruway during this exiting maneuver, so 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 17 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

TABLE 1
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 Corporation	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

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. Table 1 shows some of the generators of transient visitation in the area, along with the distance in miles from the subject property.

As can be seen, 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.) Table 2 shows the local utility companies that serve the subject property. The unavailability of natural gas decreases the

TABLE 2
Local Utility Companies

Utility	Company providing service
Water	Spring Valley Water Corporation
Electricity	Rockland Power and Light
Telephone	New York Telephone
Sewer	Town of Clarkstown
Oil	Various private suppliers
Refuse removal	Various private carters
Storm drainage	Town of Clarkstown

flexibility of alternating between gas and oil based on availability and price, and forces a greater dependence on electricity, which tends to be more expensive and less desirable, for cooking and laundry operations.

APPLICABLE REGULATIONS

According to the Town of Clarkstown Zoning Regulations and Map, dated July 1984, 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 10 stories, so a mid-rise structure would be permitted. One parking space per guestroom is required, plus an additional space for each 20 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-facility 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 and the availability of utilities have been examined and evaluated, and 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 in order 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, so the general conclusion is that the subject parcel is well-suited for hotel development.

CHAPTER 8

Neighborhood and Market Area Analysis

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8.01 INTRODUCTION

A neighborhood and market area analysis is an essential step in a market study and appraisal, because such an analysis, when properly done, yields an assessment of the economic climate in which the proposed lodging facility would operate. 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 and involves a much larger geographic area. Historical and projected data pertaining to both the economy and the population of the area are first used to evaluate current conditions and identify probable future changes. The statistics are then used to forecast future growth or decline in transient visitation to the area by market segment and thus to 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.

8.02 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 such as retail, office, industrial, rural, suburban, and urban.
- An inventory of specific land uses within $\frac{1}{4}$ to $\frac{1}{2}$ mile (depending on density) of the subject property (e.g., strip shopping center with the following tenants:; single-user office building; free-standing mid-price chain restaurant; driving range; etc.).
- 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, eco-

conomic development agencies, real estate 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 relating to neighborhood trends that affect hotel occupancy, average room rate, food and beverage revenues, and overall profitability. The useful information that these sources can often provide includes:

- 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 provide the basis for a conclusion as to whether or not the local area is suited over the long term for the proposed subject property. The appraiser should bear in mind that 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.

8.03 MARKET AREA ANALYSIS

A market area includes the immediate neighborhood surrounding a lodging facility as well as the larger geographic territory within which can be found most of the lodging demand for which a hotel can compete. The market area defines the boundaries of lodging demand, and also 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 will also be located within the market area.

Overnight travelers generally seek lodging accommodations that are convenient to the demand generator that they are visiting. Given the local competitive lodging alternatives, travelers may be willing to travel somewhat out of their way to reach a desired lodging facility. In most instances, transient visitors will travel up to 20 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 20 travel minutes. In most instances, where the primary mode of transportation is the automobile, 20 travel minutes is the same as 20 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 20-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 20-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 a series of interviews to find out how far overnight visitors are actually traveling between their demand generator and lodging accommodations.

[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.¹ The importance of information concerning future trends cannot be overemphasized. Historical data provide an indication of what has happened within the market over the past, but 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, so appraisers usually develop their demand projections using, for the most part, historical economic data.

¹ See Appendix 1 for a checklist of the type used by appraisers when they collect this sort of information.

Some of the types of 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, when 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, and 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 age group is likely to create increased lounge- and entertainment-related patronage. The 35- to 49-year 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-type goods. As with population trends, retail sales have no direct correlation with hotel room-night demand, but rather, tend to 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), which is 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 tends not to be particularly 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, communication, and public utilities (TCPU) sector 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 tend to 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 based on 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 these data are 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. Table 8.1 lists several valuable publications that provide economic and demographic data and the types of information that each publication offers.

Table 8.2 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

TABLE 8.1
Published Sources of Economic and Demographic Data

Sources	Data	
Sales and Marketing Management (by county, state, and nation)	Population levels	
	Age distribution	
	Retail sales	
	Eating and drinking place sales	
	Effective buying income (EBI)	
Woods and Pooles (by MSA, state, and nation)	<i>Population levels</i>	<i>Employment</i>
	General and by age group	Agriculture
	<i>Income levels</i>	Mining
	Wages and salaries	Construction
	Other labor income	Manufacturing
	Proprietor's income	Transportation/communication/public utility (TCPU)
	Dividends, interest, and rental	Wholesale trade
	Per capita	Retail trade
	<i>Household</i>	Finance/insurance/real estate (FIRE)
	Number of households	Services
	Persons per household	Federal, state, and local government
	Mean income	Military
	Federal Aviation Administration (from nearest major airports)	Air carrier enplanements
Operations projections (by specific airports)		
Restaurant Business (by county)	Restaurant activity index (RAI)	
	Restaurant growth index (RGI)	

appraisal through discussions and interviews with local officials and other knowledgeable people.

[4] Data Analysis

After the appraiser collects the necessary data, they 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. In order to do so, the appraiser needs to 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, data should be collected that reflect a span of at least two years, and should be uniform in quality over the period of time they were collected. As an example, in the case of traffic counts, the counter used to collect data should be placed in the same location during the same periods each year it is used.

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 Table 8.3, the change in highway traffic between 1982 and 1983 is calculated as follows:

$$\frac{1983}{1982} = \frac{12,943,767}{12,566,764} = 1.03 - 1.00 = +3\%$$

The change between 1983 and 1984 was

$$\frac{1984}{1983} = \frac{12,614,836}{12,943,767} = .975 - 1.00 = -2.5\%$$

TABLE 8.2
Other Sources of Economic and Demographic Data

Types of data	Sources
Office space absorption	Real estate brokers Chamber of Commerce
Office vacancies	Real estate brokers Chamber of Commerce
Office space under development	Real estate brokers Chamber of Commerce Building department
Inventory of:	
• Office space	Real estate brokers Chamber of Commerce
• Retail space	Real estate brokers Chamber of Commerce
• Industrial space	Real estate brokers Chamber of Commerce
Highway traffic counts	Highway department
Origination and destination studies	Highway department
Major business by employment sector —Number of employees	Chamber of Commerce Economic Development Authority 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 Economic Development Authority
Businesses leaving area	Chamber of Commerce 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 Airport Authority
Tourist visitation	Tourism Authority Visitors' and Convention Bureau

Between 1982 and 1983, the direction of change was positive, which suggests growth; between 1983 and 1984, 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 Table 8.3, the annual compounded percent change in traffic counts between 1982 and 1986 is determined by the following formula:

$$-1 + \left(\frac{A}{B}\right)^{\frac{1}{N-1}} = C$$

TABLE 8.3
State Thruway Traffic Counts

Year	Count	% change from previous year
1982	12,566,764	—
1983	12,943,767	3.0
1984	12,614,836	(2.5)
1985	13,522,145	7.2
1986	14,377,202	6.3

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 1982 through 1986 is

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

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, so it is necessary to calculate all growth rates in real terms, using constant, rather than current, inflated dollars.

Table 8.4 shows retail sales in Rockland County from 1982 to 1986. According to this information, sales increased a total of 30 percent, using current (inflated) dollars. Performing the same calculation using 1986 (constant) dollars shows a 14 percent increase, which is the amount of real growth in retail sales over the same period. The difference between the inflated dollar calculation (30 percent) and the constant dollar calculation (14 percent) is attributed to inflation rather than real growth in retail demand. The annual compounded percent change in real terms over this period is 3.4 percent.

To determine constant dollar amounts, calculations are made utilizing the Consumer Price Index (CPI). Table 8.5 shows the CPI for the ten-year period from 1978 to 1987.

TABLE 8.4
Rockland County Retail Sales (in millions of dollars)

Year	Retail sales (current dollars)	Retail sales (1986 dollars)	Real change from previous year
1982	\$1,118,539	\$1,270,382	—
1983	1,223,391	1,346,221	+ 6.0%
1984	1,310,534	1,382,430	+ 2.7
1985	1,407,998	1,434,169	+ 3.7
1986	1,451,832	1,451,832	+ 1.2
Annual compounded percent change from 1982			3.4%

TABLE 8.5
Consumer Price Index

Year	CPI	Year	CPI
1978	65.2	1984	103.9
1979	72.6	1985	107.6
1980	82.4	1986	109.6
1981	90.9	1987	113.6
1982	96.5	1988	118.3
1983	99.6		

To adjust 1985 current dollars to 1986 constant dollars, the 1986 CPI is divided by the 1985 CPI:

$$\frac{1986 \text{ CPI}}{1985 \text{ CPI}} = \frac{109.6}{107.6} \times \frac{\$1,407,998}{1} = \$1,434,000$$

The current dollar amount for 1984 is converted to 1986 constant dollars in the same way:

$$\frac{1986 \text{ CPI}}{1984 \text{ CPI}} = \frac{109.6}{103.9} \times \frac{\$1,310,534}{1} = \$1,382,000$$

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 only be 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 upon the accuracy with which the various types of economic and demographic data will 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). Table 8.6 shows the three primary market segments and the types of data that best reflect changes in the hotel room-night demand that they generate.

TABLE 8.6
Data Used for Analysis of Transient Visitation

Commercial	Meeting and convention	Leisure
Total employment by category	Convention center patronage	Tourist visitation
Office space absorption	Total employment by category	Highway traffic counts
Office vacancies	Airport enplanements	Visitor counts at local attractions
Office space under development	Air cargo data	Total employment by category
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 vacancies	
Airport enplanements	Office space under development	
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 enplanements. 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 typi-

cally 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 will sometimes meet on weekends. Commercial groups tend to have a low double occupancy rate (1.3 to 1.5 percent) while social groups are likely to have somewhat higher double occupancy rates ranging from 1.5 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 type of demand is known as induced demand.²

[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 their destination and purpose for traveling. The rate of double occupancy is generally a high 1.8 to 2.5.

Leisure travelers tend to be the most price-sensitive segment in the lodging market. They tend to prefer low-rise accommodations where parking is convenient to the rooms and typically 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 upon 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.

² For a discussion of the methods used to forecast induced demand, see Chapter 10.

[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 property is characterized by a mixture of first-class retail and office space along Central Avenue (State Route 59) and middle-class residential housing on the secondary streets in the vicinity of Central Avenue. This area is considered suburban in character, as compared to the more developed downtown Spring Valley area that is situated two miles to the north. The boundaries of the subject's neighborhood are defined as the commercial strip running along Central Avenue, extending from a regional shopping mall just south of the subject north to the start of Spring Valley's central business district.

Development of Neighborhood

Development of the proposed subject property's neighborhood began approximately 15 years ago as a result of the natural southerly expansion of Spring Valley's city limits. Growth occurred rapidly, and within ten years most of the property along Central Avenue north of the New York State Thruway was fully improved with high-quality retail stores interspersed among mid-rise office buildings. The surrounding residential areas were concurrently developed by tract developers.

The subject parcel was formerly a drive-in movie theater constructed 30 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.

The property along Central Avenue south of the Thruway has only recently captured developers' interest. For a long time, the Thruway has acted as a natural barrier, inhibiting the southerly growth of Spring Valley. This situation changed rapidly four years ago with the development of the Spring Valley Mall, a 500,000-square-foot regional shopping center located just south of the proposed subject property on the southwestern quadrant of Central Avenue and the Thruway.

Development of several office complexes and multi-family apartment projects is currently underway on the land surrounding the mall. Although the quality level and image of this area south of the Thruway are good, property located here is still not on a par with Central Avenue property north of the Thruway.

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.

The property immediately north of the subject site, on the western side of Central Avenue, is a one-story, strip-type shopping center containing 15 upscale businesses. The various tenants include a men's wear shop, women's lingerie boutique, a travel agent, a real estate brokerage, a jewelry store, an ice cream shop, a liquor store and an antiques dealer. The high quality of these shops, coupled with their retail mix, would complement an adjacent lodging facility, but would, however, compete directly with any shops that may be included in the subject property.

Continuing north on Central Avenue, the next parcel contains a Mercedes-Benz automobile dealer. A three-story commercial office building immediately north houses many of the area's prominent physicians. Another office building adjacent to the medical building contains the regional office of IBM Office Equipment Marketing. This branch of the national computer firm is responsible for developing local marketing programs in the Northeast 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.

Clustered further to the north is another group of retail shops. This parcel was one of the first commer-

cial improvements constructed south of downtown Spring Valley and contains eight older, residentially oriented establishments including a grocery store, a drug store, a beauty shop, and a bank branch office. Traveling still further north, a similar mixture of retail, office, and commercial improvements stretches into the downtown business district of Spring Valley.

The Spring Valley Mall, situated south of the subject property, is anchored by Saks Fifth Avenue and Macy's, and contains 68 stores and shops of the kind typically found in regional malls throughout the United States. The high quality level of these retail establishments strongly enhances the area's image.

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

The residential neighborhoods on each side of Central Avenue contain attractive middle-class housing. Most of the owners are employed by area businesses; approximately 10 percent commute to 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, but would not have a detrimental impact on its attainable occupancy, average rate, or food and beverage volume. The availability of developable land south of the Thruway as well as the growth trends anticipated for this area should serve to generate further lodging demand and maintain the desirability of the neighborhood.

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 direc-

tion of the economy, the rate of future change must be quantified. These trends are then correlated based on 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 the New York County of Rockland and the northern portion of the neighboring New Jersey County of Bergen. Some demand may also originate from the New York Counties of Westchester, Putnam, and Orange and the New Jersey County of Passaic that surround Rockland County; however, their impact on transient visitation would be minimal.

The overall geographic character of 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-87/I-287), which traverses the southern part of Rockland County in mostly an east-west direction, cutting through the rugged hills and intersecting with each of the north-south highways. The funnel effect of collecting all east- and westbound traffic on virtually one roadway will have a definite beneficial effect on the adjacent subject property from the viewpoints of both access and visibility.

TABLE 1
Historical and Future Population Trends (+000)

Source: Sales and Marketing Management

Year	Rockland County	Change from previous year	Change since 1980	New York State	Change from previous year	Change since 1980	U.S.A.	Change from previous year	Change since 1980
1980	262.1	—	—	17,526.3	—	—	228,497.1	—	—
1981	265.3	1.22%	1.22%	17,456.0	(0.40)%	(0.40)%	231,009.5	1.10%	1.10%
1982	270.4	1.92	1.57	17,509.6	0.30	(0.05)	233,298.3	0.99	1.05
1983	275.6	1.92	1.69	17,740.7	1.32	0.41	235,524.3	0.95	1.01
1984	275.7	0.04	1.27	17,915.5	0.99	0.55	238,274.7	1.17	1.05
1985	275.6	(0.04)	1.01	17,966.2	0.28	0.50	240,833.5	1.07	1.06
1986	272.0	(1.31)	0.62	17,979.6	0.07	0.43	243,211.7	0.99	1.05
1991	281.1	0.66	0.64	18,312.1	0.37	0.40	254,135.6	0.88	0.97

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 triangular-shaped area contains approximately 176 square miles, with borders measuring 18 by 19 by 20 miles. The county is politically divided into five towns, 13 villages and numerous hamlets.

The economic history of Rockland County was strongly conditioned by its topography and soil as well as by the nearby mountains and rivers. The area's accessible river transit provided the means for development of the county's natural resources. When the destruction of much of New York City by the British during the Revolutionary War raised the demand for building materials, the Hudson River formed the transportation link between the stone quarries and brickmaking facilities of Rockland County and the users of these products in New York City. During the same time period, a substantial industrial center developed in the Ramapo Pass near Suffern as the result of the initiative of the Pierson family. Members of this family were responsible for establishing firms that produced a variety of iron, steel, and cotton products. Textile mills sprang up along the banks of the Minisceongo Creek, where water power was utilized in the milling process. As a result of these new industries coming to Rockland County in the middle of the 19th century, the orientation of the local economy shifted from an agricultural base to one influenced primarily by industry.

The need to transport goods from the Suffern area to the New York City market gave impetus to the construction of the Nyack Turnpike (now Route 59) from Suffern to Nyack, along with several railroads which criss-cross the county. In the 1950s, the construction of the Tappan Zee Bridge, New York State Thruway, 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. The resulting economic growth of Rockland County is an important factor in quantifying transient lodging demand.

Population

Between 1980 and 1986, the population of Rockland County grew at a faster rate than New York State, but slower than the nation as a whole. For this six-year period, Rockland County experienced an annual compounded growth of .62 percent, as compared to .43 percent for New York State and a 1.05 percent increase for the United States (see Table 1). This positive migration of population, particularly in comparison with New York State as a whole, is a healthy economic trend that reflects increased business activity and transient visitation.

During this same six-year period, neighboring New Jersey experienced a 0.18 percent compounded annual population increase. Concurrently, adjacent Bergen County showed an annual population decline of 0.70 percent.

Of even greater importance is the projected change in population between 1986 and 1991. During this period, Rockland County is expected to experience a population growth of 0.66 percent compounded per year. This is still higher than New York State's expected increase of 0.37 percent and close to the projected change in the United States population of 0.88 percent.

The population growth trends projected for Rockland County foreshadow a healthy economic climate through 1991 and probably beyond. Of particular significance is the fact that Rockland's population growth has outperformed that of New York State as a whole in

the past and is expected to continue to do so in the foreseeable future.

Although there is no direct correlation between population and hotel room-night demand, the rate of population growth will generally establish a minimum rate of increase for an area's commercial segment lodging demand. This observation also holds true for the meeting and convention market segment if the majority of meetings are business-oriented.

Based on Rockland County's projected annual population growth of 0.66 percent, it is anticipated that commercial segment lodging demand within the subject property's market area will increase at a rate equal to or more than 0.66 percent per year. Meeting and convention demand should experience similar minimum trends.

Age Distribution

Table 2 shows the expected trends in the population age distribution for Rockland County in comparison to those of the United States.

Between 1980 and 1986, the median age of the Rockland County population increased from 30.2 to 33.1 years, which is slightly higher than the national average of 31.7 years. During this period of time the shift in age distribution was greatest in the population age segments of 35-49 years and over 50 years.

Compared to the nation as a whole, Rockland County has a greater percentage of its population in the age segments of under 17 and 35-49, which indicates the presence of a large number of middle-age parents and children. The middle-age bulge in population is indicative of the baby boom, which has become an important factor in national spending patterns. As this well-educated group of Americans becomes increasingly affluent, in combination with subsidiary trends toward smaller families and working spouses, a greater consumption of meals away from

home is anticipated. Primary beneficiaries of these events are the nation's restaurants, which will accommodate the added patronage. Rockland County's area food service facilities will face a similar positive demographic outlook, with growing population age groups that are strongly inclined to spend personal income for meals consumed away from home.

BUSINESS AND ECONOMIC TRENDS

Retail Sales

Table 3 lists annual compounded percent changes in historic and projected future retail sales trends for Rockland County, with comparable data for New York State and the United States as a whole; retail sales are given in both current value dollars for each respective year, as well as constant 1986 dollars; the real change represents growth or decline without inflation.

Between 1980 and 1986, Rockland County experienced a compounded real growth in retail sales of 1.21 percent. At the same time, New York State averaged 2.02 percent per year. The United States fared somewhat better during this period, realizing an average 2.34 percent yearly real gain between 1980 and 1986.

However, projected real growth in retail sales looks strong for Rockland County, with a 4.09 percent yearly increase expected between 1986 and 1991. This amount exceeds the projected gains of 1.88 percent for New York State and 4.08 percent for the United States.

The projected retail sales figure for Rockland County is a good indication of a positive economic environment for the subject property's market area. With greater retail growth, local business will prosper, and new firms are likely to enter the market. This trend should result in more transient visitation and an increased demand for lodging facilities.

Effective Buying Income

The following is the 1986 average EBI per capita for Rockland County, New York State, and the United States.

	<i>1986 average EBI per capita</i>
Rockland County	\$17,270
New York State	14,010
United States	12,260

The average per capita EBI for Rockland County is significantly higher than that of New York State and the United States as a whole, which is clear indication

**TABLE 2
Population Age Distribution**

Source: Sales & Marketing Management

Age group	Rockland County		U.S.A.
	1980	1986	1986
Under 17	31.1%	28.0%	25.8%
18-24	9.6	9.4	11.5
25-34	17.8	15.5	17.6
35-49	21.5	24.7	19.3
Over 50	20.0	22.4	25.8
Median age (years)	30.2	33.1	31.7

TABLE 3
Historical and Future Retail Sales Trends (+000,000)

Source: Sales and Marketing Management

Source: Sales and Marketing Management

Year	Rockland County			New York State			United States		
	Current \$	1986 \$	Change from previous year since 1980	Current \$	1986 \$	Change from previous year since 1980	Current \$	1986 \$	Change from previous year since 1980
1980	\$1,015,830	\$1,351,153	—	\$ 68,385,105	\$ 90,958,829	—	\$ 965,746	\$1,284,536	—
1981	1,072,985	1,293,720	(4.25)%	72,661,338	87,609,270	(3.68)%	1,056,107	1,273,370	(0.87)%
1982	1,118,539	1,270,382	(3.04)	75,334,984	85,561,806	(2.34)	1,065,918	1,210,618	(4.93)
1983	1,223,391	1,346,221	5.97	81,561,943	89,750,893	4.90	1,186,387	1,305,502	7.84
1984	1,310,534	1,382,430	2.69	89,498,386	94,408,307	5.19	1,296,660	1,367,795	4.77
1985	1,407,998	1,434,169	3.74	95,806,920	97,587,718	3.37	1,395,243	1,421,177	3.90
1986	1,451,832	1,451,832	1.23	102,542,772	102,542,772	5.08	1,476,173	1,476,173	3.87
1991	2,075,295	1,774,199	4.09	131,674,895	112,570,737	1.88	2,109,158	1,803,149	4.08

TABLE 4
Historical and Future Effective Buying Income (+000)

Source: Sales and Marketing Management

Source: Sales and Marketing Management

Year	Rockland County			New York State			United States		
	Current \$	1986 \$	Change from previous year since 1980	Current \$	1986 \$	Change from previous year since 1980	Current \$	1986 \$	Change from previous year since 1980
1980	\$2,544,724	\$3,386,091	—	\$146,996,000	\$198,259,000	—	\$1,814,166,815	\$2,413,988,582	—
1981	2,747,637	3,312,496	(2.17)%	165,255,000	199,228,000	0.49%	2,012,346,959	2,426,045,306	0.50%
1982	3,254,459	3,696,867	11.60	178,848,000	203,160,000	1.97	2,169,679,437	2,464,623,753	1.59
1983	3,547,046	3,903,653	5.59	192,225,000	211,551,000	4.13	2,329,209,922	2,563,379,820	4.01
1984	3,835,057	4,046,321	3.71	210,021,000	221,700,000	4.80	2,576,533,480	2,719,812,262	6.10
1985	4,286,317	4,368,797	7.92	228,985,000	233,391,000	5.27	2,800,258,883	2,854,143,443	3.41
1986	4,697,537	4,697,537	7.52	251,898,000	251,898,000	7.93	2,981,720,801	2,981,720,801	4.47
1991	6,673,394	5,700,964	3.95	344,120,000	293,976,000	3.14	4,331,880,101	3,700,649,393	4.41

that residents of Rockland County have more income available to spend for retail goods, dining out, and services. These facts indicate a favorable climate for local commercial establishments in general and restaurants in particular.

Trends in EBI reflect the tendency of area inhabitants to spend money in the local economy. As with population trends, EBI has no direct correlation with hotel room-night demand, but rather is a fairly accurate indicator of the economic health and vitality of a market area.

Table 4 shows the historic and projected annual compounded percent changes in EBI for Rockland County along with comparable data for New York State and the United States as a whole.

Since 1980, Rockland County has experienced a compounded real growth in EBI of 5.61 percent per year, which compares favorably with the annual increase of 4.07 percent for New York State and 3.58 percent for the United States. While future expectations are for slower growth in EBI, Rockland County is projected to see real gains of 3.95 percent per year until 1991. During this same period, New York State's EBI should grow 3.14 percent per year and the United States is expected to see a 4.41 percent annual increase.

Work Force Characteristics

Table 5 sets forth the Rockland County work force distribution by business sector for the period extending from 1970 to 1984, with forecasts for 1990 and 1995. As Table 5 illustrates, the most rapid growth during the past decade occurred in the mining, service, and FIRE sectors. Employment in trade, construction, TCPU, and state and local government increased at a moderate pace, while agricultural, manufacturing, federal civilian government, and federal military government sectors showed minimal gains and losses. Total employment increased at a moderate 2 percent annual compounded rate.

These employment growth patterns are expected to continue into the 1990s and illustrate a positive trend for local lodging demand. Particular significance should be placed on the gains in the FIRE and services sectors, which tend to have the greatest impact on transient visitation. Construction employment also shows good gains, which indicates further growth in the area.

A second positive economic characteristic displayed by Table 5 is the diversification of the Rockland County economy. In 1984, the government sector accounted for approximately 16 percent of the employment base, with services, trade and manufac-

turing controlling 24 percent, 21 percent, and 17 percent, respectively. The local economy is not tied to the prosperity of any single sector, so the negative impact of the downside of any one business cycle on the economy is lessened by the presence of other types of businesses.

Manufacturing

Employment in Rockland County's manufacturing firms showed practically no growth over the past decade. In 1986, Rockland County had more than 100 manufacturing plants, which shipped a combined total of more than \$1.2 billion of products out of the area; this volume is up approximately 9 percent from 1985. Rockland represents just over 4 percent of total manufacturing production in the New York metropolitan area. Between 1976 and 1986, Rockland County gained three large manufacturing plants, while, at the same time, Orange County lost one, Westchester lost six and Bergen lost 16. All told, the metropolitan area lost a total of 408 major manufacturing plants during this period. Manufacturing employment is expected to grow at a 0.9 percent annual rate from 1990 to 1995.

The manufacturing base in Rockland County is diversified, with pharmaceuticals and cosmetics firms having some prominence (see Table 6).

The composition (i.e., whether the companies manufacture durable or non-durable goods) and size of the manufacturing employment base also affect the economic stability of a market area. In Rockland County, 65 percent of the manufacturing employment produces non-durable goods.

In periods of economic downturns, purchasers tend to defer buying durable goods, but continue to purchase non-durable items. The relative strength of non-durable manufacturing in Rockland County further stabilizes the area's economy.

A 1987 survey conducted by the Private Industry Council of Rockland County found that 54 percent of the existing local manufacturers plan to increase their employment in the immediate future and 31 percent plan plant expansions. The effect on the lodging industry of new manufacturing capacity, particularly high technology-related activities, is positive. Manufacturing plants tend to attract various types of transient visitors such as superintendents, auditors, and salespeople. High-tech manufacturers also attract engineers and consultants, all of whom are likely to stay in the area for one or more nights and use local lodging facilities.

The composition of the Rockland County manufacturing base, with a growing percentage of employment projected for firms that normally generate

TABLE 5
Rockland County Historical and Projected Employment

Source: 1987 MSA Profile

Source: 1987 MSA Profile

	1970	Percentage of total	1984	Percentage of total	Forecasted 1990	Percentage of total	Forecasted 1995	Percentage of total	Average annual compounded growth			
									1970-1984	1984-1990	1990-1995	1984-1995
Farm and other agriculture	4,865	5.4%	4,927	4.2%	4,742	3.6%	4,722	3.4%	0.1%	(0.6)%	(0.1)%	(0.4)%
Mining	697	0.8	1,283	1.1	1,275	1.0	1,335	0.9	4.5	(0.1)	0.9	0.4
Construction	4,340	4.8	5,830	4.9	6,797	5.2	7,317	5.2	2.1	2.6	1.5	2.1
Manufacturing	19,643	21.9	19,774	16.6	21,012	15.8	21,966	15.7	0.0	1.0	0.9	1.0
TCPU	4,836	5.4	5,682	4.8	6,456	4.9	6,820	4.8	1.2	2.2	1.1	1.7
Wholesale trade	4,144	4.6	6,011	5.1	6,505	4.9	6,821	4.8	2.7	1.3	1.0	1.2
Retail trade	13,496	15.1	19,237	16.2	20,768	15.8	21,835	15.5	2.6	1.3	1.0	1.2
Total trade	17,640	19.7	25,248	21.3	27,273	20.7	28,656	20.3	2.6	1.3	1.0	1.2
FIRE	4,896	5.5	8,377	7.1	9,704	7.4	10,411	7.4	3.9	2.5	1.4	2.0
Service	16,474	18.4	28,424	24.0	33,704	25.6	37,133	26.4	4.0	2.9	2.0	2.5
Federal civilian government	2,896	3.2	2,999	2.5	3,230	2.5	3,400	2.4	0.2	1.2	1.0	1.2
Federal military government	3,112	3.5	2,899	2.3	2,878	2.2	2,907	2.1	(1.0)	1.1	0.2	0.7
State & local government	10,192	11.4	13,246	11.2	14,682	11.1	16,004	11.4	1.9	1.7	1.7	1.7
Total government	16,200	18.1	18,944	16.0	20,791	15.8	22,312	15.9	1.1	1.6	1.4	1.5
Total employment	89,594	100.0%	118,491	100.0%	131,759	100.0%	140,676	100.0%	2.0%	1.8%	1.3%	1.6%

NEIGHBORHOOD AND MARKET AREA ANALYSIS

**TABLE 6
Rockland County's Major Manufacturing Firms**

Source: Rockland County Chamber of Commerce

Firm	Product	Number of employees
Lederle	Pharmaceuticals	3,600
Avon	Cosmetics	1,200
Chromalloy	Metals	650
BSR	Electronics	600
Ciba-Geigy	Pharmaceuticals	500
Materials Research	Plastics	460
RCA	Electronics	350

transient visitation, is a positive indication of future lodging demand. In addition, the diversity of this employment and the relatively small amount of durable goods manufacturing should help maintain stability in lodging demand during periods of natural economic cycles.

The location of the county's manufacturing firms with respect to the subject property is an important consideration. While out-of-town visitors are likely to travel reasonable distances between a generator of visitation and their lodging facility, a 20-minute driving time is generally considered the maximum limit. The proposed subject property's centralized location in Rockland County adjacent to the New York State Thruway increases its ability to attract much of the county's manufacturing-generated visitation. A survey of all the county's manufacturers shows that more

than 90 percent are located within 20-driving-minute radius of the subject property.

Construction

The construction industry represents a relatively small portion of the Rockland County employment base. Between 1970 and 1984, employment in the construction sector increased from 4,340 to 5,830 for an annual compounded yearly growth of 2.1 percent. Most of the construction employment is in the special trade category which comprises small carpentry, electrical, and plumbing firms.

Reflecting the rise in construction employment in Rockland County in recent years, actual construction activity has been on a slight upturn over the last decade. Table 7 lists the amount of residential construction activity on a unit basis compiled by the number of building permits issued. Over the past nine years, single-family residential building activity has averaged 521 units per year. This growth is expected to continue at a somewhat higher rate until 1998. Multi-family construction has averaged 1,113 units during the past decade, with 1,200 units per year anticipated for the 1990s.

Although housing activity does not have a direct bearing on transient lodging demand, the level of positive growth does represent a healthy economic environment.

A more direct indication of lodging demand is nonresidential construction activity. New commercial, industrial and retail space generally foreshadows growth in existing and new businesses, which typically results in increased visitation from a variety of parties who are directly or indirectly conducting busi-

**TABLE 7
Rockland County Dwelling Units Authorized by Building Permit**

Source: Rockland County Economic Development Authority

Year	Single-family		Multi-family		Total	
	Number of units	Percentage change	Number of units	Percentage change	Number of units	Percentage change
1978	360	—	810	—	1,170	—
1979	396	10%	931	15%	1,327	13%
1980	455	15	1,052	13	1,507	14
1981	492	8	1,084	3	1,576	5
1982	507	3	1,105	2	1,612	2
1983	557	10	1,272	15	1,829	13
1984	529	(5)	1,144	(10)	1,673	(8)
1985	508	(4)	972	(15)	1,480	(11)
1986	467	(8)	875	(10)	1,342	(9)
1987	420	(10)	770	(12)	1,190	(11)
1988-1998 (annual)	580	—	1,200	—	1,780	—

TABLE 8
Rockland County Non-Residential Building Activity
Based on County Property Assessments

Source: Rockland County Assessment Department

Year	Total non-residential assessed value in constant 1977 dollars (millions)	Percent change
1977	\$ 840	—
1978	882	5%
1979	908	3
1980	963	6
1981	1,011	5
1982	1,052	4
1983	1,083	3
1984	1,105	2
1985	1,116	1
1986	1,149	3
1987	1,195	4

ness with the new or expanded local firms. The amount of additional visitation depends on the types of firms and their tendencies to generate transient demand.

The total assessed value of all non-residential property located in Rockland County for the years 1977–1987 is shown in Table 8. The assessment for each year is expressed in constant 1977 dollars, so that percent change represents real growth from factors such as new construction. Between 1977 and 1987, the real gain in Rockland County's non-residential tax base was approximately 42 percent. This represents a compounded yearly growth rate of 3.6 percent. The composition of the non-residential construction over the past decade was estimated by the county's building department as 55 percent office, 20 percent retail, and 25 percent industrial. Office usage typically generates transient visitation at a higher rate than retail and industrial-oriented firms. As a result, these construction trends have been favorable for the local lodging market. A review of construction projects currently in progress indicates continued strong growth into the foreseeable future. Growth in construction employment is projected as being 1.5 percent per year from 1990 to 1995.

Transportation, Communication, and Public Utilities

The TCPU sector represents only a minor portion of Rockland County's employment base. Most of these employees work for either the postal service or the telephone company. Over the past 14 years, employ-

ment in this sector showed an annual compounded growth rate of 1.2 percent. Further increases in TCPU employment are expected to continue at approximately the historic rate.

Firms in this sector do not generate a great deal of transient visitation. Communication and utility firms are typically not labor intensive and thus are unlikely to produce significant lodging demand. Projected growth in this segment is 1.1 percent per year from 1990 to 1995.

Finance, Insurance and Real Estate

The FIRE employment sector occupies a strategic position with respect to control of investment capital, property transfers, and the provision of insurance. The professionally-oriented firms in this sector usually generate good transient demand, particularly in the commercial market segment. According to projections in employment, growth in the FIRE sector is expected to increase at a 2 percent compounded rate for the next several years. This gain in the FIRE sector should have a favorable effect on future lodging demand.

Wholesale and Retail Trade

The trade sector is the second largest employer within Rockland County, with retail trade representing approximately 75 percent of the sector's employment and the remaining 25 percent attributed to wholesale trade. By nature, firms engaged in trade, particularly wholesale trade, usually generate significant amounts of transient visitation. In Rockland County, the trade sector is well diversified, with no particular industry exhibiting a dominance in terms of employment.

The prominent position of the trade sector in the local economy is attributable to the role the area plays as a regional market for the tri-state area. The well-established, high-speed roadway network, along with the availability of existing industrial parks and distribution centers, further increases the dominance of the trade sector.

The local projected employment in the trade sectors shows a moderate growth in trade employment, which averaged 2.6 percent per year over the past decade. With the availability of developable land in existing industrial parks and distribution centers, and the county's desire to re-zone additional acreage for new industrial parks, local officials anticipate that a 1.2 percent yearly growth rate in the trade sector is likely.

Services

Services constitute the largest employment sector in the Rockland economy, with hospital services accounting for a large share of this category. Over the past decade, the service sector experienced the second highest level of growth, averaging 4 percent compounded per year.

The dominance of a strong service sector within a local economy is typically a favorable indicator of transient lodging demand. Firms engaged in service-related activities usually generate out-of-town visitation that must make use of local lodging facilities. In addition, service firms are not as likely to be affected by economic fluctuations, and tend to stabilize a local economy. Over the next five years, the Rockland County service sector is expected to continue its strong 2.5 percent annual growth rate.

Government

With almost 19,000 workers, government is the fourth largest employment sector in the Rockland County economy. Included in the government sector are employees of the local municipalities, as well as those of state, regional, and federal agencies. Over the past ten years, governmental employment has increased at an annual rate of 1.1 percent.

Although the government sector typically generates a good level of transient demand, which usually has a positive impact on local lodging facilities, this business is generally tied to a governmental per diem that is normally below the prevailing rate charged by moderate rate and first-class lodging facilities. While the government sector may not directly represent potential demand for the proposed subject property due to this rate sensitivity characteristic, the government-related transient demand nevertheless accounts for occupied room-nights in the lower-rated facilities, which has a positive effect on the area's overall lodging occupancy.

Major Businesses and Industries

The major employers in Rockland County (see Table 9) represent a cross-section of potential lodging demand. Some are nationally-oriented, while others are local in character. Some are engaged in product manufacturing, while others are active in research and development. This diversification may not maximize the area's transient demand, but it does tend to stabilize the local economy during its various cycles.

Most of the major employers are concentrated within the various office parks situated along the New

**TABLE 9
Rockland County's Major Employers**

Source: Rockland County Chamber of Commerce

Firm	Product	Number of employees
Lederle Laboratories	Pharmaceuticals	3,600
Avon Products, Inc.	Cosmetics	1,200
Chromalloy Corp.	Metal research	650
BSR	Audio equipment	600
Lamont Geological	Geological research	600
Swivelieri Co.	Light fixtures	500
Ciba-Geigy	Pharmaceuticals	500
Le Croy Research	Electronics	475
Materials Research	Research equipment	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
Volkswagen	Automobiles	380
RCA	Electronics	350

York State Thruway. All are less than 20 minutes driving time away from the proposed subject property and can be considered primary lodging demand generators.

Office Space

An important economic indicator that often directly reflects transient lodging demand is the amount of present and projected occupied office space within a market area, because the firms and businesses that occupy the office space usually generate the most commercial visitation. Although it is difficult to directly quantify commercial transient demand based on the amount of occupied area office space, it is worth noting that any changes or trends that will either increase or decrease the amount of occupied space often have a proportional impact on commercial lodging demand and, to a lesser degree, on transient meeting demand.

Office space in Rockland County is concentrated in several office parks situated adjacent to the New York State Thruway near Nyack, Spring Valley, and Suffern. In addition, the downtown areas of these cities, along with New City, have office developments.

Most of the companies occupying office space in Rockland County are either local firms or branch

TABLE 10
Major Office Parks in Rockland County

	Nyack Office Center	Eastwood Office Park	Suffern Corporate Center
Location	Exit 11, N.Y. State Thruway, Nyack, New York	Exit 14A, N.Y. State Thruway, Spring Valley, New York	Exit 15, N.Y. State Thruway, Suffern, New York
Size	500 acres	300 acres	600 acres
Number of firms	250	125	73
Amount of occupied office space	2,475,000 square feet	937,500 square feet	438,000 square feet
Amount of total office space	2,524,500 square feet	947,000 square feet	461,000 square feet
Vacancy rate	2%	1%	5%
Major tenants	Avon Products, Ciba-Geigy, Lederle Laboratories, U.S. Polychemical	Chromalloy American Corp., Materials Research, BSR	Chrysler Motors, World-Wide Volkswagen
Comments	This office park, situated approximately two miles east of the proposed subject property, is considered the top corporate location within Rockland County. Approximately 75 percent of the available land is currently utilized and park owners expect an office space growth rate of 3 to 5 percent per year.	This office park tends to attract research-oriented companies. It is the closest concentration of office space to the proposed subject property, which should benefit from the transient commercial and meeting demand generated by the tenants. Approximately 60% of the Eastwood Office Park is currently developed and the owners expect occupied office space to grow at an annual rate of 2 to 3 percent.	This new office park, situated approximately 12 miles west of the proposed subject property, opened in 1983. It is currently 25 percent developed with manufacturing-oriented companies. Future growth expectations for this area are 2 to 3 percent per year.

TABLE 11
Inventory of Rockland County Office Space

Source: Rockland County Real Estate Board

Year	Total available space	Per-cent change	Total occupied space	Per-cent change	Vacancy rate
1978	4,526,000	—	4,087,000	—	9.7%
1979	4,834,000	6.8%	4,326,000	5.8%	10.5
1980	5,336,000	10.4	4,621,000	6.8	13.4
1981	5,939,000	11.3	4,840,000	4.7	18.5
1982	6,242,000	5.1	5,299,000	9.4	15.1
1983	6,442,000	3.2	5,650,000	6.6	12.3
1984	6,545,000	1.6	5,845,000	3.4	10.7
1985	6,617,000	1.1	6,200,000	6.1	6.3
1986	6,637,000	0.3	6,278,000	1.2	5.4
1987	6,697,000	0.9	6,362,000	1.3	5.0

offices of national organizations. Table 10 lists the major area office parks, their larger tenants, and the total amount of occupied office space.

The Rockland County Real Estate Board maintains an inventory of the total available and the total occupied office space within the county. Table 11 shows these data for the years 1978 to 1987:

Between 1978 and 1987, total available office space in Rockland County increased from 4,526,000 to 6,697,000, a compounded annual growth rate of 4 percent. During this same period, total occupied office space increased from 4,087,000 to 6,362,000. This represents a real growth of 4.5 percent per year, compounded, with a reduction in the vacancy rate from 9.7 percent in 1978 to 5.0 percent in 1987.

Much of the growth in occupied office space within the county took place at the three major office parks in the county. Most of the growth was the result of the construction of new offices, but there was some expansion of existing buildings.

Discussions with the Rockland County Planning and Building Departments indicate that additional new office space is either under construction or in the planning process, and the growth rate experienced

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TABLE 12
Highway Traffic Counts

Source: New York State Department of Highways

Year	N.Y. State Thruway ¹	Percent change	Garden State Parkway ²	Percent change	Palisades Parkway ³	Percent change
1982	12,566,764	—	6,153,928	—	5,431,492	—
1983	12,943,767	3.0%	6,369,315	3.5%	5,632,457	3.7%
1984	13,614,836	5.2	6,604,980	3.7	5,846,490	3.8
1985	13,522,145	(0.7)	6,803,129	3.0	6,056,964	3.6
1986	14,377,202	<u>6.3</u>	7,068,451	<u>3.9</u>	6,299,243	<u>4.0</u>
Average percent change ⁴		3.4%		3.5%		3.8%

¹ Spring Valley toll plaza

² Intersection of Garden State Parkway and N.Y. State Thruway

³ Intersection of Palisades Parkway and N.Y. State Thruway

⁴ Annual compounded percent change from 1982

over the past ten years should continue for the foreseeable future.

These positive trends demonstrate the healthy economic climate within Rockland County, and will have a direct impact on future commercial and meeting visitation to the area. The most advantageous orientation for the proposed subject property would be toward the commercial and meeting and convention market segments in order to capitalize on its highly visible and accessible location adjacent to the New York State Thruway and near these growing office areas.

Highway Traffic

The proposed subject property occupies a prominent location adjacent to the New York State Thruway and within several miles of the Garden State and Palisades Parkways. The quantity of highway traffic passing through the area relates directly to transient commercial and leisure demand and indirectly to meeting demand. The yearly traffic count trends for each of these three major highways is shown in Table 12.

Between 1982 and 1986, traffic on all the major highways in the vicinity of the proposed subject property have shown increasingly greater volumes. The annual compounded growth rates for the New York State Thruway, Garden State Parkway and Palisades Parkway during this period were 3.4, 3.5, and 3.8 percent, respectively.

The average rates of 3.4 to 3.8 percent reflect strong growth. Much of the rising traffic volume can be attributed to favorable local economic trends,

which should have a positive effect on the demand for transient accommodations.

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. Changes in passenger counts also reflect trends in local business activity and the overall economic health of an area.

The proposed subject property is situated within approximately 20 minutes driving time of Stewart Airport in Newburgh, New York. This regional air facility is served by American and Delta Airlines, as well as by several commuter carriers. Stewart Airport has grown in popularity in recent years as more business firms have relocated to Rockland and Putnam Counties and the congestion around the New York City airports has intensified.

Most of the arriving passengers at Stewart Airport are commercial travelers visiting firms in Rockland and Putnam Counties, which is a strong indication of lodging demand. Car rental agencies report airport rentals averaging two-and-one-half to three days, which indirectly demonstrates lodging demand.

Table 13 shows historic and projected air passenger enplanement trends at Stewart Airport. It also illustrates air cargo tonnage data, a useful reflection of manufacturing usage trends.

Historic passenger enplanements at Stewart Airport increased at an annual compounded rate of 4.5 percent between 1976 and 1981. This growth slowed to 3.9 percent over the next five-year term, due to

TABLE 13
Stewart Airport Statistics and Projections

Source: Stewart Airport Authority

Year	Passenger enplanement	Percent change ¹	Percent change ²	Cargo tons	Percent change ¹	Percent change ²
1976	197,105	—	—	53,120	—	—
1981	245,628	4.5%	4.5%	67,796	5.0%	5.0%
1986	297,423	4.2	3.9	88,189	5.2	5.4
1991 ³	372,420	4.6	4.6	114,171	5.3	5.3
1996 ³	475,321	4.8	5.0	149,217	5.4	5.5
2001 ³	609,546	4.9	5.1	194,099	5.4	5.4

¹ Annual compounded percent change from 1976 for actual statistics and 1986 for projected statistics

² Annual compounded percent change from previous year

³ Projected by FAA

construction that closed the main runway for months in 1986. Projected rates of future passenger enplanements are expected to grow at an increasing pace through 2001.

The statistics for air cargo tonnage display a still greater growth rate as the local economy strengthened and new businesses moved into the area. While the absolute annual cargo tonnage is relatively small, a compounded growth rate of over 5 percent per year is considered very strong.

These airport statistics demonstrate a very favorable economic growth trend for the market area encompassing the subject property. As air passenger enplanements often exhibit a high degree of correlation with transient lodging demand, their strength holds particular significance. Although this economic growth indicator is strongly positive, its overall impact on transient visitation is somewhat minimized by the small number of passengers using Stewart Airport.

Rockland County Convention and Exhibition Center

The business of meetings and conventions in Rockland County took on greater significance during the past seven years with the 1982 opening of the Rockland County Convention and Exhibition Center in Suffern.

Situated approximately eight miles west of the proposed subject property in downtown Suffern, this county-operated convention facility has had moderate success in generating meeting and convention demand within the area. The center's facilities include a 50,000-square-foot exhibition hall that can accommodate moderate groups of 5,000 to 7,500. In addi-

tion, 15 meeting rooms are available that can seat 25 to 500 people each.

Most of the functions that the Convention Center attracts are retail trade shows, and entertainment and sporting events. These types of activities generally do not generate significant amounts of transient visitation. Over the course of a year, however, the facility typically draws 35 to 40 meetings that do represent potential hotel demand. The number of convention-type events requiring overnight accommodations along with the number of delegate attendees that have used the Convention Center over the past seven years are shown in Table 14.

During its six years of operating history, the Rockland County Convention and Exhibition Center has shown an impressive record of growth, averaging more than a 26 percent per year increase in the number of conventions and a 33 percent annual gain in the number of delegates. Discussions with representatives of the Rockland County Convention

TABLE 14
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
1982	14	—	7,000	—
1983	22	57%	12,100	72%
1984	36	63	20,700	71
1985	30	(17)	18,000	(13)
1986	41	36	25,625	42
1987	45	10	29,250	14

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TABLE 15
Out-of-State Tourist Visitation (1978–1987, in millions)

Source: *New York State Visitor Commission*

Year	Rockland County	Percent change	Metro New York	Percent change	New York State	Percent change
1978	1.31	—	12.8	—	20.9	—
1979	1.32	0.8%	12.9	0.8%	21.5	2.9%
1980	1.36	3.0	13.1	1.6	22.2	3.3
1981	1.40	2.9	14.2	8.4	23.5	5.9
1982	1.46	4.3	14.5	2.1	24.3	3.4
1983	1.53	4.8	15.2	4.8	25.8	6.2
1984	1.58	3.3	17.5	15.13	28.2	9.3
1985	1.66	5.1	17.1	(2.3)	28.8	2.1
1986	1.68	1.2	17.0	(0.6)	29.1	1.0
1987	1.70	<u>1.2</u>	16.9	<u>(0.6)</u>	29.6	<u>1.8</u>
Average annual change		2.9%		3.1%		3.9%

Bureau, which markets and operates this facility, indicate that future bookings appear to have stabilized; the number of delegates will probably increase at a future growth rate of 3 to 4 percent. This stabilization is due to several factors. The primary difficulty in attracting additional groups is the lack of sufficient first-class hotel rooms within a reasonable distance of the convention center. At the present time, the only nearby lodging facility is the 245-room Holiday Inn–Suffern. The county is currently seeking a developer to construct a convention hotel adjacent to the center, but no proposals have been received. The second problem with drawing additional transient-oriented convention demand is the policy of the county to seek the trade shows and sporting and entertainment events (because they are generally more profitable than meetings and conventions). The Convention Bureau claims that this policy will change once a convention center hotel is developed, when greater effort will be made to attract meeting and convention groups.

The proposed subject property will most likely not derive a significant benefit from the Rockland County Convention and Exhibition Center given the combination of its relatively distant location, the availability of the nearby Holiday Inn, and its stabilized growth expectations.

Leisure Travel

Leisure travel is an important industry in Rockland County, with more than 35 percent of the total land area reserved for some type of recreational use. Trends in leisure travel within a market area are key

indicators of lodging demand. Leisure travel is usually negatively correlated with commercial visitation because the leisure segment of demand generally seeks lodging accommodations during the normally slow hotel periods such as weekends, holidays and summer months. This added occupancy is especially desirable because it smooths a hotel's operational peaks and valleys, creating increased efficiency and profits.

The New York State Department of Tourism compiles data on out-of-state tourist visitation to each of the counties of New York. Table 15 shows these trends since 1978.

While Rockland County's tourist visitation statistics are low compared to those of metropolitan New York City and New York State as a whole, they do reflect good potential demand for area lodging. The tourist statistics also demonstrate a history of growth affected to a degree by cycles in the national economy.

On a monthly basis, leisure travel to Rockland County (see Table 16) shows the normal cycle associated with this segment of demand.

The summer months of July and August account for 30 percent of the leisure demand within Rockland County. September and October show strong weekend tourist visitation, particularly during the foliage season. The weekends of January and February also represent high levels of leisure travel by skiers and other winter sports enthusiasts.

The origin of leisure demand is an important factor influencing the demand for area lodging facilities. Generally, market areas that attract vacationers from distant points experience greater transient demand

TABLE 16
Leisure Visitation—Rockland County

Source: New York State Tourism Commission

Month	Percentage of yearly visitation	Month	Percentage of yearly visitation
January	7%	July	15%
February	8	August	15
March	4	September	11
April	3	October	12
May	3	November	4
June	12	December	6

TABLE 17
Rockland County—Total Acreage in Recreational Use

Source: Rockland County Planning Board

Jurisdiction	Acreage
New York State parks	29,524
Rockland County parks	1,139
Town and village parks	1,823
School district recreational areas	1,417
Watershed lands (private)	1,645
Private golf courses	471
Private schools, resorts, camps, and country clubs (recreational area only)	3,320
Total	39,339

and longer length of stays than those destinations that draw more local tourists.

According to the New York State Tourism Commission, the top five states of origin of leisure demand to Rockland County are New York, Pennsylvania, Massachusetts, New Jersey, and Connecticut. These five top states of origin are all relatively close together, so it is reasonable to assume that much of this type of visitation would be either single-day or short, one- to two-day stays.

Recreational Land Use

The recreational facilities and natural resources of an area are primary generators of leisure visitation. Rockland County has a variety of natural and man-made attributes that attract visitors, as shown in Table 17.

With a total county land area of 110,355 acres, recreational use accounts for approximately 35 percent of Rockland County's available land.

Another major attraction of transient visitors to the Rockland County area is the Palisades Interstate Park System, which comprises eleven different recreational

TABLE 18
Palisades Interstate Park System

Source: Rockland County Planning Board

Name of park	Total acreage	Facilities
Bear Mountain—Harriman State	2,600	Undeveloped; hiking, horseback riding, roller skating, skiing, swimming, boating, and fishing
Blauvelt	590	Undeveloped; hiking and horseback riding by special appointment
Haverstraw Beach	73	Closed (except for hiking and bicycle paths)
High Tor	564	Hiking, picnicking, swimming, scenery
Hook Mountain	661	Undeveloped; hiking, picnicking, biking, scenery
Iona Island	118	Undeveloped
Nyack Beach	61	Picnicking, scenery, fishing, hiking
Palisades	16	Undeveloped; hiking, scenery
Rockland Lake	1,095	Golf courses, tennis, picnicking, scenery, boating, fishing, swimming, hiking
Stony Point Battlefield	87	Historic site; scenery, hiking, picnicking
Tallman Mountain	687	Hiking, scenery, picnicking, swimming, field games, nature study

areas. Table 18 lists each park and describes its individual features.

Visitor Attractions

U.S. Military Academy. Located in West Point, New York, approximately 15 miles north of Spring Valley, this nationally known, historic institution is one of the area's most popular tourist attractions. West Point has been of military importance since Revolutionary days, when it was one of four points on the mid-Hudson fortified against the British. The military academy was founded by an Act of Congress in 1802.

Today, 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 ordnance. Nearby Fort Putnam is a fully restored Revolutionary War fortification.

Visitor counts taken at the West Point Information Center (see Table 19) show a ten-year history of moderate growth. The recession affected visitation temporarily in 1982, but growth revived again in 1983.

Over the past ten years, tourist-oriented visitation to West Point increased at an annual compounded

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TABLE 19
Visitor Count—West Point
Information Center

Year	Number of visitors	Percent change
1978	189,746	—
1979	196,387	3.5%
1980	205,813	4.8
1981	248,211	20.6
1982	209,986	(15.4)
1983	218,176	3.9
1984	232,793	6.7
1985	242,338	4.1
1986	237,249	(2.1)
1987	244,366	3.0
Annual compounded growth		2.8%

growth rate of 2.6 percent. Although the absolute visitor count has some importance in evaluating the local transient demand, the yearly compounded growth trend provides a solid benchmark for forecasting future growth potential in the leisure market segment. Discussions with West Point officials indicate that future visitor growth is expected to maintain its historical pattern.

The seasonality of West Point visitation is shown by the fact that 75 percent of the yearly visitor count occurs during the months of June, July and August. The remainder generally represents weekend traffic or special events at the Academy.

Sunnyside. Washington Irving's Hudson River estate is situated approximately eight miles east of the proposed subject property in Tarrytown, New York. This beautifully landscaped estate, built in 1835, contains much of Irving's furnishings, personal property, and library.

Philipsburg Manor. Situated in North Tarrytown, this 17th century, three-story manor house features a restored operating gristmill, granary, wharf, and wooden dam across a local river. A tour is conducted of the premises, featuring a 15-minute film.

Old Dutch Church of Sleepy Hollow. This quaint Dutch church, located in Tarrytown, was built 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. A historic restoration of the famous Stony Point Battlefield,

located eight miles north of the proposed subject property. This park contains numerous cannons and bunkers, and its museum offers an extensive collection of Revolutionary firearms.

General Motors Assembly Plant. On the Hudson River in Tarrytown, this factory tour shows the assembly of automobiles from raw metal body parts to completion. The tour utilizes a speaker-equipped tour train.

Nyack's "Antique Row". Eight miles east of Spring Valley, this area of Nyack is a famous haunt for antique enthusiasts.

There are a variety of activities that draw vacationers to Rockland County either as a leisure destination or as an interesting stopping point on a longer journey. In addition to this attraction-generated visitation, numerous vacationers pass through Rockland County on the area's well-developed highway system, bound for destinations outside of the subject's market area. A portion of these transients will utilize local lodging facilities as intermediate stopping points for both eating and/or sleeping. The proposed subject property's highly visible location adjacent to the New York State Thruway should assist in capturing a share of this "en route" visitation.

Conclusion

A review of the various sources of economic and demographic data for the market area encompassing the proposed subject property indicates that the local economy has experienced a moderate (1 to 3 percent) growth trend over the past five to ten years, and projections into the future indicate similar economic growth can be anticipated. These trends are favorable for the proposed subject property and reflect a growing transient demand.

Table 20 summarizes the various economic and demographic data previously described to this point. It shows historical and forecasted growth trends based on annual compounded percentage change.

Summary of Market Conditions

As described, demand for transient accommodations in the Rockland County area is primarily generated by three market segments: commercial, meeting and convention, and leisure. Fieldwork, area analysis, and knowledge of the local lodging market allow the following estimate of the distribution of the accommodated hotel room-night demand during 1987 to be made:

Market segment	Annual room-night demand	Percentage of total
Commercial	271,000	57%
Meeting and convention	122,000	26
Leisure	78,000	17
Total	471,000	100%

As can be seen, commercial demand currently predominates within the local market area, accounting for approximately 57 percent of the room-night demand. Meeting and convention travelers follow with a 26 percent share of the transient market. Vacationers show a relatively strong presence, capturing 17 percent of the market.

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.

Commercial Market Demand

In the market surrounding the proposed subject property, the commercial segment consists primarily of individual businesspeople 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.

Future commercial demand potential is tied primarily to the business and economic health of the surrounding area. Over the past ten years, the economy of Rockland County has shown a positive growth trend as reflected in most of the available economic and demographic data. Future forecasts indicate a continuation of these favorable growth patterns.

In order to reach a more specific forecast of the future demand expectations in the commercial segment, the data that most clearly reflects changes in commercial visitation has been evaluated. Table 20 sets forth the historical and forecasted area growth rates for various types of economic data; of this accumulated information, the data listed in Table 21 are considered most relevant in forecasting future trends in commercial visitation.

The historical growth trends range from a low of 0.0 percent in manufacturing employment to a high of 5.6 percent for EBI. Future expectations call for growth rates ranging from 0.7 percent in population and wholesale employment to 5.4 percent in airfreight. In projecting commercial visitation, the greatest weight is given to trends in total employment and the amount of occupied office space. Total employ-

TABLE 20
Economic and Demographic Data for Proposed Subject Property's Market Area

Data type	Period	Annual compounded percentage change
Historical population	1980-1986	0.6%
Projected population	1986-1991	0.7
Historical retail sales	1980-1986	1.2
Projected retail sales	1986-1991	4.1
Historical EBI	1980-1986	5.6
Projected EBI	1986-1991	4.0
Historical employment:		
Total employment	1970-1984	2.0
Manufacturing	1970-1984	0.0
Construction	1970-1984	2.1
TCPU	1970-1984	1.2
Wholesale and retail trade	1970-1984	2.7
FIRE	1970-1984	3.9
Services	1970-1984	4.0
Government	1970-1984	1.1
Projected employment:		
Total employment	1990-1995	1.3
Manufacturing	1990-1995	0.9
Construction	1990-1995	1.5
TCPU	1990-1995	1.1
Wholesale and retail trade	1990-1995	1.0
FIRE	1990-1995	1.4
Services	1990-1995	2.0
Government	1990-1995	1.4
Office space:		
Available	1976-1987	4.0
Occupied	1976-1987	4.5
Non-residential tax base	1976-1987	3.6
Traffic counts:		
New York State Thruway	1982-1986	3.4
Garden State Parkway	1982-1986	3.5
Palisades Parkway	1982-1986	3.8
Convention activity:		
Convention attendance	1982-1987	33.0
Number of conventions	1982-1987	26.0
Projected attendance	1988-1993	3.5
Airport statistics:		
Historical passenger enplanements	1976-1986	4.2
Historical airfreight	1976-1986	5.2
Projected passenger enplanements	1986-1996	4.8
Projected airfreight	1986-1996	5.4
Tourist visitation	1978-1987	2.9
West Point visitation	1978-1987	2.8

**TABLE 21
Commercial Visitation Data**

Data type	Period	Annual compounded percentage change
Historical population	1980-1986	0.6%
Projected population	1986-1991	0.7
Historical retail sales	1980-1986	1.2
Projected retail sales	1986-1991	4.1
Historical EBI	1980-1986	5.6
Projected EBI	1986-1991	4.0
Historical employment:		
Total employment	1970-1984	2.0
Manufacturing	1970-1984	0.0
Construction	1970-1984	2.1
TCPU	1970-1984	1.2
Wholesale and retail trade	1970-1984	2.7
FIRE	1970-1984	3.9
Services	1970-1984	4.0
Government	1970-1984	1.1
Projected employment:		
Total employment	1990-1995	1.3
Manufacturing	1990-1995	0.9
Construction	1990-1995	1.5
TCPU	1990-1995	1.1
Wholesale and retail trade	1990-1995	1.0
FIRE	1990-1995	1.4
Services	1990-1995	2.0
Government	1990-1995	1.4
Office space:		
Available	1976-1987	4.0
Occupied	1976-1987	4.5
Non-residential tax base	1976-1987	3.6
Traffic counts:		
New York State Thruway	1982-1986	3.4
Garden State Parkway	1982-1986	3.5
Palisades Parkway	1982-1986	3.8
Airport statistics:		
Historical passenger enplanements	1976-1986	4.2
Historical airfreight	1976-1986	5.2
Projected passenger enplanements	1986-1996	4.8
Projected airfreight	1986-1996	5.4

ment had a historic growth of 2.0 percent and is expected to increase at 1.3 percent per year until 1995. Occupied office space has increased at an annual rate of 4.5 percent. Based on this information, it would be reasonable to expect the commercial transient demand for the local market area to increase at a rate of between 1 and 3 percent. For the purposes of this study, the median of 2 percent has been used.

Meeting and Convention Market Demand

The meeting and convention demand in the Rockland County area is generated primarily by local businesses and represents activities such as training sessions, small exhibits, product announcements, meetings, and seminars. The size of these meetings is generally small, ranging from 15 to 20 people. A secondary source of meeting and convention demand is the non-commercial group meetings that include civic groups and professional societies. These types of meetings are somewhat larger in size, ranging from 75 to 250 people. Most of the area's meeting and convention demand is currently handled by local hotels and motels. The larger, non-commercial groups and trade shows that require more space than area hostelrys can provide utilize the Rockland County Convention and Exhibition Center.

Future demand potential in the meeting and convention market segment is closely related to the growth trend expected for the commercial segment. Since most meetings have either a direct or indirect business purpose, the economic considerations that impact commercial travel also affect meeting and convention demand. The non-commercial meetings, however, are generally tied more to the economic factors influencing leisure travel. Table 22 sets forth the trends considered most relevant in forecasting future meeting and convention demand.

Table 22 is similar to Table 21 with the exception that the Thruway data were not considered relevant and the convention center, tourist and West Point visitation trends are included. The historic growth trends range from a low of 0.0 percent in manufacturing employment to a high of 33 percent in convention center patronage. Future expectations call for growth rates ranging from 0.7 percent in population to 5.4 percent in airfreight. For projecting meeting and convention visitation, the greatest weight is given to trends in total employment, occupied office space, convention center patronage, and tourist visitation. Total employment had a historic growth of 2.0 percent and is expected to grow at 1.3 percent per year until 1995. Occupied office space has increased at an annual rate of 4.5 percent. Although convention center patronage has grown at 33 percent per year, this growth was due to its recent opening and the stabilized future forecast of 3.5 percent is a more reasonable indication. Area tourist visitation showed a 2.6 percent growth pattern. Based on this information, one could anticipate meeting and convention demand in the local market area to increase at a future rate of between 1.3 percent to 3.5 percent.

TABLE 22
Meeting and Convention Visitation Data

Data type	Period	Annual compounded percentage change
Historical population	1980-1986	0.6%
Projected population	1986-1991	0.7
Historical retail sales	1980-1986	1.2
Projected retail sales	1986-1991	4.1
Historical EBI	1980-1986	5.6
Projected EBI	1986-1991	4.0
Historical employment:		
Total employment	1970-1984	2.0
Manufacturing	1970-1984	0.0
Construction	1970-1984	2.1
TCPU	1970-1984	1.2
Wholesale and retail trade	1970-1984	2.7
FIRE	1970-1984	3.9
Services	1970-1984	4.0
Government	1970-1984	1.1
Projected employment:		
Total employment	1990-1995	1.3
Manufacturing	1990-1995	0.9
Construction	1990-1995	1.5
TCPU	1990-1995	1.1
Wholesale and retail trade	1990-1995	1.0
FIRE	1990-1995	1.4
Services	1990-1995	2.0
Government	1990-1995	1.4
Office space:		
Available	1976-1987	4.0
Occupied	1976-1987	4.5
Non-residential tax base	1976-1987	3.6
Traffic counts:		
New York State Thruway	1982-1986	3.4
Garden State Parkway	1982-1986	3.5
Palisades Parkway	1982-1986	3.8
Convention activity:		
Convention attendance	1982-1987	33.0
Number of conventions	1982-1987	26.0
Projected attendance	1988-1993	3.5
Airport statistics:		
Historical passenger enplanements	1976-1986	4.2
Historical airfreight	1976-1986	5.2
Projected passenger enplanements	1986-1996	4.8
Projected airfreight	1986-1996	5.4
Tourist visitation	1978-1987	2.6
West Point visitation	1978-1987	2.6

TABLE 23
Leisure Visitation Data

Data type	Period	Annual compounded percentage change
Traffic counts:		
New York State Thruway	1982-1986	3.4%
Garden State Parkway	1982-1986	3.5
Palisades Parkway	1982-1986	3.8
Tourist visitation	1978-1987	2.9
West Point visitation	1978-1987	2.8

For the purposes of this study, a growth rate of 3 percent per year has been used.

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 non-commercial visitation. Traffic and visitor counts on nearby major highways and attractions can also form a basis for future projections (see Table 23).

The various commercial-related trends considered earlier are not useful for projecting changes in leisure visitation and so are not included in Table 23. Of the data types set forth, tourist visitation and West Point visitation provide the most supportable base from which to forecast future growth. Thruway traffic is of lesser importance, as it is partially influenced by commercial travel.

Both tourist and West Point visitation have shown yearly historical growth of 2.8 percent. Forecasted future trends for these data types are not available, but with the recovery of the national economy, it is logical to assume that leisure demand will probably maintain this rate of growth into the foreseeable future. For the purpose of this study, a 1 percent compounded yearly growth rate for the leisure market segment is used.

Conclusion

The purpose of segmenting the transient lodging market is to define each major type of demand and

NEIGHBORHOOD AND MARKET AREA ANALYSIS

to estimate future growth trends and customer characteristics. Starting with an analysis of the local area, three segments have been defined as being representative of the subject property's lodging market. Various types of economic and demographic data have been evaluated to determine how clearly they reflect future changes in transient demand. Based on this procedure, and adding a factor of conservatism because the subject property

is proposed and, therefore, has no track record, the following forecast of market segment growth rates has been made.

	1988	1989	1990	1991	1992	1993	1994
Commercial	2%	2%	2%	2%	2%	2%	2%
Meeting and convention	3	3	3	3	3	3	3
Leisure	1	1	1	1	1	1	1

CHAPTER 9

Lodging Supply Analysis

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9.01 INTRODUCTION

The lodging supply in a given market area includes any facility that caters to transient overnight visitors, such as conference centers, bed and breakfast inns, and health spas, in addition to 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 usually evaluated.

An analysis of lodging supply begins with the identification of the market area, which is generally considered to be all of the area within twenty travel minutes of the subject property (see Chapter 8). In terms of supply, the market area in which the subject property is located is often 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 10 travel minutes beyond its perimeter). These peripheral demand generators may neighbor other lodging facilities that are out of the market area, but prove to some degree competitive with the subject property, and thus are included in the supply of which the subject property is a component.

The analysis continues with the identification of 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 types of amenities that they offer. This information is generally gathered by means of interviews with competing lodging facilities in the subject area.

The case study at the end of this chapter is an example of a lodging supply analysis. It illustrates the manner in which competitor interview data should be evaluated in order to estimate the occupancy levels of the competitive lodging facilities in a market area. It also shows the information that is typically gathered during a supply analysis and that is used to identify and evaluate primary and secondary suppliers of transient accommodations.

9.02 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 only 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 types of accommodations transient visitors actually select or by examining the local supply and determining the types of 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. In order 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 within 20 travel minutes of 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, casino, and health spa.
- 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, golf courses, and so forth.
- Is the hotel similar to the subject property in quality and price? Classes of lodging facilities include: luxury, first, standard/mid-rate, economy/budget, and microbudget.
- Does the hotel in question have an image similar to that of the subject property? Image refers to the hotel's brand name, local reputation, management expertise, and any unique or distinctive characteristics (e.g., unusual lobby decor).

Primary competition consists of lodging facilities that are similar to the subject property with respect to these criteria—particularly, types of facilities offered, class, and image. Secondary competition usually comprises 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 this category are considered competitive because they sometimes attract the same customers as do 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. Travelers are inclined to stay at the first hotel they encounter, especially during inclement weather, so a secondary competitor with a convenient

location will attract a certain percentage of the market for which the subject property competes.

Some hotels in the market area may 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.

9.03 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 only be determined 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, so the appraiser should anticipate an individual's viewpoint on the subject prior to undertaking any interviews. The local visitors' and convention bureaus and Chamber of Commerce will 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 in the market. Local government (e.g., building and planning departments or assessors) typically will take a neutral stance.

9.04 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 will provide this data on a property-by-property basis but will not identify 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.¹

If the rooms tax paid is a known quantity, then 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, so when rooms tax data for an individual property can be obtained along with an average room rate, the appraiser can very often 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:

$$\text{January rooms revenue} = \$10,416 \div 0.04 = \$260,400$$

$$\text{Rooms revenue per day} = \$260,400 \div 31 = \$8,400$$

$$\text{Rooms revenue per room per day} = \$8,400 \div 200 = \$42.00$$

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

- 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.² 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:

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

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

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

¹ 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.

² It could be argued that information provided in the Lodging 400 survey may contain exaggerated data because the reporting hotels are interested in achieving a ranking that is higher than it actually should be. Experience 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.

9.05 **COMPETITOR INTERVIEWS**

Once the appraiser has 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 11).

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

- Date of opening
- Physical condition
- Access and visibility
- Identification of franchise and management company
- Room count
- Amenities
 - Restaurants
 - Lounges
 - Meeting and banquet rooms
- Room rates
 - Published
 - Special
- Effectiveness of reservation system
 - Number of fill nights
 - Number of turn-aways
- 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
- Area economic trends
- 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. Additionally, 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 earlier, 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 also is likely to be somewhat understated.

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.

CASE STUDY Lodging Supply Analysis

IDENTIFICATION OF COMPETITION

According to lodging directories published by the Rockland and Bergen County Chambers of Commerce, the subject property's market area of southern Rockland and northern Bergen Counties currently has 21 lodging facilities containing a total of 2,197 guest-rooms. The majority of these hostelries are older family-run motels with an average of 35 units each. These properties cater primarily to price-conscious transient travelers and semipermanent residents who rent accommodations by the week or month. Although these motels attract a portion of the transient lodging demand in the area, only a few of them are considered competitive with the larger and newer hostelries now in operation.

PRIMARY COMPETITORS

There are seven hotels and motels in the market area that offer facilities and amenities that are directly competitive with the proposed property. These hostelries have a total of 1,705 rooms, which represents more than 77 percent of the available lodging units in the area.

Operating Characteristics

Table 1 summarizes the important operating characteristics of each of the primary competitors. The information in the table was derived from personal interviews and inspections and from reviews of lodging directories and in-house operating data.

The data in Table 1 indicates a good competitive environment. The area occupancy is strong for a commercially dominated market and all of the hotels are currently achieving reasonable operating levels given their age, rate structure, and location.

Interview Spreadsheet

To establish as accurately as possible the occupancy rates for each of the seven primary competitors in the market area, interviews were conducted with the general managers of the hotels and the directors of both the Hotel Association and the local Chamber of Commerce. Representatives of the municipal assessing, building, and planning depart-

ments were also interviewed. This information is summarized in Table 2.

During previous work in the area, it was determined that the actual occupancy rate for the Holiday Inn-Orangeburg facility was 80 percent. The upward or downward bias shown in the table was calculated based on each response to the occupancy question for the Holiday Inn-Orangeburg. In addition, averages were calculated for all the hotel managers' and hotel association's responses, which showed a downward bias, and the convention bureau and Chamber of Commerce responses, which showed an upward bias. The average of these two extremes (high and low) was calculated. Finally using all this data and analysis, an estimate of occupancy was made for each competitive hotel.

Occupancy Data

Additional information was made available from the Rockland-Bergen Hotel Association, which gathers monthly occupancy data from its twelve member properties. This data includes the 11 hostelries that are considered to be directly or indirectly competitive with the subject property plus five noncompetitive motels, the total of which represents 2,024 of the 2,197 rooms in the market area. Table 3 shows the monthly occupancies of this sample in 1985, 1986, and 1987.

The monthly occupancy pattern shown in Table 3 demonstrates a typical commercial-meeting-oriented lodging market with peak periods during the months of March, April, May, and October, when commercial travel and meetings are strongest, and slack periods during January, July, August, and December, when commercial and meeting travelers traditionally are relatively inactive. The data also demonstrates a growing overall occupancy rate, which is a positive market demand indicator.

INDIVIDUAL EVALUATIONS OF PRIMARY COMPETITORS

The following individual evaluations of the seven primary competitive lodging facilities are based on inspections and interviews undertaken at each of these facilities.

TABLE 1
Directly Competitive Lodging Facilities

Property	Location	Number of rooms	AAA rating (diamonds)	Year opened	Market segmentation			Published room rates			Estimated average rates	
					Commercial	Meeting	Leisure	Single	Double	Occupancy	Room	
Howard Johnson's	Nanuet	190	2	1964	65%	5%	30%	\$63-\$67	\$68-\$ 74	76%	\$68.00	
Sheraton Inn	Nanuet	230	3	1981	60	30	10	75-83	80- 91	70	82.00	
Holiday Inn	Nanuet	200	2	1979	55	20	25	70- 78	77- 85	60	77.00	
Holiday Inn	Orangeburg	260	4	1974	65	15	20	78- 83	81- 85	80	80.00	
Ramada Inn	Montvale	220	3	1978	60	30	10	79- 90	84- 95	78	87.00	
Hilton Inn	Woodcliff Lake	360	4	1984	50	40	10	85- 95	90-100	75	88.00	
Holiday Inn	Suffern	245	3	1985	50	35	15	70- 77	76- 82	65	78.00	
Area totals & weighted averages		1,705			58%	25%	17%			72%	\$81.00	

TABLE 2
Interview Spreadsheet

Interviewee	Howard Johnson's	Bias	Sheraton	Bias	Holiday Inn-Nanuet	Bias	Holiday Inn-Orangeburg	Bias	Ramada Inn	Bias	Hilton	Bias	Holiday Inn-Suffern	Bias	Average bias
Howard Johnson's	72%	4	65%	5	57%	3	75%	5	74%	4	71%	4	62%	3	4
Sheraton	71	5	66	4	58	2	74	6	75	3	72	3	62	3	4
Holiday Inn-Nanuet	73	3	66	4	59	1	75	5	73	5	72	3	61	4	4
Holiday Inn-Orangeburg	72	4	66	4	55	5	76	4	74	4	70	5	60	5	4
Ramada Inn	73	3	64	6	56	4	75	5	73	5	71	4	61	4	4
Hilton	74	2	66	4	60	0	77	3	73	5	71	4	63	2	3
Holiday Inn-Suffern	73	3	67	3	58	2	78	2	75	3	72	3	62	3	3
Hotel Association	72	4	66	4	58	2	74	6	74	4	71	4	62	3	4
Convention Bureau	80	-4	75	-5	66	-6	83	-3	82	-4	78	-3	68	-3	-4
Chamber of Commerce	79	-3	76	-6	65	-5	84	-4	83	-5	77	-2	69	-4	-4
Tax Assessor	75	1	71	-1	61	-1	79	1	80	-2	76	-1	66	-1	-1
Building Dept.	77	-1	72	-2	58	2	79	1	77	1	76	-1	66	-1	0
Planning Dept.	75	1	72	-2	60	0	80	0	77	1	76	-1	66	-1	0
Average of data cited by: Hotel General Managers and Hotel Association															
Convention Bureau and Chamber of Commerce	73%		66%		58%		76%		74%		71%		62%		
Municipal Tax Assessor, Building and Planning Dep'ts	80%		76%		66%		84%		83%		78%		69%		
Average of high and low estimates	76%		72%		60%		79%		78%		76%		66%		
Estimated occupancy	76%		70%		60%		80%		78%		75%		65%		

**TABLE 3
Average Monthly Occupancy Levels for Sixteen
Rockland and Bergen County Lodging Facilities**

Month	1985	1986	1987
January	54%	55%	55%
February	68	70	70
March	74	76	78
April	72	73	75
May	71	73	75
June	69	70	72
July	61	62	65
August	60	62	63
September	68	69	71
October	72	75	78
November	71	71	72
December	54	55	55
12 month average	66%	67%	69%

Howard Johnson's Motor Lodge

Address: Route 59 and Exit 14, New York State Thruway
Nanuet, New York 10954

Number of rooms: 190

Estimated occupancy: 76%

Estimated average rate: \$68.00

The Howard Johnson's Motor Lodge is a two-story, roadside-type motel situated directly across the Thruway from the proposed subject property. This facility is leased to the Howard Johnson Company, which operates both the motel and restaurant on the property.

Typical of the motels constructed in the early 1960s, the Howard Johnson's comprises three guest-room buildings with exterior corridors and walkways. Its orange-roofed restaurant is a separate building situated more than 100 yards from the motel. The rooms and food entities are operated as separate profit centers, with very little coordination between the two.

The restaurant is a typical Howard Johnson's operation with 20 seats at a counter and 125 in the dining room. A small service bar is situated in the dining room, but beverage revenue is minimal. The property has no meeting or banquet rooms. Amenities consist of an outdoor swimming pool and a small playground.

This facility derives approximately 65 percent of its occupancy from commercial travelers. With no meeting facilities, the property cannot attract in-house groups, but it does benefit from overflow meeting business utilizing nearby hotels, and this accounts for approximately 5 percent of the demand it experi-

ences. Leisure travelers represent the remaining 30 percent of the Howard Johnson's transient demand. The property's highly visible Thruway location and strongly leisure-oriented image make the property the most popular motel in the area for vacationers.

A recent furniture replacement program has upgraded the interior of this property but the exterior still appears dated and functionally obsolete. This property is not foreseen as competing directly with the proposed subject property for commercial and meeting patronage but it will continue to be a significant competitor for leisure travelers.

Nanuet Sheraton Inn

Address: Route 59 and Rose Road
Nanuet, New York 10954

Number of rooms: 230

Estimated occupancy: 70%

Estimated average rate: \$82.00

The Nanuet Sheraton Motor Inn is a two-story, first-class hotel, located on Route 59, near the Palisades Parkway, approximately three miles southeast of the subject property. The property is independently owned and operated under a franchise from Sheraton Inns.

The food and beverage facilities consist of an all-purpose restaurant that seats 150 and a cocktail lounge that can accommodate 140. The food and beverage outlets are leased to an outside operator and have not been redecorated since the property opened in 1981. As a result, the decor is somewhat worn and dated. Most of the patronage comes from in-house guests, but there is a fair amount of restaurant lunch trade generated from the local community. The cocktail lounge offers entertainment Wednesday through Saturday nights that attracts mostly local residents.

The Sheraton Inn is not a meeting-oriented property. Its meeting and banquet facilities consist of one ballroom of approximately 3,000 square feet that can accommodate 300 banquet-style and one small meeting room that holds 50 people. This lack of banquet space limits the Sheraton's ability to cater to the serious meeting planner. This property is not foreseen as a major competitor for meeting business in the area.

On-site recreational amenities include a heated outdoor swimming pool and a game room. The hotel has made arrangements with a nearby health club to provide privileges for the use of the spa, indoor tennis, and golf.

The Sheraton Inn currently derives approximately 60 percent of its occupancy from commercial travel-

ers. Its meeting patronage accounts for 30 percent and business from leisure travelers amounts to 10 percent of the total demand. According to management, a complete refurbishing program has been authorized that should increase the competitiveness of the Sheraton's food and beverage facilities. No plans have been made to increase the meeting and banquet space. This property will thus likely be moderately competitive with the proposed subject property, particularly for commercial travelers.

Holiday Inn-Nanuet

Address: Route 59 and Exit 14, New York
State Thruway
Nanuet, New York 10954

Number of rooms: 200

Estimated occupancy: 60%

Estimated average rate: \$77.00

The Holiday Inn-Nanuet is a three-story motel located on Route 59 near Exit 14 of the New York State Thruway, approximately one mile southeast of the subject property. The property is independently owned and operated under a franchise from Holiday Inns.

The food and beverage facilities are extensive for a 180-room motel, consisting of two restaurants and a large cocktail lounge/entertainment room. The main restaurant seats 180 people and was recently redecorated in an early American motif. It has never been successful at drawing patronage from the local area beyond luncheon hours, but with an extensive promotional program, management hopes to develop a greater dinner clientele. The second food outlet is a 100-seat coffee shop open 24 hours per day. Specializing in breakfast at any time, particularly pancakes and waffles, this restaurant is very active during the late evening and early morning hours.

The cocktail lounge/entertainment room seats 225 and has a country-western-type decor. It is an extremely popular night spot that offers live bands seven nights per week and is filled to capacity most evenings, which causes heavy congestion in the parking area. The patrons sometimes become unruly, which often results in excessive noise and, occasionally, more serious disturbances. Management claims that the lounge has little negative impact on its rooms business, but its 60 percent occupancy level is the lowest in the area.

Meeting and banquet space consists of three rooms accommodating 75, 100, and 300 people, respectively. With its location adjacent to the active cocktail lounge/entertainment room, most meeting planners have little interest in holding conferences

that may extend into the period the lounge is open. As a result, this facility does not enjoy a particularly strong meeting and banquet trade.

Recreational amenities include a heated outdoor swimming pool and an exercise room (actually a converted guestroom) with several pieces of equipment and a sauna. A large game room adjacent to the lounge receives a great deal of use.

The Holiday Inn-Nanuet currently derives approximately 55 percent of its occupancy from commercial travelers. Its location near the New York State Thruway is convenient for leisure travelers, which account for 25 percent of the market. Meeting business makes up the remaining 20 percent of the total patronage.

The Holiday Inn (with a two-star Mobil rating) is not seen as a strong competitor of any new, first-class lodging facility entering the market. Should the property be upgraded and its entertainment policy changed, its proximity to the proposed subject property could increase its level of competitiveness.

Holiday Inn-Orangeburg

Address: 329 Route 303
Orangeburg, New York 10962

Number of rooms: 260

Estimated occupancy: 80%

Estimated average rate: \$80.00

The Holiday Inn-Orangeburg is a two-story, first-class motor hotel, located on Route 303 near Exit 6 of the Palisades Parkway, approximately eight miles southeast of the subject property. The property is independently owned and operated under a franchise with Holiday Inns.

This 13-year-old facility has been extremely well maintained and is currently in excellent condition, having just undergone its second complete renovation and total replacement of furnishings and equipment.

Food and beverage outlets consist of an all-purpose restaurant seating 190 and a cocktail lounge that accommodates 140. The restaurant's new decor is similar to TGI Friday's, with multi-level seating, old-fashioned memorabilia and hanging plants. Its lunch and dinner menus are diverse, featuring light sandwich items, quiche, and salads, as well as more filling meals, such as steaks and seafood. The restaurant only recently opened under this new concept and menu, so it is too early to evaluate the local usage. Area reaction has been favorable and in-house patronage has been strong.

The lounge, which opens into the restaurant, has also been redecorated in a similar motif. Formerly a

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discotheque that featured recorded music, business began to decline two years ago when regular patrons left for lounges offering live entertainment. The lounge now features quiet music during the dinner period followed by light rock later in the evening. Local reaction to the new lounge and its entertainment has been mixed and management is currently evaluating future groups in order to achieve a more positive indication of success.

This facility is not meeting-oriented. Its meeting and banquet space comprises the following room configuration:

<i>Name</i>	<i>Square footage</i>	<i>Banquet seating</i>
Empire Ballroom	2,200	200
Downstate Room	825	75
River Room	550	50
Mountain Room	440	40

The meeting rooms have also been redecorated. However, because of the relatively small size of the ballroom and the lack of adequate breakout meeting space, this property cannot handle groups of much more than 125. Management would like to increase the size of the meeting facilities, but because of local zoning and inadequate parking, such an expansion has not been permitted.

Recreational amenities consist of a heated outdoor swimming pool, one tennis court, jogging track, game room, and an extensive children's playground.

The Holiday Inn-Orangeburg currently derives approximately 65 percent of its occupancy from the commercial segment. Meeting patronage accounts for 15 percent of its accommodated demand because of the meeting space restrictions, and leisure demand represents a strong 20 percent.

This established property has always achieved a high level of occupancy. Its four-star Mobil rating and connection with the excellent Holidex reservation system are factors that contribute to this success. In addition, ownership has never been reluctant to reinvest profits in the form of furnishings replacements and new concepts. It is reasonable to anticipate that the Holiday Inn will offer a high level of competition for the subject property.

Ramada Inn

Address: 100 Chestnut Ridge Road
Montvale, New Jersey 07645

Number of rooms: 220

Estimated occupancy: 78%

Estimated average rate: \$87.00

The Ramada Inn is a three-story, first-class motor hotel situated in a quiet, wooded area in the northern New Jersey town of Montvale, approximately seven miles south of the subject property. The property is owned and operated by Ramada Inns.

Its somewhat remote and secluded location inhibits off-the-road patronage, but this hotel is very popular among meeting and seminar planners looking for a quiet environment. The Ramada's function rooms include a complete seminar/conference center, featuring an amphitheater-type room with elevated seating, executive chairs and elaborate audiovisual capacities. Similar meeting and breakout rooms have been designed to accommodate think-tank sessions. The total meeting room capacity of this property can comfortably handle four individual groups of 50 each.

Food and beverage facilities include the Seven Oaks Restaurant, which seats 150, the Acorn Coffee Shop, which seats 125, and the Fieldstone Cocktail Lounge, accommodating 100. Outside restaurant patronage is not actively pursued because of the property's conference center orientation. Management wants to maintain a quiet, academic-type environment.

Recreational amenities include an outdoor heated swimming pool, health club, and game room.

The Ramada Inn currently derives approximately 60 percent of its patronage from commercial travelers. Thirty percent of its accommodated demand is generated by the conference center. A weak 10 percent comes from leisure travelers. This property has developed and captured the highly selective conference market by providing both the atmosphere and the unique facilities that these types of groups require. The proposed subject property will most likely not compete directly for this form of meeting business.

Hilton Inn

Address: Tice Boulevard and Chestnut
Ridge Road
Woodcliff Lake, New Jersey
07675

Number of rooms: 360

Estimated occupancy: 75%

Estimated average rate: \$88.00

The Hilton Inn is a modern, four-story hotel nestled in a 21-acre apple orchard in northern New Jersey, approximately eight miles south of the subject property. It is independently owned and operated under a franchise from Hilton Inns.

The Hilton's extensive food and beverage facilities are elaborately decorated in different themes and include the following outlets:

<i>Name</i>	<i>Type</i>	<i>Seating</i>
Copperfield's	French cuisine	125
Orchard's	Coffee shop	175
Beastro Lounge	Nightclub	150
Gazebo Lounge	Cocktail lounge	75

Copperfield's is a locally popular restaurant that draws heavily from the surrounding area and in-house guests. Orchard's caters mostly to hotel guests for breakfast and dinner, but draws a good outside lunch trade. The Beastro Lounge is an active entertainment spot for both guests and local residents. The Gazebo Lounge is a small, intimate lobby bar.

The Hilton Inn is known for its meeting and banquet facilities, which can handle groups from 10 to 1,000 persons. Located in a separate wing off the main lobby, this convention center offers the following facilities:

<i>Name</i>	<i>Square footage</i>	<i>Banquet seating</i>
Ground ballroom	7,200	720
Section A	1,800	180
Section B	1,800	180
Section C	1,800	180
Section D	900	90
Section E	900	90
Birches	476	30
Palisades	952	70
Ramapo	952	70
Cortland	486	30
Blake	486	30
Executive	234	10

The meeting rooms are well equipped to handle a variety of conferences. Audio and video equipment includes slide and rear-view projection, movie and filmstrip viewers, video tape recorders and closed circuit television, and overhead projecting.

Recreational amenities consist of indoor and outdoor swimming pools, saunas, whirlpool, exercise gymnasium, two racquetball and two tennis courts, putting green, and a one-mile jogging trail.

The Hilton Inn derives approximately 50 percent of its occupancy from commercial travelers. Meeting patronage represents a strong 40 percent and leisure travelers account for 10 percent. Of the seven primarily competitive properties, the Hilton Inn offers the most extensive facilities and the highest quality. Its Mobil rating of four stars reflects its competitive position, and the high occupancy and average rate provide an indication of the Hilton's excellent reputation.

This property will offer the most competition to the proposed subject property, particularly for meeting and group patronage.

Holiday Inn-Suffern

Address: 3 Executive Boulevard
Exit 14B, New York State
Thruway

Number of rooms: 245
Estimated occupancy: 65%
Estimated average rate: \$78.00

The Holiday Inn-Suffern is the newest and most extensive lodging facility in the market area. This two-year-old, holidome-type motor hotel is situated approximately five miles west of the subject property, adjacent to the New York State Thruway at Exit 14B. It is owned and operated by Brock Hotels under a franchise from Holiday Inns.

Constructed around a huge enclosed and climate-controlled courtyard, this facility was designed to accommodate large meetings and banquets as well as year-round vacationers and escape-weekenders utilizing the elaborate indoor amenities.

A variety of food and beverage outlets, situated in and around the Holidome, provide a festive atmosphere.

<i>Name</i>	<i>Type</i>	<i>Seating</i>
Colony Restaurant	Continental	180
Terrace Room	Cafe	150
Snack Shop	Short-order	35
Colony Lounge	Lounge	200
Holi Dome	Lounge	50

The Colony Restaurant is a gourmet dining room that specializes in tableside cooking. Its plush velvet Southern-type decor create a luxury image that complements the elegant service. Although it did not draw a significant amount of local patronage when it opened two years ago, its popularity is gaining in the surrounding area. The Terrace Room is a coffee shop-style outlet featuring a wide selection of deli sandwiches. This outlet is always filled during lunch periods by local business people and shoppers. The Snack Shop is a short-order snack bar situated in the Holidome. The Colony Lounge is a locally popular lounge and entertainment room featuring live groups. The Holi Dome Lounge is a small bar located within the holidome area of the property.

The Holiday Inn-Suffern's meeting and banquet facilities can accommodate the largest groups in Rockland and northern Bergen Counties. The following list shows the capacity of each room:

**TABLE 4
Secondary Competition**

Property	Location	Number of rooms	Market segmentation			Occupancy	Competitive %
			Commercial	Meeting	Leisure		
Galaxy Motor Inn	Spring Valley	35	65%	5%	30%	55%	25%
Midway Inn	Spring Valley	25	80	0	20	50	10
Seven Seas Motel	Spring Valley	75	70	10	20	60	40
Seacrest Motor Inn	Spring Valley	100	50	20	30	68	50

Name	Square footage	Banquet seating
Regency A	3,000	300
Regency B	3,000	300
Regency C	3,000	300
Regency D	3,000	300
Regency A-D	12,000	1,200
Embassy A	1,500	150
Embassy B	1,500	150
Embassy C	1,500	150
Embassy A-C	4,500	450
Boardroom	750	75
Flower Room	500	50
Tree Room	250	25

In addition to these ballrooms and meeting rooms, the holidome area can be used for receptions of up to 3,000 people.

The recreational amenities are an outstanding feature of the Holiday Inn-Suffern. Situated within a huge enclosed holidome area is an indoor-outdoor swimming pool, putting green, miniature golf course, playground, game room, table tennis, health club, sauna, and whirlpool. Outside, guests can use two lighted tennis courts and a jogging and health fitness track.

The Holiday Inn-Suffern currently derives approximately 50 percent of its occupancy from commercial travelers. Meeting patronage accounts for 35 percent and leisure travelers represent 15 percent. This property is extremely well managed and should be highly competitive with the proposed subject property in all market segments. Its three-star Mobil rating understates the desirability and quality of this hotel and it is expected that, as the operation matures, it will receive an additional star.

SECONDARY COMPETITION

In addition to the seven competitive lodging facilities considered primary competition, the local market area contains four motel-type facilities that are con-

sidered secondary competition. Table 4 outlines the characteristics of this secondary competition.

All four of these properties are situated in the Spring Valley area within three miles of the subject property, which makes them somewhat competitive by virtue of location. The Galaxy Motor Inn is a small, well maintained property with small guestrooms, and is estimated to be 25 percent competitive which means that 8.75 of its rooms will compete with the primary competition ($35 \times .25 = 8.75$). The Midway Inn is similar to the Galaxy except that its condition has deteriorated in recent years. It is considered only 10 percent competitive. The Seven Seas Motel and the Seacrest Motor Inn are larger properties with some meeting space, but no food and beverage facilities. They are both maintained in good condition with the Seven Seas estimated to be 40 percent competitive and the Seacrest 50 percent competitive.

The weighted average segmentation for the secondary competition is calculated as follows:

Property	Number of rooms	Competitive %	Effective number of rooms
Galaxy Motor Inn	35	× 25	= 8.75
Midway Inn	25	× 10	= 2.50
Seven Seas Motel	75	× 40	= 30.00
Seacrest Motor Inn	<u>100</u>	× 50	= <u>50.00</u>
Total	235		91.25

Effective number of rooms	Commercial segmentation	Weighted segmentation
8.75	× 65%	= 5.70
2.50	× 80	= 2.00
30.00	× 70	= 21.00
<u>50.00</u>	× 50	= <u>25.00</u>
91.25		53.70

Weighted average: $\frac{53.70}{91.25} = 58\%$ (Commercial)

The effect of the secondary competition is best thought of in the aggregate, so the characteristics of the four properties have been combined as follows:

Rooms	Market segmentation			Occupancy
	Commercial	Meeting	Leisure	
91	58%	15%	27%	64%

POSSIBLE FUTURE COMPETITION

A 210-unit Travelodge is currently under construction adjacent to the Ramada Inn, seven miles south of the proposed subject property, in Montvale, New Jersey. Discussion with the developer indicated that the facilities of this motel will be oriented toward both commercial and leisure travelers, with a minimal number of meeting rooms for groups. Opening of the Travelodge is scheduled for June 1989. Although this motel occupies a remote location similar to that of the Ramada Inn, the Travelodge is expected to attract the rate-sensitive commercial traveler. Its resort-type setting and amenities, including indoor swimming pool, three tennis courts, handball, and horseback riding, along with inexpensive rooms rates, should also be popular among rate-sensitive vacationers. Because of its lower rate structure and budget-type image, the Travelodge is not seen as a significant competitor of the proposed subject property.

Two proposed lodging facilities are currently in the discussion stages for sites near the subject property. A budget-type Days Inn is under consideration for a parcel of land adjacent to the Holiday Inn-Suffern. Developers are currently seeking a zoning change in order to start this project, and financing has not been secured. Marriott Corporation has been considering a site in Montvale, New Jersey for the past several years. They are presently evaluating market conditions to determine whether the acquisition and development of this property is feasible. Discussions with local building officials, real estate brokers, and hotel operators reveal that neither of these two proposed projects are likely to be developed within the

short-term future and so they have been excluded from consideration in the competitive room-night analysis phase of this study.

CONCLUSION

The competitive environment in the market area of the proposed subject property appears suitable for new hotel development. With an area occupancy rate of 72 percent for seven comparable lodging facilities, along with the finding that none of these properties operates at an occupancy below 60 percent, it can be concluded that additional hotel rooms could be readily absorbed into the marketplace. In general, the better quality hotels (among which the subject property would be counted) achieve both the highest room rates and occupancy levels. Other positive signs include the fact that all properties derive more than half of their occupancies from commercial patronage and that meeting demand is good for the facilities that are so oriented. Leisure travelers represent the smallest market segment, but since the proposed property would not be relying on their trade, this factor is not considered significant.

Although a 210-room Travelodge is currently under development, its budget rate structure should not directly affect the higher-rate, first-class properties within the market. The two proposed facilities in the area are still in the early planning stages, so they should not be considered as likely competition in the foreseeable future.

Based on the competitive structure of the marketplace, it is strongly recommended that the proposed subject property be oriented toward the commercial and meetings market segments because these areas offer the greatest competitive potential for achieving profitable levels of occupancy and average rates. Although leisure travel will not likely be a significant generator of occupancy, adequate amenities should be included in the subject property's design to establish a competitive position for this segment.

CHAPTER 10

Lodging Demand Analysis

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10.01 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). Table 10.1 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. The case study 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 are 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.

TABLE 10.1
Lodging Demand Generators

Airports	County seats and state capitals	National or state parks and scenic areas
Amusement parks	Court houses	Racetracks
Association headquarters	Festival sites	Regional shopping centers
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

10.02 **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 approach 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. As described in Chapter 9, 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 will be 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 simply finding and talking 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, examples of bookers are 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 will be able to provide information concerning the preferences of travelers, such as 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 10.1 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 10.2 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 approach 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.

10.03 **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 are 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 9. 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:

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

[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 frequently 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 9) 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 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 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 approach¹ 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 8 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, will 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 will usually increase rapidly over a period of time and then stabilize 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, and 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.

¹ See 10.02 supra.

- 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 based on 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. Based on discussions with the building department and 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 earlier, 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
- American Hotel and Motel Association development reports
- Local real estate brokers
- Local lenders
- Hotel appraisers and consultants

Once the currently proposed additions to the lodging supply are 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 8.

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 provided the supply of rooms were adequate. It differs from accommodatable latent demand only in that it may be a smaller amount. In other words, while there may be the capacity in the market 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 to 60 percent. If the overall area occupancy is projected to fall below 50 percent, a hotel project is rarely justified.

EXHIBIT 10.1 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; elicit reasons for response.

13. Indicate the proposed hotel's location and ask whether interviewee thinks this would be a good location; elicit reasons for response.

Interview by: _____

EXHIBIT 10.2 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) 555-8828.

1. Your Name/Title _____
2. Company Name _____
3. Department _____
4. Street Address _____
5. City, State, Zip Code _____
6. Telephone Number _____
7. What is the current number of employees at this location?
Entire firm _____ Your department _____
8. 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.

9. 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?
 10. During an average month, how many people visiting your FIRM/DEPARTMENT require overnight hotel accommodations? _____
 11. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations arrive during the following seasons?
Winter _____ Spring _____ Summer _____ Fall _____ (Total 100%)
 12. What percentage of the visitors described above currently:
Book their own accommodations? _____
Have their 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 _____

13. 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?

<i>Reason for overnight stay</i>	(a) <i>Percent of total visitors</i>	(b) <i>Average length of stay</i>	(c) <i>Number of people per room</i>
Relocation			
Training			
Temporary Assignment			
Consulting			
Meeting/conference			
Other (please specify)			

14. Which lodging facilities does your firm currently use (in order of preference)? (Please complete the following chart.)

<i>Name of facility</i>	<i>Room rate charged</i>
1.	
2.	
3.	
4.	

15. 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)

<i>Factor</i>	<i>Rating</i>	<i>Factor</i>	<i>Rating</i>
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? _____

16. 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.)

	<i>For meetings</i>	<i>For banquets</i>
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?	_____	_____

17. a. Are you familiar with the location of the Spring Valley project? _____
 b. How would you rank the location of the Spring Valley project compared to the locations of the hotels you now currently use? (Please circle one)
 Better About the same Inferior

18. Given a choice between a full service hotel (e.g., Marriott, Holiday Inn, Hilton) and a limited service hotel (e.g., Days Inn, Red Roof Inn, Comfort Inn), which would you be more likely to choose when booking overnight accommodations for visitors? _____
 Why? _____

19. All suite hotels (e.g., Guest Quarters, 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? _____

20. Please rank the following hotel chains (fifteen are listed) in the order that you would choose them when booking overnight accommodations for visitors.

<i>Hotel chain</i>	<i>Rank</i>	<i>Hotel chain</i>	<i>Rank</i>	<i>Hotel chain</i>	<i>Rank</i>
Doubletree	_____	Holiday Inn	_____	Pickett Suites	_____
Embassy Suites	_____	Hyatt	_____	Quality Inn	_____
Four Seasons	_____	Loews	_____	Radisson	_____
Guest Quarters	_____	Marriott	_____	Red Roof Inn	_____
Hilton	_____	Omni	_____	Sheraton	_____

Thank you for your cooperation.

CASE STUDY Lodging Demand Analysis

DEMAND GENERATORS

The following is a list of the largest demand generators for each market segment in the Spring Valley market area as determined by the results of interviews and surveys.

<i>Market segment</i>	<i>Demand generator</i>
Commercial	Nyack Laboratories
Meeting and convention	Rockland County Convention and Exhibition Center
Leisure	U.S. Military Academy—Tourist Visitation

DEMAND GENERATOR INTERVIEW

The results of the interview with Nyack Laboratories are as follows.

Demand generator:	Nyack Laboratories
Major business:	Pharmaceuticals
Location:	Nyack Office Center Exit 11, NYS Thruway, Nyack, New York Two miles east of subject property
Number of employees at this location:	3,600
Types of visitation:	As the national headquarters, this facility is utilized for administrative meetings, sales training, recruiting and personnel, and worldwide purchasing. All of these functions generate transient visitation.
Administrative meetings:	A number of administrative meetings are held on a regular basis at this facility, ranging in size from an individual plant manager visiting a division vice-president to monthly Board of Directors' and annual stockholders' meetings. This demand is relatively price-insensitive, and most of these visitors are booked into the area's upscale lodging facilities, such as the Hilton Inn and the Ramada Inn. Average stays are approximately three nights, Monday to Thursday, year-round. Reservations are normally booked by the travel department in Nyack. Because neither the Hilton Inn nor the Ramada Inn are convenient to this facility (seven and eight miles distant, respectively), the subject property would have a definite competitive advantage.
Sales training:	All sales training for Nyack is performed at this facility. Training sessions generally

last two weeks, with attendees utilizing in-house classrooms, and relying on nearby lodging facilities for overnight accommodations. The company is somewhat price-sensitive at this administrative level, and requires most personnel to double up in hotel rooms. The Howard Johnson's and the Holiday Inn—Nanuet are presently utilized for this purpose. While these facilities are somewhat dated, they do offer special low rates as well as shuttle bus service to and from Nyack. Sales training accommodations are booked by the marketing department.

Recruiting and personnel:

All hiring and personnel functions are handled at this facility. Nyack is price-sensitive in this area also, and maintains the same accommodations arrangements as described above for sales training. Accommodations for recruiting and personnel are booked by the personnel department.

Worldwide purchasing:

All purchasing for Nyack is performed at this facility. As a result, hundreds of salespeople from various purveyors and vendors visit this office each week to make sales calls and presentations. Most salespeople stay in the area only one or two nights, and tend to utilize the entire range of lodging facilities available in the market. Convenience to the Nyack offices is a major consideration, as are good food and beverage facilities for entertaining.

Future trends:

Nyack appears to be a growing company, with increasing needs for nearby transient accommodations. It appears to generate a wide range of transient demand which varies between price-sensitive and price-insensitive.

LODGING ACTIVITY BUILD-UP APPROACH

Fieldwork and in-house market data have provided the basis for an estimate of the current annual occupancies for the properties considered competitive to the Spring Valley project. The total occupancy has been divided among each of three market segments according to the percentage of the total room-nights occupied that each segment represents. Based on the analysis of the Spring Valley hotel market, the following three demand segments have been defined:

- Segment 1 Commercial
- Segment 2 Meeting and convention
- Segment 3 Leisure

The number of room-nights occupied per year by each of the market segments has been calculated for a given hotel by multiplying the number of rooms available by 365 days, by the estimated occupancy, by the percentage allocated to each of the three segments. The number of room-nights occupied by segment on a per-room basis (room-nights per room per year) has been derived by dividing the number of room-nights

occupied per year by each segment by the number of rooms available. The result is the competitive index, which has been used to compare the relative competitiveness of each property. Table 1 sets forth these calculations for the subject property's competitors.

The total of the room-nights occupied per year for each of the competitive hotels represents the area's accommodated room-night demand.

TABLE 1
Market Segment and Occupancy Data for Competitive Facilities

Hotel	Market segment	Percentage of total patronage	Room-nights occupied per year	Room-nights occupied per room per year (competitive index)
Howard Johnson's-Nanuet				
Rooms: 190	Commercial:	65%	34,259	180
Occupancy: 76%	Meeting:	5	2,635	14
	Leisure:	30	15,812	83
Sheraton Inn-Nanuet				
Rooms: 230	Commercial:	60%	35,259	153
Occupancy: 70%	Meeting:	30	17,630	77
	Leisure:	10	5,877	26
Holiday Inn-Nanuet				
Rooms: 200	Commercial:	55%	24,090	120
Occupancy: 60%	Meeting:	20	8,760	44
	Leisure:	10	10,950	55
Holiday Inn-Orangeburg				
Rooms: 260	Commercial:	65%	49,348	190
Occupancy: 80%	Meeting:	15	11,388	44
	Leisure:	20	15,184	58
Ramada Inn-Montvale				
Rooms: 220	Commercial:	60%	37,580	171
Occupancy: 78%	Meeting:	30	18,790	85
	Leisure:	10	6,263	28
Hilton Inn-Woodcliff Lake				
Rooms: 360	Commercial:	50%	49,275	137
Occupancy: 75%	Meeting:	40	39,420	110
	Leisure:	10	9,855	27
Holiday Inn-Suffern				
Rooms: 245	Commercial:	50%	29,063	119
Occupancy: 65%	Meeting:	35	20,344	83
	Leisure:	15	8,719	36
Secondary competition				
Rooms: 91	Commercial:	58%	12,329	135
Occupancy: 64%	Meeting:	15	3,189	35
	Leisure:	27	5,740	63

Market segment	Accommodated room-night demand
Commercial	271,203
Meeting and convention	122,156
Leisure	<u>78,400</u>
Total	471,759

Latent Demand

Latent demand is defined as demand that potentially exists in a market but for a number of reasons is not accommodated by the existing competitive supply of lodging facilities. Latent demand comprises both unaccommodated demand and induced demand.

The existing hotels in the Spring Valley area are unable to accommodate an estimated 5 percent of the current commercial demand, 4 percent of the meeting and convention demand, and 2 percent of the leisure demand. The following is a summary of estimates of the total current accommodated and unaccommodated demand for the Spring Valley market area.

Market segment	Accommodated room-night demand	Unaccommodated demand percentage	Unaccommodated room-night demand
Commercial	271,203	5	13,560
Meeting and convention	122,156	4	4,886
Leisure	<u>78,400</u>	2	<u>1,568</u>
Total	471,759		20,014

Table 2 lists the projected unaccommodated room-night demand for each market segment, based on historical trends and an analysis of the area's economic and demographic indicators.

The proposed subject property, with its extensive meeting and convention facilities, is expected to cause a significant amount of induced demand, i.e., additional room-night demand that currently does not exist in the market. It is estimated that with a strong marketing effort, the subject property should attract an additional 10,950 room-nights of meeting demand to be phased in 60 percent the year the subject opens, 90 percent the second year, and 100 percent the third year (see Table 3).

LODGING DEMAND ANALYSIS

**TABLE 2
Unaccommodated Demand**

	Historical	1988	1989	1990	1991	1992	1993	1994	1995	1996
Commercial segment										
Growth rate (percent)	—	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Unaccommodated demand	13,560	13,831	14,108	14,390	14,678	14,972	15,271	15,576	15,888	16,206
Meeting and convention segment										
Growth rate (percent)	—	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Unaccommodated demand	4,886	5,033	5,184	5,340	5,550	5,665	5,835	6,010	6,190	6,376
Leisure segment										
Growth rate (percent)	—	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Unaccommodated demand	1,568	1,584	1,600	1,616	1,632	1,648	1,664	1,681	1,698	1,715
Total										
Unaccommodated demand	20,014	20,448	20,892	21,346	21,810	22,285	22,770	23,267	23,776	24,297

**TABLE 3
Induced Demand**

	1988	1989	1990	1991	1992	1993
Phase in	0	0	60%	90%	100%	100%
Commercial	0	0	0	0	0	0
Meeting and convention	0	0	6,570	9,855	10,950	10,950
Leisure	0	0	0	0	0	0
Total	0	0	6,570	9,855	10,950	10,950

Accommodatable Latent Demand

A projection of total accommodatable demand has been made based on the number of new rooms expected to enter the market, areawide occupancy levels, and market segment characteristics. Total latent demand was then compared with total accommodatable demand in order to determine the lesser of the two, which is the total usable latent demand in the market area.

In June 1989, a 210-room TraveLodge will open for business. For the six-month period it is operational in 1989, a total of 38,325 (210 × 182.5) rooms will be available to absorb latent demand. Because the unaccommodated demand is the result of strong Monday-through-Thursday visitation, the total number of additional available rooms is reduced by the projected 1989 areawide occupancy of 73.88 percent. Thus, the total accommodatable latent demand is 38,325 × 73.88% = 28,314 room-nights. This accommodatable latent demand is allocated to each of the three market segments based on the percentage relationship of the unaccommodated demand for

a particular segment divided by the total unaccommodated demand. In 1989, this allocation is made as follows:

Commercial segment	Accommodatable latent room-night demand
$\frac{14,108}{20,892} = 67.5\% \times 28,314 =$	19,120
Meeting and convention segment	
$\frac{5,184}{20,892} = 24.8\% \times 28,314 =$	7,026
Leisure segment	
$\frac{1,600}{20,892} = 7.6\% \times 28,314 =$	$\frac{2,168}{28,314}$
Total	

Table 4 shows the various elements of demand projected for the market area in 1989. There will be no induced demand, so total latent demand will equal total unaccommodated demand. Total latent demand is smaller than the total accommodatable

TABLE 4
Elements of Demand in 1989

Market Segment	Total unaccommodated demand	Total induced demand	Total latent demand	Total accommodatable latent demand	Total usable latent demand
Commercial	14,108	0	14,108	19,120	14,108
Meeting and convention	5,184	0	5,184	7,026	5,184
Leisure	1,600	0	1,600	2,168	1,600
Total	20,892	0	20,892	28,314	20,892

TABLE 5
Total Usable Latent Demand

	Historical	1988	1989	1990	1991	1992	1993	1994	1995	1996
Commercial segment										
Unaccommodated demand	13,560	13,831	14,108	14,390	14,678	14,972	15,271	15,576	15,888	16,206
Induced demand	0	0	0	0	0	0	0	0	0	0
Latent demand	13,560	13,831	14,108	14,390	14,678	14,972	15,271	15,576	15,888	16,206
Latent demand	13,560	13,831	14,108	14,390	14,678	14,972	15,271	15,576	15,888	16,206
Accommodatable demand	0	0	19,120	60,420	55,800	55,463	56,913	58,396	59,916	61,469
Total usable latent demand	0	0	14,108	14,390	14,678	14,972	15,271	15,576	15,888	16,206
Meeting and convention segment										
Unaccommodated demand	4,886	5,033	5,184	5,340	5,550	5,665	5,835	6,010	6,190	6,376
Induced demand	0	0	0	6,570	9,855	10,950	10,950	10,950	10,950	10,950
Latent demand	4,886	5,033	5,184	11,910	15,355	16,615	16,785	16,960	17,140	17,326
Latent demand	4,886	5,033	5,184	11,910	15,355	16,615	16,785	16,960	17,140	17,326
Accommodatable demand	0	0	7,026	50,007	58,374	61,549	62,555	63,584	64,637	65,717
Total usable latent demand	0	0	5,184	11,910	15,355	16,615	16,785	16,960	17,140	17,326
Leisure segment										
Unaccommodated demand	1,568	1,584	1,600	1,616	1,632	1,648	1,664	1,681	1,698	1,715
Induced demand	0	0	0	0	0	0	0	0	0	0
Latent demand	1,568	1,584	1,600	1,616	1,632	1,648	1,664	1,681	1,698	1,715
Latent demand	1,568	1,584	1,600	1,616	1,632	1,648	1,664	1,681	1,698	1,715
Accommodatable demand	0	0	2,168	6,785	6,204	6,105	6,202	6,302	6,403	6,505
Total usable latent demand	0	0	1,600	1,616	1,632	1,648	1,664	1,681	1,698	1,715

latent demand for each market segment, so total latent demand will also equal total usable latent demand.

Table 5 shows the total usable latent demand from 1987 to 1996. In 1989, when the 210-room Travelodge will have been open for six months, all of the latent demand (unaccommodated and induced) will be absorbed. The subject property will open in 1990, creating the induced demand in the meeting and convention segment and additional supply, which increases the accommodatable latent demand.

Total Usable Room-Night Demand

Based on the same trends used to project the unaccommodated room night demand previously described, the following annual growth rates are assumed for the accommodated demand.

Market segment	Compounded yearly growth rate
Commercial	2%
Meeting and convention	3
Leisure	1

LODGING DEMAND ANALYSIS

**TABLE 6
Total Usable Room-Night Demand**

	Historical	1988	1989	1990	1991	1992	1993	1994	1995	1996
Commercial segment										
Growth rate (percent)	—	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0
Accommodated demand	271,203	276,627	282,160	287,803	293,559	299,430	305,419	311,527	317,758	324,113
Usable latent demand	0	0	14,108	14,390	14,678	14,972	15,271	15,576	15,888	16,206
Meeting and convention segment										
Growth rate (percent)	—	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Accommodated demand	122,156	125,821	129,596	133,484	137,489	141,614	145,862	150,238	154,745	159,387
Usable latent demand	0	0	5,184	11,910	13,355	16,615	16,785	16,960	17,140	17,326
Leisure segment										
Growth rate (percent)	—	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Accommodated demand	78,400	79,184	79,976	80,776	81,584	82,400	83,224	84,056	84,897	85,746
Usable latent demand	0	0	1,600	1,616	1,632	1,648	1,664	1,681	1,698	1,715
Total										
Commercial demand	271,203	276,627	296,268	302,193	308,327	314,402	320,690	327,103	333,646	340,319
Meeting & convention demand	122,156	125,821	134,780	145,394	152,844	158,229	162,647	167,198	171,885	176,713
Leisure demand	78,400	79,184	81,576	82,392	83,216	84,048	84,888	85,737	86,595	87,461
Total usable room-night demand	471,759	481,632	512,624	529,979	544,297	556,679	568,225	580,038	592,126	604,493

Combining the forecasted usable latent demand with the forecasted accommodated room-night demand results in the forecast of total usable room night demand shown in Table 6.

	Room-nights available	Room-nights available
Historical	655,540	1991 841,690
1988	655,546	1992 841,690
1989	693,865	1993 841,690
1990	841,690	1994 841,690

Room Supply

The total number of rooms available in the competitive properties is currently 1,796. In 1989, the addition of the 210-unit Travelodge Inn increases the number of rooms available to a total of 2,006. However, since the Travelodge will not open until June of that year, the effective addition to supply in 1989 is 105 rooms, for a total of 1,901. At the beginning of 1990, the addition of the subject property's 300 guestrooms will increase the number of available rooms to a total of 2,306. The following is the projected competitive supply of available rooms.

	Available rooms	Available rooms
Historical	1,796	1991 2,306
1988	1,796	1992 2,306
1989	1,901	1993 2,306
1990	2,306	1994 2,306

The annual room-nights available are calculated by multiplying the above annual room supply by 365, as follows:

Overall Competitive Occupancy

The overall occupancy for the competitive rooms within the market area can be calculated by dividing the total room-night demand by the room-nights available; the results are shown in Table 7.

**TABLE 7
Overall Competitive Occupancy**

Year	Room-night demand	Room-nights available	Overall competitive occupancy
Historical	471,759	655,540	72.0%
1988	481,632	655,540	73.5
1989	512,624	693,865	73.9
1990	529,979	841,690	63.0
1991	544,297	841,690	64.7
1992	556,679	841,690	66.1
1993	568,225	841,690	67.5
1994	580,038	841,690	68.9
1995	592,126	841,690	70.3
1996	604,493	841,690	71.8
1997	617,146	841,690	73.3

CHAPTER 11

Analysis of Market Share, Occupancy, and Average Room Rates

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11.01 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 task entails determining the current market share, occupancy rates, and average room rates of the existing competitor facilities and 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, most importantly, for the subject property, so that a determination can be made concerning 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. The key determination of either method is 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 captured, a calculation can be made to determine the expected level of occupancy for the facility.

11.02 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 equals the number of rooms that are occupied per day 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. The following example illustrates the calculations that are used to determine the actual market share, the fair market share, and finally the market penetration of four hypothetical hotels.

<i>Hotel</i>	<i>Number of rooms</i>	<i>Percentage of occupancy</i>	<i>Number of occupied rooms per day</i>	<i>Actual market share</i>
A	100	× 80%	80.0	13.2%
B	200	× 65	130.0	21.4
C	250	× 75	187.5	30.9
D	<u>300</u>	× 70	<u>210.0</u>	<u>34.5</u>
Total	850		607.5	100.0%

<i>Hotel</i>	<i>Number of rooms</i>	<i>Fair market share</i>	<i>Actual market share</i>	<i>Fair market share</i>	<i>Penetration</i>
A	100	11.8%	13.2%	11.8%	1.12
B	200	23.5	21.4	23.5	.91
C	250	29.4	30.9	29.4	1.05
D	<u>300</u>	<u>35.3</u>	<u>34.5</u>	<u>35.3</u>	.98
Total	850	100.0%	100.0%	100.0%	

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 very slightly above its fair market share; and Hotel D is achieving 2 percent less than its fair market share.

As can be seen in this example, the penetration method requires three separate computations to determine actual market share, fair market share, and market penetration.

11.03 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 follows:

<i>Property</i>	<i>Percentage of occupancy</i>		<i>Days per year</i>		<i>Competitive index</i>
A	80%	×	365	=	292
B	65	×	365	=	237
C	75	×	365	=	273
D	70	×	365	=	255

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 following calculations:

	<i>Hotel A</i>		<i>Hotel B</i>		<i>Relative competitiveness</i>
Competitive index:	292	÷	237	=	1.23
Penetration:	1.12	÷	.91	=	1.23

[1] Advantages

An advantageous feature of the competitive index is that the one calculation that it requires is based on a single room and thus is a simple matter 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. The following calculations would have to be performed for each method.

Penetration Method

<i>Hotel</i>	<i>Number of rooms</i>		<i>Percentage of occupancy</i>		<i>Number of occupied rooms per day</i>	<i>Actual market share</i>
A	100	×	80%	=	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	21.0
Total	1,075				769.5	100.0%

Penetration Method (*cont'd*)

<i>Hotel</i>	<i>Number of rooms</i>	<i>Fair market share</i>	<i>Actual market share (percent)</i>		<i>Fair market share (percent)</i>		<i>Penetration</i>
A	100	9.3%	10.4	÷	9.3	=	1.12
B	200	18.6	16.9	÷	18.6	=	.91
C	250	23.3	24.4	÷	23.3	=	1.05
D	300	27.9	27.3	÷	27.9	=	.98
E	<u>225</u>	<u>20.9</u>	<u>21.0</u>	÷	<u>20.9</u>	=	1.01
Total	1,075	100.0%	100.0		100.0		

Competitive Index Method

<i>Hotel</i>	<i>Percentage of occupancy</i>		<i>Days per year</i>		<i>Competitive index</i>
A	80%	×	365	=	292
B	65	×	365	=	237
C	75	×	365	=	273
D	70	×	365	=	255
E	72	×	365	=	263

	<i>Hotel A</i>		<i>Hotel B</i>		<i>Relative competitiveness</i>
Competitive index	292	÷	237	=	1.23
Penetration	1.12	÷	.91	=	1.23

As can readily be seen, 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:

<i>Hotel</i>	<i>Market segment percentage</i>			<i>Market segment competitive index</i>		
	<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>	<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>
A	60%	10%	30%	175	29	88
B	50	30	20	118	71	48

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 percent more competitive in the leisure market. Hotel B is, however, almost 150 percent more competitive than Hotel A in the meeting market.

[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 following data:

<i>Hotel</i>	<i>Occupancy</i>	<i>Market segment percentage</i>			<i>Market segment competitive index</i>		
		<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>	<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>
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	<u>72</u>	45	35	20	118	92	53
Average	72%						

One might expect the proposed subject property to have the following competitive indexes:

	<i>Market segment competitive index</i>		
	<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>
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 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.¹

¹ See 10.03 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 found to be:

<i>Hotel</i>	<i>Room-nights captured</i>		
	<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>
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	<u>26,609</u>	<u>20,695</u>	<u>11,826</u>
Total accommodated	150,253	82,198	48,418
Latent demand	<u>7,513</u>	<u>2,466</u>	<u>484</u>
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 referred to as 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:

Commercial Segment

<i>Hotel</i>	<i>Number of rooms</i>		<i>Commercial competitive index</i>		<i>Market share adjuster</i>	<i>Market share</i>
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	=	<u>28,500</u>	<u>15.9</u>
Total					178,650	100.0%

Meeting segment

<i>Hotel</i>	<i>Number of rooms</i>		<i>Meeting competitive index</i>		<i>Market share adjuster</i>	<i>Market share</i>
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	=	<u>4,500</u>	<u>5.2</u>
Total					86,650	100.0%

Leisure Segment						
<i>Hotel</i>	<i>Number of rooms</i>		<i>Leisure competitive index</i>		<i>Market share adjuster</i>	<i>Market share</i>
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	=	<u>7,500</u>	<u>13.4</u>
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, which results in the room-nights captured for the corresponding segment. The percentage of occupancy is then determined by dividing total room-nights captured by the number of available rooms per year (i.e. room count multiplied by 365).

[c] Projected Occupancy

The following table 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.²

Room-nights captured					
<i>Hotel</i>	<i>Commercial</i>	<i>Meeting</i>	<i>Leisure</i>	<i>Total</i>	<i>Occupancy¹</i>
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 increase the difficulty of an evaluation of the relative competitiveness of a new lodging facility. However, even though such an evaluation depends greatly on the judgement of the appraiser, competitive indexes are useful tools in that they help to portray the competitive dynamics of a market area.

² See ¶ 11.03[2][a] supra.

11.04 **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 and 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, rather than assuming a stabilized occupancy level starting with the first year. 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 considerations:

<i>Market-Specific</i>	<i>Property-Specific</i>
Historical occupancy cycles	Age
Composition of demand	Degree of obsolescence
Supply and demand trends	Location
Trends in competitive properties	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 following daily occupancies:

	<u>Percentage of occupancy</u>
Monday	100
Tuesday	100
Wednesday	100
Thursday	100
Friday	30
Saturday	35
Sunday	<u>40</u>
Weekly average	72

Under these market conditions, 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. The following is the 20-year occupancy cycle, with related statistical data, for three different cities:

<i>Year</i>	<i>City A</i>	<i>City B</i>	<i>City C</i>
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	60.0
19	69.0	70.0	57.0
20	70.0	69.0	60.0

	<i>City A</i>	<i>City B</i>	<i>City C</i>
Average occupancy	66.4%	71.3%	57.5%
Highest occupancy	72%	78%	68%
Lowest occupancy	59%	64%	46%
Difference—high & low	13 points	14 points	22 points
Standard deviation from average occupancy	3.8	3.6	5.8

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 20-year period.

11.05 AVERAGE RATE PER OCCUPIED ROOM

The average rate per occupied room is one of 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:

$$\text{Overall Average Rate Per Occupied Room} = \frac{\text{Net Rooms Revenue}}{\text{Number of Paid Rooms Occupied}}$$

The *Uniform System of Accounts for Hotels*³ 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. It should be noted that the overall average rate per occupied room does not include any occupancy derived from complimentary rooms.

11.06 FORECASTING AVERAGE RATE PER OCCUPIED ROOM

The procedure used to forecast average rates per occupied room for lodging facilities will differ 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

³ Hotel Association of New York City, Inc. *Uniform System of Accounts for Hotels* (8th ed.). HANYC, Inc. (1986).

future trends in average rates. Proposed hotels have no operating history, so 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

[a] Analysis of Subject Property Average Rates

The first step for the appraiser in this procedure is to compile overall average rates by month for the last three to five years for the property. 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.

[b] Comparison of Occupancy and Average Rates

After the data regarding historical average room rates have 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 market-wide 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 tend to 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 program of price cutting, 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. So in a declining market, 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 higher 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.

[c] 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 rather than 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 often payment is billed directly to the firm or organization using the room. Depending upon the amount and timing of the usage, a contract rate can be heavily discounted and significantly lower than either the average rate or commercial rate.

[d] **Comparison of Subject Property With Competitive Properties**

The next step for the appraiser is to contrast 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.

[e] **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 reaches 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.

[f] Average Rate Projection for Subject Property

Once all the previously described data is 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 utilized 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 using data taken from the Spring Valley case study.

[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 terms of quality, size, facilities, market orientation, and location.

The average room rates of the primary competition in the Spring Valley market area are as follows:

<u>Property</u>	<u>Estimated 1987 average room rate</u>
Howard Johnson's	\$68.00
Sheraton Inn	82.00
Holiday Inn-Nanuet	77.00
Holiday Inn-Orangeburg	80.00
Ramada Inn	87.00
Hilton Inn	88.00
Holiday Inn-Suffern	78.00
Average	\$81.00

An analysis of the attributes of these hotels reveals the Hilton Inn to be the most similar of the group to the proposed property. Based on this conclusion, the appraiser should give the room rate achieved by the Hilton the most weight when setting the average rate for the proposed property. Upon further analysis, the appraiser should realize that the Hilton Inn rate of \$88.00 should be scaled slightly upward for the following reasons:

- The subject property will be new when it opens. The Hilton Inn will be six years old.
- The Hilton Inn 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 the Hilton Inn.

It appears that an average room rate of between \$89 and \$90 (expressed in 1987 dollars) would be justified and reasonable for the subject property.

- 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.

The following is an abridged version of the income and expense statement for the proposed Spring Valley property:

Required net income*	\$2,883,000.00
Total fixed charges	+ 878,000.00
Undistributed operating expenses	+ <u>3,207,000.00</u>
Required house profit	6,968,000.00
Estimated departmental profits (non-rooms)	- <u>1,519,000.00</u>
Required rooms profit	5,449,000.00
Estimated rooms expense (22.6%)	+ <u>1,591,000.00</u>
Required rooms revenue	7,040,000.00
Total occupied rooms (300 × 72% × 365)	÷ <u>78,840.00</u>
Estimated average room rate	<u>\$ 89.29</u>

* Net income required to cover debt service and rate of return on invested equity

Using the bottom-up method, it was determined, based on 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. Based on 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 instance, the computation above 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. The following calculations illustrates this theory:

Total hotel property value	\$26,780,000.00
Number of available rooms	÷ <u>300</u>
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	× \$ <u>300</u>
Total hotel 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, which means 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 (commercial, meeting and convention, 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.

[3] **Summary**

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.

CASE STUDY Analysis and Forecast of Market Share, Occupancy, and Average Room Rates

The competitive indexes of the hotels in the Spring Valley market area range from 119 to 190 in the commercial market segment in 1987, as shown in Table 1.

The competitive indexes in Table 1 show that the Holiday Inn—Orangeburg is the most competitive property in the commercial market, with an index of 190. The Howard Johnson's and Ramada Inn hold second and third place, with indexes of 180 and 171, respectively. The fair share is calculated by dividing each hotel's room count by the total number of rooms within the market; for example, the fair share for the Hilton would be calculated as $360 \div 1,796 = 20.0\%$. Thus, if the Hilton were to capture its average or fair share of the commercial market, it would receive 20.0 percent of the demand. In fact, the Hilton is capturing 18.2 percent of the commercial market ($49,275 \div 271,203 = 18.2\%$), and is thereby penetrating 91 percent of its fair share ($18.2\% \div 20.0\% = 91\%$).

The proposed subject property, with its prime location and extensive facilities, should be a strong competitor in the commercial segment. It should enter this market on a competitive level just below that of the Sheraton, which has a competitive index of 153. As the subject property matures, it is very likely that it will become more competitive in the commercial market segment, eventually reaching a stabilized competitive position at a level near the Sheraton and above the Hilton, which has a competitive index of 137. Based on this competitive analysis, the projected

commercial segment index of competitiveness for the subject property is as follows:

Year	Commercial index of competitiveness— subject property
1990	140
1991	145
Stabilized	150

In addition to estimating the competitive indexes for the proposed subject property, a similar forecast must be made for the Travelodge Inn, which is under construction and scheduled to open in 1989, as well as the Holiday Inn—Suffern, which is new and still experiencing a build-up in competitiveness. The Travelodge Inn will have only a minimum number of meeting rooms, and probably will not be a major competitor in the meeting and convention market. It should therefore be somewhat more competitive than the subject property for commercial room-nights since it will not attract much meeting and convention demand. The Holiday Inn—Suffern should be a good competitor in the commercial segment, with a stabilized competitive index just above the Sheraton. The following are the projected commercial competitive indexes for the Travelodge Inn and the Holiday Inn—Suffern.

Year	Commercial index of competitiveness— Travelodge Inn	Commercial index of competitiveness— Holiday Inn—Suffern
1989	140	130
1990	150	140
Stabilized	155	155

TABLE 1
Commercial Segment—1987

	Number of rooms	Annual occupancy	Percent segment demand	Room-nights per year	Competitive index	Fair share	Market share	Penetration factor
Howard Johnson's	190	76%	65%	34,259	180	10.6%	12.6%	119%
Sheraton	230	70	60	35,259	153	12.9	13.0	101
Holiday Inn—Nanuet	200	60	55	24,090	120	11.1	8.9	80
Holiday Inn—Orangeburg	260	80	65	49,348	190	14.5	18.2	126
Ramada	220	78	60	37,580	171	12.2	13.9	114
Hilton	360	75	50	49,275	137	20.0	18.2	91
Holiday Inn—Suffern	245	65	50	29,063	119	13.6	10.7	79
Secondary Competition	91	64	58	12,329	135	5.1	4.5	88
Total	1,796			271,203		100.0%	100.0%	

ANALYSIS OF MARKET SHARE, OCCUPANCY, AND AVERAGE ROOM RATES

TABLE 2
Commercial Segment—1989

Hotel	Number of rooms	Competitive index	Market share adjuster	Market share (rounded)	Room-nights captured (rounded)	Fair share	Penetration factor
Howard Johnson's	190	180	34,200	11.9%	35,256	10.0%	119%
Sheraton	230	153	35,190	12.2	36,144	12.1	101
Holiday Inn—Nanuet	200	120	24,000	8.3	24,590	10.5	79
Holiday Inn—Orangeburg	260	190	49,400	17.1	50,662	13.7	125
Ramada	220	171	37,620	13.0	38,515	11.6	112
Hilton	360	137	49,320	17.1	50,662	18.9	90
Holiday Inn—Suffern	245	130	31,850	11.0	32,589	12.9	85
Secondary Competition	91	135	12,285	4.3	12,740	4.8	90
Proposed Travelodge	105	140	14,700	5.1	15,110	5.5	93
Total	1,901		288,565	100.0%	296,268	100.0%	

Table 2 illustrates the competitive situation in the commercial segment of the Spring Valley market area as of 1989 and reflects the addition to the market of the 210-room Travelodge, which slightly changes the fair share percentages, penetration factors, and room-nights captured shown in Table 1. The Travelodge room count in 1989 is 105, which is the effective number of rooms for the entire year because it is scheduled to open in June 1989. Also, the Holiday Inn—Suffern has become more competitive, thereby increasing its competitive index to 130.

MARKET SHARE AND ROOM DEMAND

To calculate market share and allocate the commercial room-night demand, the room count of each property is first multiplied by its respective commercial competitive index, yielding a number referred to as the market share adjuster. The purpose of the market share adjuster is to relate the per-room competitive index to the property's actual size. The competitive index quantifies competitiveness of only one room, so multiplying the competitive index by the room count adjusts the competitive index upward to reflect the entire property's competitiveness. The purpose of this intermediate step is to calculate each property's new market share by dividing the market share adjuster for one property by the total market share adjuster for all of the area's hotels. For example, the Sheraton's 1989 commercial market share is calculated as follows:

$$\frac{\text{Sheraton's market share adjuster}}{\text{Total market share}} = \frac{35,190}{288,565} = 12.2\%$$

Multiplying the calculated market share by the 1989 commercial room night demand produces the commercial room-nights captured by the Sheraton.

$$296,268 \text{ room-nights} \times .122 = 36,144 \text{ room-nights}$$

Table 3 shows the competitive situation for the commercial segment in 1990. With the opening of the proposed subject property, one would expect the market to be diluted by the additional rooms, resulting in a decline in the market share of all the competitive properties. The new market shares for the area's hotels are recalculated by first multiplying the room count of each property by its competitive index to determine the market share adjuster. With the exception of the Holiday Inn—Suffern, the room counts and competitive indexes of the existing hotels have remained constant for 1990, so the market share adjuster for these properties is unchanged. The Holiday Inn—Suffern has become more competitive in the commercial segment, increasing its competitive index from 130 in 1989 to 140 in 1990. This creates a new market share adjuster of 34,300. The Travelodge Inn, with a 1990 competitive index of 150, creates a new market share adjuster of 31,500. In addition, the proposed subject property, with a 1990 competitive index of 140 and a room count of 300, creates a market share adjuster of 42,000, which changes the total market share adjuster from 288,565 in 1989 to 349,815 during 1990. This increase in the denominator of the market share calculation (market share adjuster for one property divided by the total market share adjusters for all the properties) causes all the market shares to decline in proportion to each property's competitive position in the market. For example,

TABLE 3
Commercial Segment—1990

Hotel	Number of rooms	Competitive index	Market share adjuster	Market share (rounded)	Room-nights captured (rounded)	Fair share	Penetration factor
Howard Johnson's	190	180	34,200	9.8%	29,615	8.2%	120%
Sheraton	230	153	35,190	10.0	30,220	10.1	99
Holiday Inn—Nanuet	200	120	24,000	6.9	20,851	8.7	79
Holiday Inn—Orangeburg	260	190	49,400	14.1	42,609	11.3	125
Ramada	220	171	37,620	10.8	32,637	9.5	114
Hilton	360	137	49,320	14.1	42,609	15.6	90
Holiday Inn—Suffern	245	140	34,300	9.8	29,615	10.6	92
Secondary Competition	91	135	12,285	3.5	10,577	3.9	99
PROPOSED SUBJECT	300	140	42,000	12.0	36,263	13.0	92
Proposed Travelodge	210	150	31,500	9.0	27,197	9.1	99
Total	2,306		349,815	100.0%	302,193	100.0%	

TABLE 4
Meeting and Convention Segment
Competitive Index

Year	Subject property	Travelodge	Holiday Inn—Suffern
1989	—	20	88
1990	75	30	90
1991	95	35	90
1992	105	35	90

TABLE 5
Leisure Segment Competitive
Index

Year	Subject property	Travelodge	Holiday Inn—Suffern
1989	—	70	40
1990	30	80	45
1991	35	85	45
1992	40	85	45

the Sheraton's new market share is calculated as follows:

$$\frac{\text{Sheraton's market share adjuster}}{\text{Total Market Share}} = \frac{35,190}{349,815} = 10.0\%$$

The Sheraton's market share in the commercial segment is expected to decline from 12.2 percent during 1989 to 10.0 percent during 1990 as a result of the Holiday Inn—Suffern and the Travelodge becoming more competitive and the proposed subject property opening and capturing part of this market. The commercial room-nights captured for the Sheraton in 1990 is:

$$302,193 \text{ room-nights} \times .100 = 30,220 \text{ room-nights}$$

It is anticipated that the proposed subject property will capture 12.0 percent of the commercial market during 1990, which equates to 36,263 room-nights.

The same process of utilizing the competitive

indexes to calculate market share and allocate the forecasted demand among the competitive lodging facilities is made for each year during the projection period and repeated for all market segments.

Table 4 shows the competitive indexes for the meeting and convention segment. The subject property is expected to compete on a level with the Hilton, which achieves an index of 110. The Travelodge offers only minimal meeting space, so its competitive index will likely be similar to the secondary competition. The Holiday Inn—Suffern is expected to reach a competitive index a little above the Ramada. Following is the projected meeting and convention segment index of competitiveness for the subject property, Travelodge, and Holiday Inn—Suffern.

Table 5 gives the competitive indexes for the leisure segment. The subject property's commercial and meeting orientation is not expected to attract a significant portion of leisure demand and will probably stabilize near the level of the Sheraton. The Travelodge, on the other hand, should experience good leisure demand and be highly competitive with

ANALYSIS OF MARKET SHARE, OCCUPANCY, AND AVERAGE ROOM RATES

**TABLE 6
Competitive Indexes and Market Share**

Commercial Segment

	1988		1989		1990		1991		1992		1993	
	Index	MS	Index	MS	Index	MS	Index	MS	Index	MS	Index	MS
Howard Johnson's	180	12.61%	180	11.85%	180	9.78%	180	9.61%	180	9.57%	180	9.57%
Sheraton	153	12.98	153	12.19	153	10.06	153	9.88	153	9.84	153	9.84
Holiday Inn-Nanuet	120	8.85	120	8.32	120	6.86	120	6.74	120	6.71	120	6.71
Holiday Inn-Orangeburg	190	18.22	190	17.12	190	14.12	190	13.87	190	13.82	190	13.82
Ramada	171	13.87	171	13.04	171	10.75	171	10.57	171	10.52	171	10.52
Hilton	137	18.19	137	17.09	137	14.10	137	13.85	137	13.79	137	13.79
Holiday Inn-Suffern	119	10.75	130	11.04	140	9.81	155	10.67	155	10.62	155	10.62
Secondary	135	4.53	135	4.26	135	3.51	135	3.45	135	3.44	135	3.44
PROPOSED SUBJECT	0	0.00	0	0.00	140	12.01	145	12.22	150	12.59	150	12.59
Proposed Travelodge	0	0.00	140	5.09	150	9.00	155	9.14	155	9.10	155	9.10

Meeting and Convention Segment

	1988		1989		1990		1991		1992		1993	
	Index	MS	Index	MS	Index	MS	Index	MS	Index	MS	Index	MS
Howard Johnson's	14	2.17%	14	2.12%	14	1.74%	14	1.66%	14	1.63%	14	1.63%
Sheraton	77	14.47	77	14.08	77	11.58	77	11.08	77	10.86	77	10.86
Holiday Inn-Nanuet	44	7.19	44	7.00	44	5.75	44	5.50	44	5.40	44	5.40
Holiday Inn-Orangeburg	44	9.34	44	9.10	44	7.48	44	7.15	44	7.02	44	7.02
Ramada	85	15.27	85	14.87	85	12.23	85	11.69	85	11.47	85	11.47
Hilton	110	32.35	110	31.49	110	25.89	110	24.75	110	24.30	110	24.30
Holiday Inn-Suffern	83	16.61	88	17.14	90	14.42	90	13.78	90	13.53	90	13.53
Secondary	35	2.60	35	2.53	35	2.08	35	1.99	35	1.95	35	1.95
PROPOSED SUBJECT	0	0.00	0	0.00	75	14.71	95	17.81	105	19.33	105	19.33
Proposed Travelodge	0	0.00	20	1.67	30	4.12	35	4.59	35	4.51	35	4.51

Leisure Segment

	1988		1989		1990		1991		1992		1993	
	Index	MS	Index	MS	Index	MS	Index	MS	Index	MS	Index	MS
Howard Johnson's	83	20.15%	83	18.21%	83	14.84%	83	14.49%	83	14.30%	83	14.30%
Sheraton	26	7.63	26	6.92	26	5.63	26	5.50	26	5.42	26	5.42
Holiday Inn-Nanuet	55	14.06	55	12.70	55	10.35	55	10.11	55	9.97	55	9.97
Holiday Inn-Orangeburg	58	19.27	58	17.41	58	14.19	58	13.86	58	13.67	58	13.67
Ramada	28	7.87	28	7.11	28	5.80	28	5.66	28	5.58	28	5.58
Hilton	27	12.42	27	11.22	27	9.15	27	8.93	27	8.81	27	8.81
Holiday Inn-Suffern	36	11.27	40	11.32	45	10.37	45	10.13	45	9.99	45	9.99
Secondary	63	7.33	63	6.62	63	5.39	63	5.27	63	5.20	63	5.20
PROPOSED SUBJECT	0	0.00	0	0.00	30	8.47	35	9.65	40	10.88	40	11.88
Proposed Travelodge	0	0.00	70	8.49	80	15.81	85	16.40	85	16.18	85	16.18

the Howard Johnson's. The Holiday Inn-Suffern, with its recreational Holidome, should be somewhat more competitive than the subject property in the leisure segment. Following is the projected leisure segment index of competitiveness for the subject property, Travelodge and Holiday Inn-Suffern.

Table 6 shows the competitive indexes and resul-

tant market share (MS) calculations for each market segment over a six-year projection period.

The following estimates of projected room-nights captured by the subject property were calculated by multiplying the subject property's projected market share of each segment by the estimated room night demand for each segment.

	1990	1991	1992	1993
Commercial segment demand	302,193	308,237	314,402	320,690
Market share	.1201	.1222	.1259	.1259
Capture	36,293	37,667	39,583	40,375
Meeting and convention segment demand	145,394	152,844	158,229	162,647
Market share	.1471	.1781	.1933	.1933
Capture	21,387	27,222	30,586	31,440
Leisure segment demand	82,392	83,216	84,048	84,888
Market share	.0847	.0965	.1088	.1088
Capture	6,979	8,030	9,144	9,236
Total room-nights captured	64,659	72,919	79,313	81,051

Dividing the subject property's total room-nights captured by its available room-nights per year (300 × 365) produces the following projected percentages of occupancy.

	1990	1991	1992	1993
Total room-nights captured	64,659	72,919	79,313	81,051
Available room-nights	109,500	109,500	109,500	109,500
Occupancy	59.05%	66.59%	72.43%	74.02%
Rounded	59%	67%	72%	74%

To forecast income and expense, occupancy levels of 59 percent in 1990, 67 percent in 1991, and a stabilized rate of 72 percent were used.

Although the preceding room-night analysis shows the proposed subject property achieving a 77 percent occupancy in 1993, a stabilized level of 72 percent has been used instead. The stabilized occupancy is intended to reflect the anticipated results of the property over its remaining economic life, given any and all changes in the life cycle of the hotel. While it is likely that the subject will operate at occupancies above this stabilized level, it is equally possible for new competition and temporary downturns in the economy to force the occupancy below this point of stability.

The following data show the overall competitiveness of the subject property and its relative position within the local lodging market. The overall fair share for the subject property has been calculated by dividing its number of available rooms by the total competitive supply.

	1990	1991	1992
Subject's room count	300	300	300
Total area supply	2,306	2,306	2,306
Fair share	13.01%	13.01%	13.01%

As a check on the above forecasts of occupancy, the market share percentage is compared to the fair share percentage:

	1990	1991	1992
Market share	12.20%	13.40%	14.57%
Fair share	13.01	13.01	13.01
Market share as a percentage of fair share	94%	103%	112%

The stabilized market share, equal to 112 percent of the subject property's fair share, indicates a strong competitive position.

AVERAGE RATE ANALYSIS

The average rate for a hotel is the weighted average of the various room rates charged for different market segments, such as commercial rates, group discounts, and contract business. It also accounts for the rate differentials during periods of either peak or low demand levels, including various seasons of the year, holidays, and weekends. Differing types of rooms within the property itself may also generate varying room rates, and therefore have an effect on the overall average rate. The average rate is sometimes more formally defined as the average rate per occupied room. It is calculated by dividing the total rooms revenue for a given period of time by the number of occupied rooms during the same period.

The projected average rate for the proposed subject property is based on the current room rates charged by local competitive lodging facilities and adjusted for factors such as quality, age of the property, chain affiliation, and market mix. The analysis will consider both the published or rack rates employed by area lodging facilities as well as the actual average rates achieved by competitive properties.

One of the factors that affects the average rate per occupied room is the weighted average of the various market segment rate categories charged by a lodging facility, so it is necessary to analyze the anticipated market mix and rate structure for each segment.

Based on the preceding room-night analysis, it is estimated that during the first three years of operation (up to the point at which the subject property achieves a stabilized level of occupancy), the market mix of room-nights captured will be as shown in Table 7.

Table 7 shows that the meeting and convention and leisure room-nights captured by the subject property are expected to comprise an increasingly

ANALYSIS OF MARKET SHARE, OCCUPANCY, AND AVERAGE ROOM RATES

**TABLE 7
Room-Night Market Mix**

Occupancy	1990		1991		1992	
	59%		67%		72%	
Segment	Room-nights	Percent of total	Room-nights	Percent of total	Room-nights	Percent of total
Commercial	36,293	56.1%	37,667	51.7%	39,583	49.9%
Meeting and convention	21,387	33.1	27,222	37.3	30,586	38.6
Leisure	6,979	10.8	8,030	11.0	9,144	11.5
Total	64,659	100.0%	72,919	100.0%	79,313	100.0%

**TABLE 8
Average Room Rates by Market Segment**

Market segment	1987 average room rate
Commercial—single occupancy	\$ 95.00
Commercial—double occupancy	110.00
Corporate discount rate	85.00
Meeting and convention—single occupancy	80.00
Meeting and convention—double occupancy	90.00
Leisure—single occupancy	90.00
Leisure—double occupancy	105.00

larger percentage of the total room-nights accommodated. This trend is typical for a new lodging facility, where the lead time required to generate meeting, convention and leisure demand is generally longer than they needed to attract commercial patronage.

Table 8 shows the room rate structure for the proposed subject property expressed in 1987 dollars. The data is based on the room rates currently charged by area lodging facilities, with particular emphasis given to the Hilton Inn rates.

The subject property is scheduled to open in January of 1990. Based on an analysis of the local economic and demographic trends, which reflect a healthy and moderately growing economy, and because the area does not appear to have an excess number of hotel rooms currently existing or proposed, it is not anticipated that hotel room rates will exhibit any radical or unusual increases or decreases over the foreseeable future.

A 5 percent annual room rate increase represents a reasonable level of growth for hotel room rates within the market area surrounding the subject property. Applying a 5 percent room rate growth factor to the previously derived 1987 average room rates by market segment results in the room rates shown in

Table 9 for the subject property's first three years of operation.

Based on an analysis of local demand generators, the projected room-night market mix, and the type of travelers anticipated to be accommodated at the subject property, the following double occupancy characteristics were developed.

It is estimated that the corporate discount rate will be applied to 70 percent of the total commercial demand. The proximity of the subject property to numerous local businesses indicates that a corporate discount program is likely to be appropriate for those firms generating a high level of transient demand. A significant component of the corporate discount rate segment will be composed of single-occupancy travelers, an overall single- and double-occupancy rate structure of \$98.40 (in 1990 dollars) is employed.

The remaining 30 percent of the commercial demand will be accommodated at full, undiscounted room rates. An estimated 80 percent of these room-nights represent single occupancy, while 20 percent will be charged the double occupancy rate. The overall double occupancy ratio for the commercial seg-

**TABLE 9
Average Room Rates by Market Segment**

Market segment	1990	1991	1992
Commercial—single occupancy	\$109.97	\$115.47	\$121.25
Commercial—double occupancy	127.34	133.71	140.39
Corporate discount rate	98.40	103.32	108.48
Meeting and convention—single occupancy	92.61	97.24	102.10
Meeting and convention—double occupancy	104.19	109.40	114.87
Leisure—single occupancy	104.19	109.40	114.87
Leisure—double occupancy	121.55	127.63	134.01

TABLE 10
Forecast of Room-Nights and Rooms Revenues

	1990		1991		1992	
	Room-nights	Rooms revenues	Room-nights	Rooms revenues	Room-nights	Rooms revenues
Commercial Segment						
Single	8,710	\$ 957,912	9,040	\$1,043,886	9,500	\$1,151,834
Double	2,178	277,290	2,260	302,178	2,375	333,426
Corporate	<u>25,405</u>	<u>2,499,814</u>	<u>26,367</u>	<u>2,724,176</u>	<u>27,708</u>	<u>3,005,884</u>
Total	36,293	3,735,017	37,667	4,070,240	39,583	4,491,144
Meeting and Convention Segment						
Single	8,555	792,260	10,889	1,058,832	12,234	1,249,163
Double	<u>12,832</u>	<u>1,336,939</u>	<u>16,333</u>	<u>1,786,780</u>	<u>18,352</u>	<u>2,107,963</u>
Total	21,387	2,129,199	27,222	2,845,612	30,586	3,357,126
Leisure Segment						
Single	1,396	145,423	1,606	175,689	1,829	210,066
Double	<u>5,583</u>	<u>678,641</u>	<u>6,424</u>	<u>819,883</u>	<u>7,315</u>	<u>980,307</u>
Total	6,979	824,065	8,030	995,573	9,144	1,190,372
Total	64,659	\$6,688,280	72,919	\$7,911,424	79,313	\$9,038,642

ment is 1.06, which is the average number of guests per occupied room.

The meeting and convention segment typically attracts a higher level of double occupancy than does the commercial segment. Based on a mixture of corporate, association, and social groups, an estimated 40 percent of the meeting and convention room-nights will be composed of single-occupancy guests, while the remaining 60 percent will be double-occupancy patrons. This equates to an overall double occupancy ratio of 1.60 for the meeting and convention segment.

The leisure market segment largely consists of families with multiple occupants per room, so a high level of double occupancy is typical. It is estimated that 20 percent of the leisure demand will be single-occupancy guests, while the remaining 80 percent will be double-occupancy. This yields an average of 1.80 people per occupied room.

The overall level of double occupancy for the subject property's three market segments generally equates to 1.32 people per occupied room in 1990, a level which is typical for a commercially-oriented lodging facility. Applying these single and double occupancy estimates to the forecasted room-night market mix and the average room rates by market segment results in the room-night and rooms revenue forecast shown in Table 10.

Based on the total number of room-nights and the forecasted total rooms revenue outlined on the

previous page, the following overall average room rates were calculated for the subject property.

	1990	1991	1992
Average room rate	\$103.44	\$108.50	\$113.96
Double occupancy ratio	1.32	1.34	1.35

During the initial build-up years, most new hotels will discount room-rates in order to capture room-nights, increase occupancy and penetrate the market. This is commonly referred to as "penetration pricing." It is assumed that this strategy will be used by the subject property, so a 10.0 percent discount has been applied to the 1990 average rate and a 5.0 percent discount to the 1991 average room rate. The discounted average room rates used to calculate total rooms revenue are as follows.

	1990	1991	1992
Undiscounted average room rate	\$103.44	\$108.50	\$113.96
Percentage discount	10%	5%	0%
Discounted average room rate	\$ 93.10	\$103.07	\$113.96

To support these estimated average room rates, each year's average rate has been deflated and expressed in 1987 dollars, as follows:

	1990	1991	1992
Inflated dollars	\$93.10	\$103.07	\$113.96
Deflated 1987 dollars	80.42	84.79	89.29

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The subject property's average rates expressed in 1987 dollars compare favorably with the \$88.00 average rate of the Hilton Inn, which is considered to be the competitor hotel that bears the closest resemblance to it. The subject property should have a rate advantage over the Hilton as a result of its new facilities and because the Hilton derives a larger percentage of its patronage from the meeting and convention

segment, which typically is characterized by a lower room rate structure than the commercial segment. The assumed 10 percent room rate discount in 1990 and a similar 5 percent room rate discount in 1991 should make the subject property extremely competitive relative to the other lodging facilities in the Spring Valley market.

CHAPTER 12

Revenue Forecast

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12.01 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*.¹ 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, so 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. 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

¹ Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYC Inc., 1986.

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, although it takes into account the specific facilities offered by the subject property. The fixed and variable component approach depends upon data from a directly comparable hotel, but can easily be adjusted to reflect differences in occupancy levels.

Although the fixed and variable component approach is actually the standard method for forecasting hotel operating expenses, it is also valuable for projecting revenue. This chapter explains the theory behind the fixed and variable component approach and demonstrates its application in revenue forecasts. Chapter 13 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.

The case study at the end of this chapter illustrates a typical revenue forecast.

12.02 **ROOMS REVENUE**

The estimated total rooms revenue is the most critical 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 actual procedure for forecasting rooms revenue is fairly straightforward. The appraiser simply multiplies the projected occupancy rate for the subject property as determined by the room-night analysis conducted earlier in the market study² by the forecasted average room rate.³ 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.

12.03 **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 meals charged on hotel employees' checks. Beverage revenue is defined as revenue derived from the sale of alcoholic beverages.⁴ 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**

Table 12.1 lists the various revenue categories comprised in the food department of a hotel. The table also shows whether the category is relatively fixed, occupancy-

² See 10.03 *supra*.

³ See 11.07 *supra*.

⁴ Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYC, Inc., 1986.

TABLE 12.1
Food Revenue

Source: Uniform System of Accounts for Hotels

Category	Percent of sales	Fixed revenue	Variable revenue		Food- and beverage-sensitive
			Occupancy-sensitive	Rate-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
Total	100				

sensitive, rate-sensitive or food-sensitive. This information is useful when food revenue is projected utilizing a fixed and variable component approach.

Food revenue varies greatly depending on the number of outlets, 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.

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 restaurant manager determines the number of patrons served during each meal period by simply totaling the number of 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, which is 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.

Turnover is generally estimated by determining the actual past turnover experienced by the subject property if it has an operating history or, 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 is 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.⁵ 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 to 80 percent of the food and beverage sales for a hotel (depending upon 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.

⁵ Guestroom usage is discussed at 10.03 supra; market segmentation is discussed at 11.07 supra.

[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:

$$\frac{\text{House count}}{\text{Occupied rooms}} = \frac{85,252}{64,659} = 1.32$$

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, so as a whole, it has a low rate of double occupancy (1–1.4). Meeting and convention demand tends to have a higher rate. Commercial groups (i.e., business meeting attendees) tend to 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. Most hotels see 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. Few guests are in the hotel at midday, so lunch demand is predominantly 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, businesspeople, 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 as follows:

<i>Meal period</i>	<i>Percentage of total food demand excluding banquet patronage</i>
Breakfast	5 to 15%
Lunch	30 to 70%
Dinner	20 to 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 businesspeople 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 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 utilized 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.

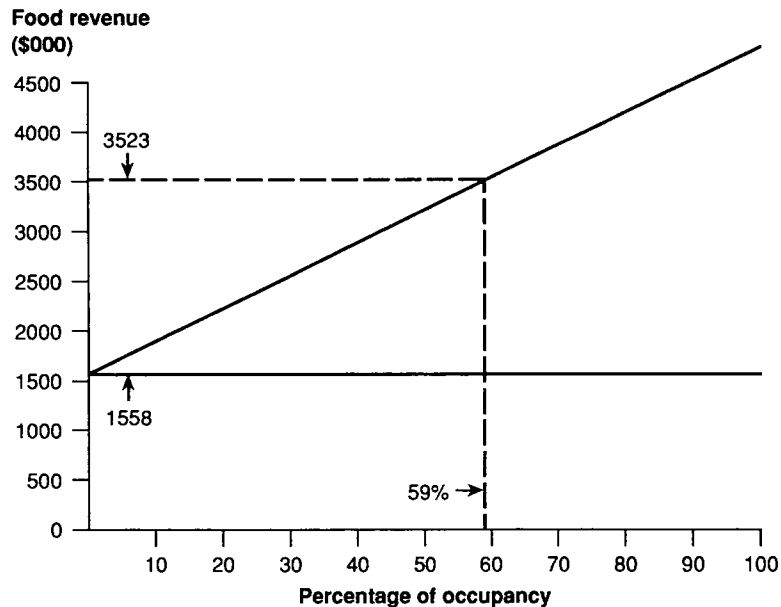
This approach is based on the concept that most items of revenue and expense within a hotel have a fixed component, which will not vary with a hotel's occupancy or other volume measure, and a variable component, which will change in direct relationship with occupancy or another measure of volume (e.g., 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.

The graph in Figure 12.1 illustrates the theory and mechanics of the fixed and variable component approach. The horizontal (x) axis of the graph represents total food revenue; the vertical (y) axis measures guestroom occupancy. As a hotel's occupancy increases, so does the total food revenue. However, as shown by the graph, the food outlets in the hotel are expected to generate a positive amount of revenue, even at 0 percent occupancy. Therefore, the fixed component in this model is the food revenue generated by out-of-house restaurant patronage and part of the total banquet revenue. The diagonal line in the graph is the variable component, representing the food revenue that increases in direct proportion with occupancy.

To use the fixed and variable component graph, the appraiser first locates the projected occupancy level on the x axis. A vertical line is then extended upward from this point until it intersects the diagonal variable line. A horizontal line is then extended from this intercept to the y axis. The point at which this horizontal line

FIGURE 12.1
Fixed and Variable Graph for Food Revenue (1990)



intercepts the y axis represents the projected total food revenue for that level of occupancy.

The data plotted on the graph are projected for 1990 for the Spring Valley hotel described in the case study in Part II. At the projected 59 percent occupancy for that year, the total food revenue is expected to reach \$3,523.

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 will 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 these data so that they reflect 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.

TABLE 12.2
Fixed and Variable Percentages for Revenues and Expenses

Revenue and expense category	Percent fixed	Percent variable	Index of variability
Revenues			
Food	30-50	50-70	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 revenue
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
Property operation and maintenance	55-75	25-45	Total revenue
Energy costs	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

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 utilized 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. Table 12.2 lists typical ranges of fixed and variable percentages along with the index utilized to measure variable changes.
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. Table 12.2 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, such as 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. Table 12.3 shows the primary units of comparison utilized 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*,⁶ 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. The bulk of beverage revenue generally comes from a lounge outlet, so 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.

[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

⁶ Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYC Inc., 1986.

TABLE 12.3
Primary Units of Comparison

Unit of comparison	Sensitivity factors	Revenue and expense categories analyzed
Percentage of total revenue	Occupancy Average room rate Food and beverage revenue	Administrative and general Management fee Marketing Property operations and maintenance
Percentage of rooms revenue	Occupancy Average room rate	Food revenue Telephone revenue Other income Rooms expense
Percentage of food and beverage revenue	Food and beverage revenue	Food and beverage expense
Per available room	Fixed categories	Administrative and general Marketing Property operations and maintenance Energy Insurance Property taxes
Per occupied room	Occupancy	Food revenue Beverage revenue Telephone revenue Other income Rooms expense Energy

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. Table 12.2 shows that beverage revenue is typically 70 to 100 percent variable and 0 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.

12.04 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

TABLE 12.4
Telephone Revenue

Source: *Uniform System of Accounts for Hotels*

Category	Percent of sales	Fixed revenue	Variable revenue		
			Occupancy-sensitive	Rate-sensitive	Food and beverage-sensitive
Local	25-60	—	Highly	—	—
Long distance	35-60	—	Highly	—	—
Service charges	0-20	—	Highly	—	—
Pay station	0-20	Somewhat	—	—	Somewhat
Total	100				

services to their guests at a reasonable profit. Prior to deregulation, hotels could only collect 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 utilization of various providers of long distance services, such as 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.

Telephone revenue tends to vary 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. Table 12.4 lists the various categories of telephone revenue and describes their individual characteristics.

Telephone revenue is normally projected through the fixed and variable component approach with 10 to 40 percent of the revenue being fixed and 60 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.

12.05 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.
- Commissions—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 is 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 monies 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.

12.06 **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.

CASE STUDY Revenue Forecast

ROOMS REVENUE

Total rooms revenue is estimated by multiplying the average room rate by the projected occupancy by the property's room count by 365 days. The following calculation shows the projected rooms revenue for the proposed Spring Valley hotel:

	1990	1991	1992
Occupancy	59%	67%	72%
Average room rate	× \$93.10	× \$103.07	× \$113.96
Room count	× 300	× 300	× 300
365	× 365	× 365	× 365
Rooms Revenue	\$6,015,000	\$7,562,000	\$8,985,000

Market segment	Estimated double occupancy
Commercial	1.06
Meeting and convention	1.60
Leisure	1.80

House Count

The house count for the proposed Spring Valley hotel in each of the three projection years is shown in Table 1.

In-House Capture

The majority of the commercial guests are expected to take breakfast at the proposed subject property. It is anticipated that the bulk of the meeting and convention segment will eat at the various food functions hosted by their groups, as opposed to utilizing the hotel's food and beverage outlets. A limited number of leisure travelers are expected to have breakfast at the hotel.

Based on this information, analysis of dining alternatives, and the type of demand anticipated to utilize the various food and beverage outlets, the following are estimates of the subject property's in-house food service covers (demand) or capture of hotel guests by meal period expressed as a percentage of the house count by market segment.

FOOD REVENUE—BUILD-UP COVER APPROACH

Double Occupancy

The range of the rate of double-occupancy bookings for the main market segments is as follows:

Market segment	Range of double occupancy
Commercial	1.0 to 1.4
Meeting and convention	1.3 to 2.0
Leisure	1.7 to 2.5

Based on these ranges, the following double occupancy rates were estimated for the subject property by market segment.

TABLE 1 House Count by Segment

Year	Segment	Occupied rooms		Double occupancy		House count
1990	Commercial	36,293	×	1.06	=	38,471
	Meeting	21,387	×	1.60	=	34,219
	Leisure	6,979	×	1.80	=	12,562
	Total	<u>64,659</u>				<u>85,252</u>
1991	Commercial	37,667	×	1.06	=	39,927
	Meeting	27,222	×	1.60	=	43,555
	Leisure	8,030	×	1.80	=	14,454
	Total	<u>72,919</u>				<u>97,936</u>
1992	Commercial	39,583	×	1.06	=	41,958
	Meeting	30,586	×	1.60	=	48,938
	Leisure	9,144	×	1.80	=	16,459
	Total	<u>79,313</u>				<u>107,355</u>

TABLE 2
In-House Food Service Covers by Segment

1990				1991				1992			
Segment	House count	Food service utilization	In-house food service covers	Segment	House count	Food service utilization	In-house food service covers	Segment	House count	Food service utilization	In-house food service covers
Breakfast				Breakfast				Breakfast			
Commercial	38,471 ×	80% =	30,777	Commercial	39,927 ×	80% =	31,942	Commercial	41,958 ×	80% =	33,566
Meeting	34,219 ×	80 =	27,375	Meeting	43,555 ×	80 =	34,844	Meeting	48,938 ×	80 =	39,150
Leisure	12,562 ×	80 =	10,050	Leisure	14,454 ×	80 =	11,563	Leisure	16,459 ×	80 =	13,167
Total			68,202	Total			78,349	Total			85,883
Lunch				Lunch				Lunch			
Commercial	38,471 ×	20% =	7,694	Commercial	39,927 ×	20% =	7,985	Commercial	41,958 ×	20% =	8,392
Meeting	34,219 ×	70 =	23,953	Meeting	43,555 ×	70 =	30,489	Meeting	48,938 ×	70 ×	34,257
Leisure	12,562 ×	50 =	6,281	Leisure	14,454 ×	50 =	7,227	Leisure	16,459 ×	50 =	8,229
Total			37,928	Total			45,701	Total			50,878
Dinner				Dinner				Dinner			
Commercial	38,471 ×	25% =	9,618	Commercial	39,927 ×	25% =	9,982	Commercial	41,958 ×	25% =	10,489
Meeting	34,219 ×	40 =	13,688	Meeting	43,555 ×	40 =	17,422	Meeting	48,938 ×	40 =	19,575
Leisure	12,562 ×	30 =	3,769	Leisure	14,454 ×	30 =	4,336	Leisure	16,459 ×	30 =	4,938
Total			27,075	Total			31,740	Total			35,002

Meal period	Commercial	Meeting and convention	Leisure
Breakfast	80%	80%	80%
Lunch	20	70	50
Dinner	25	40	30

Multiplying the house count by these in-house food service utilization rates yields the total number of food service covers generated from in-house guests by meal period and market segment (see Table 2). This is referred to as in-house food service demand. It should be noted that some of the food service demand generated by the meeting and convention segment will utilize the banquet facilities within the hotel.

TABLE 3
Out-of-House Restaurant Demand Capture Rates

Year	Meal period	Percentage of total food demand (excluding banquet percentage)
1990	Breakfast	10.0
	Lunch	37.0
	Dinner	30.0
1991	Breakfast	10.0
	Lunch	35.1
	Dinner	26.0
1992	Breakfast	10.0
	Lunch	34.2
	Dinner	21.9

Out-of-House Restaurant Demand

The Spring Valley area has experienced moderate residential development that has increased the local resident population base. As most of the housing is considered to be middle- to upper-income, these residents constitute a growing market that the hotel's food and beverage outlets should be able to penetrate. In addition, the subject property is located near several major office parks containing numerous businesses. The local businesspeople should patronize the subject property's restaurants and lounges, especially during the lunch period and, to a limited extent, the breakfast and dinner hours. Because of the considerable demand created by the office complexes, a number of new restaurants are currently under construction or in the planning phases. Nonetheless, a significant shortage of quality restaurants exists in the subject property's neighborhood, and the new entrants are not anticipated to inhibit the subject's ability to generate strong local patronage.

Based on an analysis of the local restaurant market, competitive lodging facilities, and typical out-of-house restaurant demand percentages, the out-of-house restaurant demand capture rates shown in Table 3 were estimated for the subject property.

Applying these percentages to the projected in-house food service covers produced the estimate of

REVENUE FORECAST

**TABLE 4
Food Service and Restaurant Covers**

Year	Meal period	In-house food service covers	Out-of-house restaurant demand: percentage of total covers	Total out-of-house restaurant covers
1990	Breakfast	68,202	10.0	7,578
	Lunch	37,928	37.0	22,276
	Dinner	27,075	30.0	11,603
1991	Breakfast	78,349	10.0	8,705
	Lunch	45,701	35.1	24,717
	Dinner	31,740	26.0	11,152
1992	Breakfast	85,883	10.0	9,543
	Lunch	50,878	34.2	26,444
	Dinner	35,002	21.9	9,815

**TABLE 5
Banquet Covers**

Year	Average number of banquet covers per day	Days per year	Banquet covers per year
1990	175	× 365 =	63,875
1991	175	× 365 =	63,875
1992	175	× 365 =	63,875

**TABLE 6
Total Food Service Demand**

Year	Service segment	Breakfast	Lunch	Dinner	Banquet
1990	In-house food service covers	68,202	37,928	27,075	—
	Out-of-house restaurant covers	7,578	22,276	11,603	—
	Banquet covers	—	—	—	63,875
	Total	75,780	60,204	38,678	63,875
1991	In-house food service covers	78,349	45,701	31,740	—
	Out-of-house restaurant covers	8,704	24,717	11,152	—
	Banquet covers	—	—	—	63,875
	Total	87,053	70,418	42,892	63,875
1992	In-house food service covers	85,883	50,878	35,002	—
	Out-of-house restaurant covers	9,543	26,444	9,815	—
	Banquet covers	—	—	—	63,875
	Total	95,426	77,322	44,817	63,875

the number of out-of-house restaurant covers shown in Table 4.

Banquet Demand

Table 5 shows the results of an analysis of comparable hotels and local catering facilities regarding the number of banquet covers that the subject property can be expected to generate.

Total Food Service Demand

Totaling all the food covers by meal period results in the total projected food service demand for the subject property shown in Table 6.

Average Food Check

Taking into account the pricing norms established for comparable food and banquet facilities in the Spring

TABLE 7
Average Food Check

Meal period	1987	1990	1991	1992
Breakfast	\$ 5.00	\$ 5.79	\$ 6.08	\$ 6.38
Lunch	10.00	11.58	12.16	12.76
Dinner	17.00	19.68	20.66	21.70
Banquet	22.00	25.47	26.74	28.08

Valley market, the results of other similar lodging facilities nationwide and the subject property's forecasted market mix, Table 7 sets forth the estimated average check by meal period between 1987 and 1992. These estimates have been increased at a 5 percent annual growth rate.

Total Food Revenue

Table 8 shows the subject property's total forecasted food revenue determined by the build-up cover approach. This amount was calculated by multiplying the number of covers sold by the average check per cover for each meal period.

FOOD REVENUE—FIXED AND VARIABLE COMPONENT APPROACH

Compilation of Data

The subject property has no operating history, so income and expense data from similar hotels were

used as a basis for financial forecasts. A sorting process was used to screen out data that would not provide an appropriate comparison for the subject property. The first search of the data base isolated all of the income and expense statements for hotels with average room rates similar to the subject property. Once a pool of hotels with similar average room rates had been created, the next step was to locate all of the hotels with similar room counts. In the case of the Spring Valley property, hotels with room counts within 75 rooms of the subject property's room count were used.

All properties with similar levels of occupancy were then selected from the pool that had been compiled. As the final step, additional searches were made to identify hotels with similar facilities and geographic locations. Table 9 shows the composite operating statement that was developed for the proposed Spring Valley hotel based on the sorting process.

The composite operating statement in Table 9 is arranged in five columns. Column 1 contains each revenue and expense category arranged in accordance with the *Uniform System of Accounts for Hotels*; Column 2 contains the composite dollar amount for each category; Column 3 contains the dollar amount expressed as a percentage of total revenue, or, in the case of departmental expenses, a percentage of departmental revenue; Column 4 is the amount per available room, which is the room count (299.8 rooms); and Column 5 is the amount per occupied room (occupancy × room count). These key ratios, along with the

TABLE 8
Total Food Revenue

Year	Meal period	Total covers		Average food check		Food revenue
1990	Breakfast	75,780	×	\$ 5.79	=	\$ 438,621
	Lunch	60,204	×	11.58	=	696,939
	Dinner	38,678	×	19.68	=	761,151
	Banquet	63,875	×	25.47	=	1,626,753
	Total Rounded					\$3,523,464 \$3,523,000
1991	Breakfast	87,053	×	\$ 6.08	=	\$ 529,076
	Lunch	70,418	×	12.16	=	855,931
	Dinner	42,892	×	20.66	=	886,302
	Banquet	63,875	×	26.74	=	1,708,090
	Total Rounded					\$3,979,399 \$3,979,000
1992	Breakfast	95,426	×	\$ 6.38	=	\$ 608,955
	Lunch	77,322	×	12.76	=	986,839
	Dinner	44,817	×	21.70	=	972,391
	Banquet	63,875	×	28.08	=	1,793,495
	Total Rounded					\$4,361,680 \$4,362,000

REVENUE FORECAST

TABLE 9
1987 Composite Operating Statement

Number of rooms	299.8
Occupancy	70.20%
Average rate	\$90.10

	(000)	Percentage of gross	PAR	POR
Revenues				
Rooms	6,921	55.10	23,085	32,885
Food	3,391	27.00	11,312	16,114
Beverages	1,492	11.90	4,977	7,090
Telephone	345	2.70	1,150	1,638
Other income	420	3.30	1,400	1,994
Total	12,569	100.00	41,924	59,721
Departmental Expenses				
Rooms	1,579	22.80	5,267	7,503
Food and beverage	3,600	73.70	12,008	17,105
Telephone	311	90.20	1,037	1,478
Other income	252	60.00	840	1,197
Total	5,742	45.70	19,152	27,283
Departmental income	6,827	54.30	22,772	32,438
Undistributed Operating Expenses				
Administrative and general	1,040	8.30	3,469	4,942
Management fee	377	3.00	1,258	1,792
Marketing	627	5.00	2,091	2,979
Property operations and maintenance	600	4.80	2,000	2,849
Energy	510	4.10	1,701	2,423
Total	3,154	25.20	10,519	14,985
Income before fixed charges	3,673	29.10	12,253	17,453
Fixed Charges				
Property tax	390	3.10	1,301	1,853
Insurance	120	1.00	400	570
Resource for replacement	377	3.00	1,258	1,792
Total	887	7.10	2,959	4,215
Net income	2,786	22.00	9,294	13,238

Ratios

Food to Rooms	49.00%
Beverage to Food	44.00
Food and beverage to Rooms	70.56
Telephone to Rooms	4.98
Other income to Rooms	6.06

ratios at the bottom of the statement, are used to compare various financial operating results.

Composite Data Adjustments

The composite statement reflects a property that is dissimilar to the subject property in the following areas:

	Composite property	Subject property
Number of rooms	299.8	300
Stabilized occupancy	70.2%	72.0%
Average room rate	\$90.100	\$89.355

The difference in room count is so insignificant, however, that no adjustment is necessary. (Generally, an adjustment is only necessary if the composite property is 20 to 30 percent larger or smaller than the subject property.) The difference in occupancy levels will be adjusted automatically during the fixed and variable component procedures, so the only adjustment necessary for this composite data is to account for the difference in average room rate. As a rule, any adjustments the appraiser makes should be made to the composite property, making it more similar to the subject property.

Table 10 contains the composite operating data and the 1987 base statements that have been adjusted to reflect the difference in the composite data of the proposed Spring Valley hotel. The columns in Table 10 are arranged in the same manner as in Table 9.

The following list outlines the adjustments that have been made to the composite data.

- Rooms revenue*—Room count increased to 300 available rooms, average room rate decreased to \$89.355 based on market conditions.
- Food revenue*—Maintained at 49 percent of rooms revenue.
- Beverage revenue*—Maintained at 44 percent of food revenue.
- Telephone and other income revenue*—No change.
- Rooms expense*—Increased \$1,000 because the number of occupied rooms will increase when the assumed room count changes from 299.8 to 300.
- Food and beverage expense*—Decreased \$14,000 due to anticipated lower volume.
- Administrative and general expense*—Decreased from \$1,040,000 to \$1,036,000 due to lower total revenue, thus reducing credit card commissions. Offsetting the lower volume, however, is a greater number of occupied rooms.
- Management fee*—Remains at 3 percent of total revenue.

HOTEL DEVELOPMENT OR ACQUISITION

TABLE 10
1987 Composite and Base Operating Statements

COMPOSITE					BASE				
Number of rooms		299.8			Number of rooms		300		
Occupancy		70.20%			Occupancy		70.20%		
Average rate		\$90.10			Average rate		\$89.355		
	\$000	Percentage of gross	PAR	POR		\$000	Percentage of gross	PAR	POR
Revenues					Revenues				
Rooms	6,921	55.10	23,085	32,885	Rooms	6,869	55.00	22,895	32,615
Food	3,391	27.00	11,312	16,114	Food	3,366	27.00	11,219	15,981
Beverages	1,492	11.90	4,977	7,090	Beverages	1,481	11.90	4,936	7,032
Telephone	345	2.70	1,150	1,638	Telephone	345	2.80	1,150	1,638
Other income	420	3.30	1,400	1,994	Other income	420	3.30	1,400	1,994
Total	12,569	100.00	41,924	59,721	Total	12,480	100.00	41,600	59,260
Departmental Expenses					Departmental Expenses				
Rooms	1,579	22.80	5,267	7,503	Rooms	1,580	23.00	5,267	7,502
Food and beverage	3,600	73.70	12,008	17,105	Food and beverage	3,586	74.00	11,953	17,028
Telephone	311	90.20	1,037	1,478	Telephone	311	90.10	1,037	1,477
Other income	252	60.00	840	1,197	Other income	252	60.00	840	1,197
Total	5,742	45.70	19,152	27,283	Total	5,729	45.90	19,097	27,204
Departmental income	6,827	54.30	22,772	32,438	Departmental income	6,751	54.20	22,503	32,056
Undistributed Operating Expenses					Undistributed Operating Expenses				
Administrative and general	1,040	8.30	3,469	4,942	Administrative and general	1,036	8.30	3,453	4,919
Management fee	377	3.00	1,258	1,792	Management fee	374	3.00	1,247	1,776
Marketing	627	5.00	2,091	2,979	Marketing	623	5.00	2,077	2,958
Property operations and maintenance	600	4.80	2,000	2,849	Property operations and maintenance	600	4.80	2,000	2,849
Energy	510	4.10	1,701	2,423	Energy	550	4.40	1,833	2,612
Total	3,154	25.20	10,519	14,985	Total	3,183	25.50	10,610	15,114
Income before fixed charges	3,673	29.10	12,253	17,453	Income before fixed charges	3,569	28.70	11,893	16,942
Fixed Charges					Fixed Charges				
Property tax	390	3.10	1,301	1,853	Property tax	375	3.00	1,250	1,781
Insurance	120	1.00	400	570	Insurance	120	1.00	400	570
Reserve for replacement	377	3.00	1,258	1,792	Reserve for replacement	374	3.00	1,248	1,778
Total	887	7.10	2,959	4,215	Total	869	7.00	2,898	4,129
Net income	2,786	22.00	9,294	13,238	Net income	2,699	21.70	8,995	12,813
Ratios					Ratios				
Food to Rooms		49.00%			Food to Rooms		49.00%		
Beverage to Food		44.00			Beverage to Food		44.00		
Food and beverage to Rooms		70.56			Food and beverage to Rooms		70.56		
Telephone to Rooms		4.98			Telephone to Rooms		5.02		
Other income to Rooms		6.06			Other income to Rooms		6.11		

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**TABLE 11
Projected Base Operating Statement**

Year	1987	1988	1989	1990	1991	1992
Number of Rooms	300	300	300	300	300	300
Occupancy	70.20%	70.20%	70.20%	70.20%	70.20%	70.20%
Average rate	\$89.355	\$93.82	\$98.51	\$103.44	\$108.50	\$113.96
	\$000	\$000	\$000	\$000	\$000	\$000
Revenues						
Rooms	6,869	7,212	7,573	7,951	8,340	8,760
Food	3,366	3,534	3,711	3,896	4,091	4,295
Beverages	1,481	1,555	1,633	1,714	1,800	1,890
Telephone	345	362	380	399	419	440
Other income	420	441	463	486	511	536
Total	12,480	13,104	13,759	14,447	15,161	15,921
Departmental Expenses						
Rooms	1,580	1,659	1,742	1,829	1,920	2,016
Food and beverage	3,586	3,766	3,954	4,152	4,359	4,577
Telephone	311	326	342	359	377	396
Other income	252	265	278	292	306	322
Total	5,729	6,015	6,316	6,632	6,963	7,311
Departmental income	6,751	7,089	7,443	7,816	8,198	8,610
Undistributed Operating Expenses						
Administrative and general	1,036	1,088	1,142	1,199	1,259	1,322
Management fee	374	393	413	433	455	478
Marketing	623	654	686	721	757	794
Property operation and maintenance	600	630	662	695	729	766
Energy	550	578	606	637	669	702
Total	3,183	3,342	3,509	3,684	3,869	4,062
Income before fixed charges	3,569	3,747	3,934	4,131	4,329	4,548
Fixed Charges						
Property tax	375	394	413	434	456	479
Insurance	120	126	132	139	146	153
Reserve for replacement	374	393	413	433	455	478
Total fixed charges	869	913	959	1,006	1,057	1,110
Net income	2,699	2,834	2,976	3,125	3,272	3,438

- Marketing expense*—Reduced from \$627,000 to \$623,000 due to lower rooms revenue, thus reducing the franchise fees.
- Property operations and maintenance expense*—No change.
- Energy expense*—Energy costs are geography-specific expenses and should not be derived from a nationwide composite sample.
- Property taxes*—Property taxes are geography-specific.
- Insurance expense*—No change.
- Reserve for replacement*—Remains at 3 percent of total revenue.

Inflation Adjustments

Table 11 shows the projected base income and expense for the Spring Valley hotel. An assumed infla-

tion rate of 5 percent has been applied to every category. The average room rate is taken from the average rate analysis and represents the undiscounted average room rate. The average room rate during the projection year does not always increase at the rate of inflation, particularly if the composition of the demand segments change.

The purpose of this step is to adjust for inflation so that the fixed and variable estimates are expressed in current dollars and the index of variability calculation represents real changes, unaffected by inflation.

Fixed and Variable Percentages Estimate

Table 12 contains the percentages of fixed and variable components of each revenue and expense category that was considered appropriate for the proposed subject property.

TABLE 12
Fixed and Variable Percentages

Revenue and expense category	Percent fixed	Percent variable
Revenues		
Food	40	60
Beverage	0	100
Telephone	10	90
Other income	50	50
Departmental Expenses		
Rooms	65	35
Food and beverage	55	45
Telephone	60	40
Other income	50	50
Undistributed Operating Expenses		
Administrative and general	70	30
Management fee	0	100
Marketing	70	30
Property operations and maintenance	60	40
Energy	90	10
Fixed Charges		
Property taxes	100	0
Insurance	100	0
Reserve for replacement	0	100

Fixed Component

The fixed component of the food revenue is calculated by taking the base food revenue in each projected year and multiplying it by the 40 percent fixed component of food revenue contained in Table 12. This calculation is made as follows for each of the three projected years.

	1990	1991	1992
Base food revenue	\$3,896,000	\$4,091,000	\$4,295,000
Percent fixed	40%	40%	40%
Fixed component food revenue	\$1,558,000	\$1,636,000	\$1,718,000

Variable Percentage Change

Food revenue is occupancy-variable to the extent that revenue exceeds the fixed component because of changes in occupancy. The variable percentage change for each projected year is calculated by dividing the projected occupancy by the base occupancy, as follows.

	1990	1991	1992
Projected occupancy	59.0%	67.0%	72.0%
Base occupancy	70.2%	70.2%	70.2%
	$\frac{59.0\%}{70.2\%} = .8405$	$\frac{67.0\%}{70.2\%} = .9544$	$\frac{72.0\%}{70.2\%} = 1.026$

Unadjusted Variable Component

The unadjusted variable component is calculated by multiplying the base food revenue in each projected year by the 60 percent variable percentage from Table 12. Food revenue was estimated to be 60 percent occupancy-variable. The following calculation illustrates the derivation of the unadjusted variable component for each projected year.

	1990	1991	1992
Base food revenue	\$3,896,000	\$4,091,000	\$4,295,000
Percent variable	60%	60%	60%
Unadjusted variable component of food revenue	\$2,338,000	\$2,455,000	\$2,577,000

Adjustment of Unadjusted Variable Component

The next step for the appraiser is to multiply the unadjusted variable component by the variable percentage change attributed to differing levels of occupancy, as follows:

	1990	1991	1992
Unadjusted variable component of food revenue	\$2,338,000	\$2,455,000	\$2,577,000
Variable percentage change	.8405	.9544	1.026
Adjusted variable component	\$1,965,000	\$2,343,000	\$2,644,000

Total Food Revenue Estimate

The fixed component of food revenue and the adjusted variable component of food revenue for each projected year are combined to determine the estimate of total food revenue.

	1990	1991	1992
Fixed component of food revenue	\$1,558,000	\$1,636,000	\$1,718,000
Adjusted variable component of food revenue	1,965,000	2,343,000	2,644,000
Total food revenue	\$3,523,000	\$3,979,000	\$4,362,000

BEVERAGE REVENUE

The proposed subject property will have extensive beverage facilities, and is accordingly expected to draw a strong local patronage. In fact, based on an analysis of comparable lodging facilities, beverage revenue is estimated to average approximately 44 percent of food revenue. Beverage revenue is expected to be 100 percent variable based on

REVENUE FORECAST

changes in food revenue. Therefore, beverage revenue is projected by multiplying the forecasted food revenue by 44 percent as follows:

	1990	1991	1992
Food revenue	\$3,523,000	\$3,979,000	\$4,362,000
Percent of food revenue	44%	44%	44%
Beverage revenue	\$1,550,000	\$1,751,000	\$1,919,000

To evaluate the reasonableness of the projection of beverage revenue, the unit of comparison commonly used is beverage revenue per occupied room, which yields:

	1990	1991	1992
Beverage revenue per occupied room	\$23.99	\$23.87	\$24.34

The projected beverage revenue per occupied room is within industry norms for hotels with active beverage outlets.

TELEPHONE REVENUE

Telephone revenue is largely occupancy-variable, so it is normally projected using the percent of rooms

**TABLE 13
Telephone Revenue**

	1990	1991	1992
Base telephone revenue	\$399,000	\$419,000	\$440,000
Percent fixed	10%	10%	40%
Fixed component of telephone revenue	\$ 40,000	\$ 42,000	\$ 44,000
Base telephone revenue	\$399,000	\$419,000	\$440,000
Percent variable	90%	90%	90%
Unadjusted variable component of telephone revenue	\$359,000	\$377,000	\$396,000
Variable Percent Change			
	1990	1991	1992
Projected occupancy	59.0% = .8405	67.0% = .9544	72.0% = 1.026
Base occupancy	70.2%	70.2%	70.2%
	1990	1991	1992
Unadjusted variable component	\$359,000	\$377,000	\$396,000
Variable percent change	.8405	.9544	1.026
Adjusted variable component	\$302,000	\$360,000	\$406,000
Fixed component of telephone revenue	\$ 40,000	\$ 42,000	\$ 44,000
Adjusted variable component of telephone revenue	302,000	360,000	406,000
Total telephone income	\$342,000	\$402,000	\$450,000

revenue or the occupied room as the unit of comparison. Based on the analysis of hotels comparable to the proposed subject property, it was estimated that telephone revenue for the Spring Valley hotel would run approximately 5 percent of rooms revenue, or \$4.50 per occupied room in 1987 dollars. This equates to a 1987 base of \$345,000, assuming the 70.2 percent occupancy level. Telephone revenue for the proposed subject property is projected to originate largely from in-house guest usage with very little out-of-house demand. Therefore, a 10 percent fixed component and a 90 percent occupancy-variable component will be utilized. Table 13 illustrates the fixed and variable calculations for projecting telephone revenue.

To evaluate the reasonableness of the projection of other income, the projected other income has been expressed as a percentage of rooms revenue and on a per occupied room basis, as follows:

	1990	1991	1992
Percent of rooms revenue	5.7%	5.3%	5.0%
Per occupied room	\$5.29	\$5.48	\$5.71

These units of comparison are within industry norms and appear reasonable for the proposed subject property.

OTHER INCOME

The proposed subject property will have a typical hotel gift shop, recreational amenities, and other sources of other income. This category is largely occupancy-variable, so it is normally projected using the percent of rooms revenue or the occupied room as the unit of comparison. Based on an analysis of comparable lodging facilities, other income represented approximately 6 percent of rooms revenue, or about \$5.46 per occupied room in 1987 dollars. Using this as the base and projecting out for inflation, Table 14 shows how other income is forecasted by employing the fixed and variable component approach. Fifty percent of other income was considered fixed and 50 percent was occupancy variable.

To evaluate the reasonableness of the projection of other income, the projected other income has been expressed as a percentage of rooms revenue and on a per occupied room basis, as follows:

	1990	1991	1992
Percent of rooms revenue	7.4%	6.6%	6.0%
Per occupied room	\$6.92	\$6.80	\$6.89

TABLE 14
Other Income

	1990	1991	1992
Base other income	\$486,000	\$511,000	\$536,000
Percent fixed	50%	50%	50%
Fixed component of other income	\$243,000	\$255,000	\$268,000
Base other income	\$486,000	\$511,000	\$536,000
Percent variable	50%	50%	50%
Unadjusted variable component of other income	\$243,000	\$255,000	\$268,000

Variable Percent Change

	1990	1991	1992
Projected occupancy	59.0%	67.0%	72.0%
Base occupancy	70.2%	70.2%	70.2%
	$\frac{59.0\%}{70.2\%} = .8405$	$\frac{67.0\%}{70.2\%} = .9544$	$\frac{72.0\%}{70.2\%} = 1.026$

	1990	1991	1992
Unadjusted variable component	\$243,000	\$255,000	\$268,000
Variable percent change	.8405	.9544	1.026
Adjusted variable component	\$204,000	\$244,000	\$275,000
Fixed component of other income	\$243,000	\$255,000	\$268,000
Adjusted variable component of other income	204,000	244,000	275,000
Total other income	\$447,000	\$499,000	\$543,000

TABLE 15
Total Revenue

	1990	1991	1992
Rooms	\$ 6,015,000	\$ 7,562,000	\$ 8,985,000
Food	3,523,000	3,979,000	4,362,000
Beverage	1,550,000	1,751,000	1,919,000
Telephone	342,000	402,000	450,000
Other income	447,000	499,000	543,000
Total revenue	\$11,877,000	\$14,193,000	\$16,259,000

These units of comparison are within industry norms and appear reasonable for the proposed subject property.

TOTAL REVENUE

Table 15 shows the projected total revenue for the Spring Valley hotel.

Over the first three projection years, rooms revenue becomes an increasingly larger part of the total revenue while food and beverage revenue as a percentage of the total declines. New lodging facilities typically experience a rapid initial growth in food and beverage revenue while rooms revenue grows more gradually.

CHAPTER 13

Expense Forecast

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13.01 INTRODUCTION

After the forecasted revenue for a proposed property is 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*.¹ 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 whether it 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 12.

The case study at the end of this chapter illustrates a typical expense forecast.

¹ Hotel Association of New York City, Inc. *Uniform System of Accounts for Hotels* (8th ed). HANYC, Inc., 1986.

13.02 ROOMS EXPENSE

Rooms expense comprises all of the costs involved in the sale and upkeep of guest-rooms and public space (see Table 13.1). 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. These charges are usually based on a percentage of rooms revenue, so 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.

TABLE 13.1
Rooms Expense by Category

Source: Uniform System of Accounts for Hotels

Category	Percent of total	Fixed expenses	Variable expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Salaries and wages	50-70	—	Moderately	—	—
Employee benefits	5-15	—	Moderately	—	—
China, glassware and linen	3-8	—	Very slightly	—	—
Commissions	0-3	—	Highly	Highly	—
Contract cleaning	1-3	Moderately	—	—	—
Laundry and dry cleaning	7-12	—	Slightly	—	—
Operating supplies	1-4	—	Very slightly	—	—
Other operating expenses	1-4	—	Very slightly	—	—
Reservation expenses	0-8	—	Highly	Highly	—
Uniforms	1-3	—	Very slightly	—	—
Total	100				

Rooms expense projections are usually made using the fixed and variable component approach, with 50 to 70 percent of the expense being fixed and 30 to 50 percent occupancy-variable.

13.03 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. Table 13.2 lists the categories that make up food and beverage department expense and indicates their fixed and variable qualities.

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, such as laundry and dry cleaning, operating supplies, and uniforms, tend to be either slightly food- and beverage-sensitive or moderately fixed (that is, 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, 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 effective-

TABLE 13.2
Food and Beverage Expense by Category

Source: Uniform System of Accounts for Hotels

Category	Percentage of total	Fixed expenses	Variable expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Cost of food sales	35-45	—	—	—	Highly
Cost of employee meals	1-4	—	—	—	Moderately
Cost of beverage sales	20-30	—	—	—	Highly
Salaries and wages	25-35	—	—	—	Moderately
Employee benefits	2-9	—	—	—	Very slightly
Contract cleaning	0-3	Moderately	—	—	—
Laundry and dry cleaning	1-2	—	—	—	Slightly
Licenses	1-2	Moderately	—	—	—
Music and other entertainment	2-7	Moderately	—	—	—
Operating supplies	1-3	—	—	—	Very slightly
Other operating expenses	1-3	—	—	—	Very slightly
Uniforms	1-2	—	—	—	Very slightly
Total	100				

TABLE 13.3
Telephone Expense by Category

Source: Uniform System of Accounts for Hotels

Category	Percentage of total	Fixed expenses	Variable expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Local calls	20-70	—	Moderately	—	—
Long distance calls	20-70	—	Moderately	—	—
Salaries and wages	0-10	Moderately	—	—	—
Employee benefits	0-4	Moderately	—	—	—
Other operating expenses	0-5	Moderately	—	—	—
Printing and stationery	0-5	Moderately	—	—	—
Uniforms	0-2	Moderately	—	—	—
Total	100				

ness 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 to 55 percent of the expense being fixed and 45 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.

13.04 TELEPHONE EXPENSE

Telephone expense consists of all of the costs associated with the operation of a hotel telephone department (see Table 13.3). 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. Most of these calls originate from in-house guests, so 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*² 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.

² Id.

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 to 75 percent fixed and 25 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.

13.05 **OTHER INCOME EXPENSE**

Other income expense comprises 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.³ 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.

Based on 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 to 60 percent of the expense being fixed and 40 to 60 percent varying directly with other income revenue.

13.06 **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 (see Table 13.4). 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.

³ See 12.05.

TABLE 13.4
Administrative and General Expense by Category

Source: Uniform System of Accounts for Hotels

Category	Percentage of total	Fixed expenses	Variable expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Salaries and wages	15-35	—	Very slightly	—	Very slightly
Employee benefits	1-8	—	Very slightly	—	Very slightly
Cash overages and shortages	0-3	—	Moderately	Moderately	Moderately
Commission on credit card charges	3-10	—	Highly	Highly	Highly
Credit and collection charges	0-3	—	Moderately	Moderately	Moderately
Data processing	0-10	Moderately	—	—	—
Donations	0-2	Moderately	—	—	—
Executive office	3-10	Moderately	—	—	—
Human resources	3-10	Moderately	—	—	—
Insurance (general)	1-5	Moderately	—	—	—
Internal audit	1-3	Moderately	—	—	—
Internal communicating systems	0-2	Moderately	—	—	—
Loss and damage	0-1	Moderately	—	—	—
Other	1-4	Moderately	—	—	—
Postage and telegrams	2-8	Moderately	—	—	—
Operating supplies	3-10	Moderately	—	—	—
Professional fees	2-5	Moderately	—	—	—
Provision for doubtful accounts	1-3	—	Moderately	Moderately	Moderately
Security	3-10	—	Slightly	Slightly	Slightly
Dues and subscriptions	2-4	Moderately	—	—	—
Travel and entertainment	1-8	Moderately	—	—	—
Total	100				

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.⁴

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 to 85 percent of the expense being fixed and 15 to 35 percent varying directly with total revenue.

⁴ See 13.12 infra.

13.07 **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 (see Chapter 17). 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.

13.08 **MARKETING EXPENSE**

Marketing expense includes all of the expenses associated with advertising, sales, and promotion of a lodging facility (see Table 13.5). 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 when either developing a marketing plan or reviewing the effectiveness of an established market-

TABLE 13.5
Marketing Expense by Category

Source: Uniform System of Accounts for Hotels

Category	Percentage of total	Fixed expenses	Variable Expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Salaries and wages	10-60	Budgeted	—	—	—
Employee benefits	2-10	Budgeted	—	—	—
Sales	20-60	Budgeted	—	—	—
Advertising and merchandising	20-60	Budgeted	—	—	—
Reservations	10-30	—	Moderately	Moderately	Moderately
Other marketing activities	5-30	Budgeted	—	—	—
Fees and commissions	0-50	—	Highly	Highly	Highly
Total	100				

ing effort. In order 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 ought to 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.
- The effect of marketing tends to be cumulative, so 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 to either maintain or 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.

As shown in Table 13.5, 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.⁵

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 to 85 percent of the expense being fixed and 15 to 35 percent varying directly with total revenue. The fixed and variable component approach must

⁵ See 13.02 supra.

sometimes be adjusted to account for unique marketing considerations, such as the costs incurred by fees and commissions paid to travel agencies.

13.09 **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 Table 13.6). 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.

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 only contain 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.⁶

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

⁶ See 13.13 infra.

TABLE 13.6
Property Operations and Maintenance Expense by Category

Source: Uniform System of Accounts for Hotels

Category	Percentage of total	Fixed expenses	Variable expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Salaries and wages	20-40	—	Very slightly	—	Very slightly
Employee benefits	3-10	—	Very slightly	—	Very slightly
Building	3-10	—	Very slightly	—	Very slightly
Curtains and draperies	1-7	—	Very slightly	—	Very slightly
Electrical and mechanical equipment	5-25	—	Very slightly	—	Very slightly
Elevators	0-5	Moderately	—	—	—
Engineering supplies	2-7	—	Very slightly	—	Very slightly
Floor covering	1-10	—	Very slightly	—	Very slightly
Furniture	1-20	—	Very slightly	—	Very slightly
Grounds and landscaping	1-10	Budgeted	—	—	—
Operating supplies	1-10	—	Very slightly	—	Very slightly
Painting and decorating	4-25	—	Very slightly	—	Very slightly
Refrigeration supplies	1-5	Moderately	—	—	—
Removal of waste matter	2-8	Moderately	—	—	—
Swimming pool	2-8	—	Slightly	—	—
Uniforms	0-5	—	Very slightly	—	Very slightly
Miscellaneous	2-8	Moderately	Very slightly	—	Very slightly
Total	100	Moderately			

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 to 75 percent of the expense being fixed and 40 to 60 percent varying directly with total revenue.

13.10 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 (see Table 13.7).

The total cost of energy varies with the source and quantity of fuel utilized. 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 based on a demand rate schedule.

TABLE 13.7
Energy Expense by Category

Source: Uniform System of Accounts for Hotels*

Category	Percentage of total	Fixed expenses	Variable expenses		
			Occupancy-sensitive	Rate-sensitive	Food- and beverage-sensitive
Electric current	—	—	Very slightly	—	Very slightly
Fuel	—	—	Very slightly	—	Very slightly
Steam	—	—	Very slightly	—	Very slightly
Water	—	—	Very slightly	—	Very slightly

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 12-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.

<i>Source of energy</i>	<i>Unit of consumption</i>	<i>BTUs per unit of consumption</i>
Electricity	Kilowatt-hour (kwh)	3,413
Gas	Therm	100,000
Oil	Gallon (gal)	140,000

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 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 are 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 is estimated, a projection is made using the fixed and variable component approach, with 80 to 95 percent of the expense being fixed and 5 to 20 percent varying directly with total revenue.

13.11 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).

To establish the proper allocation of the tax burden, municipalities employ assessors to assess, or value, 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.

For example, assume that a tax jurisdiction included only four properties. According to local assessment procedures, assessed value must be 30 percent market value. The following chart shows the assessed values based on the established market values:

<i>Property</i>	<i>Estimated market value</i>	<i>Assessed value (30% ad valorem)</i>
1	\$ 75,000	\$ 22,500
2	100,000	30,000
3	125,000	37,500
4	<u>150,000</u>	<u>45,000</u>
Total	\$450,000	\$135,000

The total assessed value of all of the properties in jurisdiction is known as the *tax base* and is used to calculate the rate at which the properties are taxed. If the annual municipal budget for this taxing jurisdiction is \$18,000, the tax rate would be:

$$\frac{\$18,000}{\$135,000} = \$.1333 \text{ per } \$1 \text{ of assessed value, or } \$133.33 \text{ per } \$1,000 \text{ of assessed value}$$

The total tax burden is then allocated as follows:

<i>Property</i>	<i>Assessed value</i>	<i>Tax rate</i>	<i>Real estate tax burden</i>
1	\$22,500	x \$.1333	= \$ 3,000
2	30,000	x .1333	= 4,000
3	37,500	x .1333	= 5,000
4	45,000	x .1333	= <u>6,000</u>
Total			\$18,000

Some municipalities assess properties at 100 percent of market, while others, as in the example above, use a certain percentage of market value. In any case, the allocation of the tax burden to each property will not change should the relationship between the assessed value and market value be altered. If additional property is 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 property generates additional tax revenue. If the municipal budget increases, however, the tax rate will increase proportionately.

Projecting property tax expense for an existing hotel can be done relatively simply. The assessed value is normally on public record and can be found in the appropriate municipal office. Multiplying the assessed value by the anticipated tax rate yields the estimated property tax burden. The appraiser must determine, however, whether the assessed value might escalate at some future time, either as the result 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 utilize 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, so that 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 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 dissimilarities between them and the subject property.

[1] Real Property Assessment

A unique feature of real property assessment makes it advisable to compare the assessed values of only the improvements, not the combined land and improvement values: Tax jurisdictions provide separate assessed values for land and improvements. 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. Based on these known land sales, the assessor can determine the relative desirability of the parcels—as value declines, so does desirability. Each parcel is assessed based on 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 factors such 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. Personal property assessment procedures differ widely, so 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.

13.12 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.

13.13 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, so an appraisal should reflect these expenses in the form of an appropriate reserve for replacement. As a general rule, a reserve of 2 to 4 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.

13.14 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*⁷ 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.

⁷ Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYC, Inc., 1986.

CASE STUDY Expense Forecast

ROOMS EXPENSE

The proposed subject property has a modern, efficient design, so rooms expense should be typical for a facility of this type. Based on an analysis of comparable lodging facilities in the market area, rooms expense represented approximately 23 percent of rooms revenue (at 70.2 percent occupancy), or \$7,502 per occupied room per year in 1987. Using this as the base and projecting for inflation, the following calculations show how rooms expense for the subject property has been forecasted by the fixed and variable component approach. Sixty-five percent of rooms expense was considered fixed and 35 percent was occupancy variable.

	1990	1991	1992
Base rooms expense	\$1,829,000	\$1,920,000	\$2,016,000
Percent fixed	65%	65%	65%
Fixed component of rooms expense	\$1,189,000	\$1,248,000	\$1,310,000
Base rooms expense	\$1,829,000	\$1,920,000	\$2,016,000
Percent variable	35%	35%	35%
Unadjusted variable component of rooms expense	\$ 640,000	\$ 672,000	\$ 706,000

Variable Percent Change

	1990	1991	1992
Projected occupancy	59.0%	67.0%	72.0%
Base occupancy	70.2%	70.2%	70.2%
	= .8405	= .9544	= 1.026
Unadjusted variable component	\$ 640,000	\$ 672,000	\$ 706,000
Variable percent change	.8405	.9544	1.026
Adjusted variable component	\$ 538,000	\$ 642,000	\$ 724,000
Fixed component of rooms expense	\$1,189,000	\$1,248,000	\$1,310,000
Adjusted variable component of rooms expense	538,000	642,000	724,000
Total rooms expense	\$1,727,000	\$1,890,000	\$2,034,000

The ratio of rooms expense to rooms revenue is expected to decline from 28.7 percent in 1990 to 22.6 percent in 1992, which appears reasonable for the subject market area.

FOOD AND BEVERAGE EXPENSE

It was determined that similar lodging facilities had beverage-to-food ratios ranging from 42 to 47 percent and that their food and beverage department expense was approximately 74 percent of food and beverage revenue. These figures were used to determine the total food and beverage expense base for 1987 of \$3,586,000. The following calculations show the projected food and beverage expense for the subject property as determined by the fixed and variable component approach and indexed for inflation. Fifty-five percent of the food and beverage expense was considered fixed and 45 percent was estimated to vary with food and beverage revenue. Note that the variable percentage change was projected food and beverage revenue divided by the base food and beverage revenue.

	1990	1991	1992
Base food and beverage expense	\$4,152,000	\$4,359,000	\$4,577,000
Percent fixed	55%	55%	55%
Fixed component of food and beverage expense	\$2,284,000	\$2,398,000	\$2,517,000
Base food and beverage expense	\$4,152,000	\$4,359,000	\$4,577,000
Percent variable	45%	45%	45%
Unadjusted variable component of food and beverage expense	\$1,868,000	\$1,962,000	\$2,060,000

Variable Percentage Change

	1990	1991	1992
Projected food and beverage revenue	\$3,523,000	\$3,979,000	\$4,362,000
Base food and beverage revenue	\$3,896,000	\$4,091,000	\$4,295,000
	= .9043	= .9726	= 1.0156

EXPENSE FORECAST

	1990	1991	1992
Unadjusted variable component	\$1,868,000	\$1,962,000	\$2,060,000
Variable percentage change	.9043	.9726	1.0156
Adjusted variable component	\$1,689,000	\$1,908,000	\$2,092,000
Fixed component of food and beverage expense	\$2,284,000	\$2,398,000	\$2,517,000
Adjusted variable component of food and beverage expense	1,689,000	1,908,000	2,092,000
Total food and beverage expense	\$3,973,000	\$4,306,000	\$4,609,000

The ratio of food and beverage expense to food and beverage revenue declines as the hotel increases its volume. Between 1990 and 1992 this ratio is predicted to decrease from 78.3 to 73.4 percent.

TELEPHONE EXPENSE

An analysis of similar lodging facilities revealed that telephone expense represented approximately 90.2 percent of telephone revenue at the base level of occupancy (70.2 percent), which represented a base telephone expense in 1987 of \$311,000. The following calculations show the projected telephone expense for the subject property as determined by the fixed and variable component approach and indexed for inflation. Sixty percent of the telephone expense was considered fixed and 40 percent was estimated to vary with telephone revenue. Note that the variable percentage change was projected telephone revenue divided by the telephone revenue base.

	1990	1991	1992
Base telephone expense	\$359,000	\$377,000	\$396,000
Percent fixed	60%	60%	60%
Fixed component of telephone expense	\$216,000	\$226,000	\$238,000
Base telephone expense	\$359,000	\$377,000	\$396,000
Percent variable	40%	40%	40%
Unadjusted variable component of telephone expense	\$144,000	\$151,000	\$158,000

Variable Percentage Change

	1990	1991	1992
Projected telephone revenue	\$342,000	\$402,000	\$450,000
Base telephone revenue	\$399,000	\$419,000	\$440,000
	= .8571	= .9594	= 1.0227

	1990	1991	1992
Unadjusted variable component	\$144,000	\$151,000	\$158,000
Variable percentage change	.8571	.9594	1.0227
Adjusted variable component	\$123,000	\$145,000	\$162,000
Fixed component of telephone expense	\$216,000	\$226,000	\$238,000
Adjusted variable component of telephone expense	123,000	145,000	162,000
Total telephone expense	\$339,000	\$371,000	\$400,000

The ratio of telephone expense to telephone revenue declines as the hotel's occupancy increases, resulting in a corresponding rise in telephone revenue. Between 1990 and 1992 this expense ratio is forecast to decrease from 99.1 to 88.9 percent.

OTHER INCOME EXPENSE

Other income expense for similar lodging facilities represented approximately 60 percent of other income revenue at the base level of occupancy (70.2 percent), which represented a base other income expense in 1987 of \$252,000. The following calculations show the projected other income expense for the subject property as determined by the fixed and variable component approach and indexed for inflation. Fifty percent of the other income expense was considered fixed and 50 percent was estimated to vary with other income revenue. Note that the variable percentage change was the projected other income expense divided by the base other income expense.

	1990	1991	1992
Base other income expense	\$292,000	\$306,000	\$322,000
Percent fixed	50%	50%	50%
Other income expense			
Fixed component of	\$146,000	\$153,000	\$161,000
Base other income expense	\$292,000	\$306,000	\$322,000
Percent variable	50%	50%	50%
Unadjusted variable component of other income expense	\$146,000	\$153,000	\$161,000

Variable Percentage Change

	1990	1991	1992
Projected other income expense	\$447,000	\$499,000	\$543,000
Base other income expense	\$486,000	\$511,000	\$536,000
	= .9197	= .9765	= 1.0131

	1990	1991	1992
Unadjusted variable component	\$146,000	\$153,000	\$161,000
Variable percentage change	.9197	.9765	1.0131
Adjusted variable component	\$134,000	\$150,000	\$163,000
Fixed component of other income expense	\$146,000	\$153,000	\$161,000
Adjusted variable component of other income expense	134,000	150,000	163,000
Total other income expense	\$280,000	\$303,000	\$324,000

ADMINISTRATIVE AND GENERAL EXPENSE

Based on an analysis of comparable lodging facilities, administrative and general expense as of the 1987 base year was about \$3,450 per available room, or 8.3 percent of total revenue. This equates to a 1987 base administrative and general expense of \$1,036,000. The following calculations show the projected administrative and general expense for the subject property as determined by the fixed and variable component approach and indexed for inflation. Seventy percent of the administrative and general expense was considered fixed and 30 percent was estimated to vary with total revenue. Note that the variable percentage change was the projected total revenue divided by the base total revenue.

	1990	1991	1992
Base administrative and general expense	\$1,199,000	\$1,259,000	\$1,322,000
Percent fixed	70%	70%	70%
Fixed component of administrative and general expense	\$ 839,000	\$ 881,000	\$ 925,000
Base administrative and general expense	\$1,199,000	\$1,259,000	\$1,322,000
Percent variable	30%	30%	30%
Unadjusted variable component of administrative and general expense	\$ 360,000	\$ 378,000	\$ 397,000

Variable Percentage Change

	1990	1991	1992
Projected total revenue	\$11,877,000	\$14,193,000	\$16,259,000
Base total revenue	\$14,447,000	\$15,161,000	\$15,921,000
	= .8221	= .9362	= 1.0212

	1990	1991	1992
Unadjusted variable component	\$ 360,000	\$ 378,000	\$ 397,000
Variable percentage change	.8221	.9362	1.0212

(continued)

	1990	1991	1992
Adjusted variable component	\$ 296,000	\$ 354,000	\$ 405,000
Fixed component of administrative and general expense	\$ 839,000	\$ 881,000	\$ 925,000
Adjusted variable component of administrative and general expense	296,000	354,000	405,000
Total administrative and general expense	\$1,135,000	\$1,235,000	\$1,330,000

The forecasted administrative and general expense ranges from 8.2 to 9.6 percent of total revenue, and \$3,783 to \$4,433 per available room. These ratios are typical for the hotel industry.

MANAGEMENT FEE EXPENSE

The forecast of income and expense assumes competent management by a hotel operating company with the experience and ability to properly market and manage the facilities. It is anticipated that a second-tier hotel management company will be utilized in conjunction with a franchise affiliation from a nationally recognized hotel chain. Based on these assumptions, a total management fee of 3 percent of total revenue will be utilized and there will be no incentive fee. The following is the management fee projection for the proposed subject property.

	1990	1991	1992
Total revenue	\$11,877,000	\$14,193,000	\$16,259,000
Management fee percentage	3%	3%	3%
Total management fee expense	\$ 356,000	\$ 426,000	\$ 488,000

On a per-available-room basis, the management fee expense for the subject property ranges from \$1,187 to \$1,627, which is within industry norms for this form of management fee.

MARKETING EXPENSE

Various factors, including the excellent location of the subject property, the competitive environment of the local market for transient accommodations, and the assumption that pre-opening marketing budget will be utilized, led to an estimated base marketing expense of \$623,000 for 1987, which equates to \$2,077 per available room or 5 percent of total revenue. Included in the estimated marketing expense are franchise fees totaling 5 percent of rooms revenue, which in the 1987 base year (70.2 percent occu-

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pancy) amount to \$343,000. The following calculations show the projected marketing expense for the subject property as determined by the fixed and variable component approach and indexed for inflation. Seventy percent of the marketing expense was considered fixed and thirty percent was estimated to vary with total revenue. Note that the variable percentage change is the projected total revenue divided by the base total revenue.

	1990	1991	1992
Base marketing expense	\$721,000	\$757,000	\$794,000
Percent fixed	70%	70%	70%
Fixed component of marketing expense	\$505,000	\$530,000	\$556,000
Base marketing expense	\$721,000	\$757,000	\$794,000
Percent variable	30%	30%	30%
Unadjusted variable component of marketing expense	\$216,000	\$227,000	\$239,000

Variable Percentage Change

	1990	1991	1992
Projected total revenue	\$11,877,000	\$14,193,000	\$16,259,000
Base total revenue	\$14,447,000	\$15,161,000	\$15,921,000
	= .8221	= .9362	= 1.0212

	1990	1991	1992
Unadjusted variable component	\$216,000	\$227,000	\$238,000
Variable percentage change	.8221	.9362	1.0212
Adjusted variable component	\$177,000	\$212,000	\$244,000
Fixed component of marketing expense	\$505,000	\$530,000	\$556,000
Adjusted variable component of marketing expense	177,000	212,000	244,000
Total marketing expense	\$682,000	\$742,000	\$800,000

The forecasted marketing expense ranges from 5.7 to 4.9 percent of total revenue and \$2,273 to \$2,667 per available room. These ratios are typical for hotels with a strong franchise and reservation system.

PROPERTY OPERATIONS AND MAINTENANCE EXPENSE

An analysis of recently constructed lodging facilities similar to the proposed subject property determined that property operations and maintenance expense as of the 1987 base year was about \$2,000 per available room or 4.8 percent of total revenue. Based on these figures, the 1987 base property operations and maintenance expense was estimated at \$600,000. The following calculations show the projected property operations and maintenance expense for the

subject property as determined by the fixed and variable component approach and indexed for inflation. Sixty percent of the property operations and maintenance expense was considered fixed and 40 percent was estimated to vary with total revenue. Note that the variable percentage change was the projected total revenue divided by the base total revenue.

	1990	1991	1992
Base property, operations, and maintenance expense	\$695,000	\$729,000	\$766,000
Percent fixed	60%	60%	60%
Fixed component of property, operations, and maintenance expense	\$417,000	\$437,000	\$460,000
Base property, operations, and maintenance expense	\$695,000	\$729,000	\$766,000
Percent variable	40%	40%	40%
Unadjusted variable component of property, operations, and maintenance expense	\$278,000	\$292,000	\$306,000

Variable Percentage Change

	1990	1991	1992
Projected total revenue	\$11,877,000	\$14,193,000	\$16,259,000
Base total revenue	\$14,447,000	\$15,161,000	\$15,921,000
	= .8221	= .9362	= 1.0212

	1990	1991	1992
Unadjusted variable component	\$278,000	\$292,000	\$306,000
Variable percentage change	.8221	.9362	1.0212
Adjusted variable component	\$228,000	\$274,000	\$312,000
Fixed component of property, operations, and maintenance expense	\$417,000	\$437,000	\$460,000
Adjusted variable component of property, operations, and maintenance expense	228,000	274,000	312,000
Total property, operations, and maintenance expense	\$645,000	\$711,000	\$772,000
Discount for new facilities	70%	90%	0%
Projected property, operations, and maintenance expense	\$451,000	\$640,000	\$772,000

The total property operations and maintenance expense for the subject property's first year of operation (1990) was projected to be \$645,000. This amount was then discounted 30 percent to reflect the new facilities as well as the normal maintenance warranties that come with new equipment. In the second year of operation the projected total property operations and maintenance expenses were reduced 10 percent for the same reason. In the third year no discount was applied.

The forecasted property operations and maintenance expense ranges from 3.8 to 4.7 percent of total revenue and \$1,503 to \$2,573 per available room. These ratios, especially the increase in the ratio of PO&M to total revenue during the initial years, are typical for the hotel industry.

ENERGY EXPENSE

The proposed subject property is situated in the Northeast region of the United States, so the appropriate amount of energy consumption at a stabilized level of occupancy would be approximately 162,000 BTUs per square foot. The total building area of the subject property will be approximately 194,860 square feet. Multiplying the number of BTUs per square foot per year by the hotel's total area results in the following estimate of the energy that will be consumed.

BTUs/sq. ft./year		162,000
Sq. ft.	×	194,860
BTUs per year		31,567,320,000

Assuming that 50 percent of the subject property's energy will come from electricity and 50 percent from oil, the following calculation shows the projected kilowatt hours of electricity and the gallons of oil required during the hotel's stabilized year of operation.

	Electricity	Oil
Total BTUs per year	31,567,320,000	31,567,320,000
Usage allocation	50%	50%
Energy consumption (BTU)	15,783,660,000	15,783,660,000
Conversion factor	÷ 3,413	÷ 140,000
Quantity consumed	4,624,571 kwh	112,740 gal

The current electric rate quoted by the local utility company was \$0.0875/kwh including normal demand charges, seasonal fuel adjustments, and quantity discounts. Oil prices were currently quoted as \$1,056/gallon, which included delivery charges and appropriate quantity discounts. Water charges were estimated at \$26,000. The total energy cost in 1987 dollars based on a base level 70.2 percent occupancy level was calculated as follows:

Electricity: 4,624,571 kwh × \$0.0875	\$404,649
Oil: 112,740 gal × \$1.056	119,053
Water	26,000
	<u>\$549,703</u>
Approximate total energy cost 1987	\$550,000

This energy expense estimate represents the 1987 base (70.2 percent occupancy). The following calculations show the projected energy costs for the subject facility as determined by the fixed and variable component approach and indexed for inflation. Ninety percent of the energy expense was considered fixed and 10 percent was estimated to vary with total revenue. Note that the variable percentage charge was the projected total revenue divided by the base total revenue.

	1990	1991	1992
Base energy expense	\$637,000	\$669,000	\$702,000
Percent fixed	90%	90%	90%
Fixed component of energy expense	\$573,000	\$602,000	\$632,000
Base energy expense	\$637,000	\$669,000	\$702,000
Percent variable	10%	10%	10%
Unadjusted variable component of energy expense	\$ 64,000	\$ 67,000	\$ 70,000

Variable Percentage Change

	1990	1991	1992
Projected total revenue	\$11,877,000	\$14,193,000	\$16,259,000
Base total revenue	\$14,447,000	\$15,161,000	\$15,921,000
	= .8221	= .9362	= 1.0212

	1990	1991	1992
Unadjusted variable component	\$ 64,000	\$ 67,000	\$ 70,000
Variable percentage change	.8221	.9362	1.0212
Adjusted variable component	\$ 52,000	\$ 62,000	\$ 71,000
Fixed component of energy expense	\$573,000	\$602,000	\$632,000
Adjusted variable component of energy expense	52,000	62,000	71,000
Total energy expense	\$625,000	\$664,000	\$703,000

The forecasted energy cost ranges from 5.3 to 4.3 percent of total revenue and \$2,083 to \$2,343 per available room. These ratios are typical and in line with similar hotels in the area.

PROPERTY TAX EXPENSE

The taxing jurisdiction in which the subject property is located assesses only real property at approximately 60 percent of market value. The 1987 land assessment for the subject property was \$1,496,534, or \$4,988 per room for a 300-room hotel.

A review of assessed values on comparable hotels located in the Rockland County taxing jurisdiction yielded the following information:

EXPENSE FORECAST

Hotel	Number of rooms	Assessed value			
		Total land	Total improvements	Per room land	Per room improvements
Howard Johnson's-Nanuet	190	\$ 763,800	\$5,188,900	\$4,020	\$27,310
Sheraton-Nanuet	230	1,025,800	6,975,900	4,460	30,330
Holiday Inn-Nanuet	200	720,000	4,883,400	3,600	24,417
Holiday Inn-Suffern	245	1,151,500	7,924,770	4,700	32,346

Although the lodging facility in the market area with the greatest number of similarities is the Hilton Hotel, it cannot be used to estimate property assessed values because it is located in New Jersey, which is a different taxing jurisdiction.

The assessed values of the improvements for the four hotels set forth above range from \$24,417 to \$32,346 per available room. The Holiday Inn-Suffern which is a new property that has a good location and similar facilities is closest in value to the subject property.

Based on the results of an analysis of the relative attributes between these two properties, it was estimated that assuming the subject property was complete and operational it would have had a 1987 improvement assessment of \$34,000 per room, or \$10,200,000. The estimated total 1987 assessed value for the proposed subject property was:

	Estimated 1987 assessed value
Land	\$ 1,500,000
Improvement	10,250,000
Total	\$11,750,000

The current tax rate that would be applied to this assessment is \$31.91 per \$1,000 of assessed value.

Based on this rate, the 1987 tax burden for the proposed subject property, assuming that the hotel is complete and operational, was \$375,000. The forecasted tax burden for these projected years, using an assumed 5 percent inflationary increase per year, is as follows.

Year	Estimated property tax burden
1987	\$375,000
1990	434,000
1991	456,000
1992	479,000

INSURANCE EXPENSE

Insurance expense for the subject property in 1987 was estimated at \$400 per available room or a total of \$120,000. Based on an analysis of similar lodging

facilities, the following is the projected insurance expense for the subject property, indexed for inflation.

	1990	1991	1992
Insurance expenses	\$139,000	\$146,000	\$153,000

RESERVE FOR REPLACEMENT EXPENSE

A reserve for replacement of 3 percent of total revenue was determined to be sufficient to provide for the periodic replacement of furniture, fixtures and equipment, based on an analysis of comparable lodging facilities.

	1990	1991	1992
Projected total revenue	\$11,877,000	\$14,193,000	\$16,259,000
Reserve for replacement percentage	3%	3%	3%
Reserve for replacement	\$ 356,000	\$ 426,000	\$ 488,000

OVERALL STATEMENT OF INCOME AND EXPENSE

Table 1 shows a projected statement of income and expense for the proposed Spring Valley hotel. After reviewing the various operating ratios along with the amounts per available room, it appears that this statement of income and expense is reasonable and supported by comparable hotel operating data.

TABLE 1
Projected Statement of Income and Expense

Year	1990			1991			1992		
Number of rooms	300			300			300		
Occupancy	59.00%			67.00%			72.00%		
Average rate	\$93.10			\$103.07			\$113.96		
	\$000	Percentage of gross	Per room	\$000	Percentage of gross	Per room	\$000	Percentage of gross	Per room
Revenues									
Rooms	6,015	50.50	20,050	7,562	53.40	25,207	8,985	55.30	29,950
Food	3,523	29.70	11,743	3,979	28.00	13,263	4,362	26.80	14,540
Beverages	1,550	13.10	5,167	1,751	12.30	5,837	1,919	11.80	6,397
Telephone	342	2.90	1,140	402	2.90	1,340	450	2.80	1,500
Other income	447	3.80	1,490	499	3.50	1,663	543	3.30	1,810
Total	11,877	100.00	39,590	14,193	100.00	47,310	16,259	100.00	54,197
Departmental Expenses									
Rooms	1,727	28.70	5,757	1,890	25.00	6,300	2,034	22.60	6,780
Food and beverage	3,973	78.30	13,243	4,306	75.10	14,353	4,609	73.40	15,363
Telephone	339	99.10	1,130	371	92.30	1,237	400	88.90	1,333
Other income	280	62.60	933	303	60.70	1,010	324	59.70	1,080
Total	6,319	53.20	21,063	6,870	48.40	22,900	7,367	45.30	24,556
Departmental income	5,558	46.80	18,527	7,323	51.60	24,410	8,892	54.70	29,641
Undistributed Operating Expenses									
Administrative and general	1,135	9.60	3,783	1,235	8.70	4,117	1,330	8.20	4,433
Management fee	356	3.00	1,187	426	3.00	1,420	488	3.00	1,627
Marketing	682	5.70	2,273	742	5.20	2,473	800	4.90	2,667
Property operations and maintenance	451	3.80	1,503	640	4.50	2,133	772	4.70	2,573
Energy	625	5.30	2,083	664	4.70	2,213	703	4.30	2,343
Total	3,249	27.40	10,829	3,707	26.10	12,356	4,093	25.10	13,643
Income before fixed charges	2,309	19.40	7,698	3,616	25.50	12,054	4,799	29.60	15,998
Fixed Charge									
Property tax	434	3.70	1,447	456	3.20	1,520	479	2.90	1,597
Insurance	139	1.20	463	146	1.00	487	153	0.90	510
Reserve for replacement	356	3.00	1,187	426	3.00	1,420	488	3.00	1,627
Total	929	7.90	3,097	1,028	7.20	3,427	1,120	6.80	3,734
Net Income	1,380	11.50	4,601	2,588	18.30	8,627	3,679	22.80	12,264

CHAPTER 14

Property Valuation

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14.01 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 if 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 utilized 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 different 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 similar hotels with attributes like those of 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. However, in practice the value indicated by the income capitalization approach most closely reflects the sort 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.

The case study at the end of this chapter illustrates a property valuation using the cost approach and the income capitalization approach.

14.02 **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 as if vacant and available and combining it with the depreciated value of the improvements, which is deflated to reflect any physical deterioration or functional or economic obsolescence.

The cost approach may provide a reliable estimate of value for newly constructed properties not suffering from external obsolescence; however, as buildings and other forms of improvements increase in age and begin to depreciate, the resultant loss in value becomes increasingly difficult to accurately quantify.

Knowledgeable buyers of lodging facilities generally base their purchase decisions on economic factors such 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 unsubstantiable 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: property improvement cost, furniture, fixtures, and equipment (FF&E) cost, soft costs, opening costs, and developer's costs.

The replacement cost for property improvements, which include buildings, parking facilities, landscaping, and signage, can be estimated by using information provided by one of several construction cost services, such as Marshall Stevens, Boecke, and Dow. Other sources of replacement data include local building contractors and developers, architects, engineers, and professional cost estimators.

The main element of the replacement cost for property improvements is the replacement construction cost, which is based on a dollar amount per square foot and adjusted by factors that account for time (the current cost multiplier) and location (the local multiplier) to yield the actual building cost per square foot. This amount is then multiplied by the actual square footage of the subject property in order to determine the total improvement replacement cost.

The replacement cost for FF&E can be fairly easily determined by multiplying the amount of money budgeted per room for the proposed property by the final number of rooms in the facility.

Of the remaining elements, soft costs include appraisal fees, financing costs, legal fees, property taxes, and the cost of licenses and permits; opening costs comprise the funds necessary for an operating reserve, working capital, and the initial franchise fee; and the developer's cost is the fee that must be paid to a developer for providing project administration.

[2] Land Value

Land value for a lodging facility typically ranges between 10 and 20 percent of the total value. Land value can be estimated by the sales comparison approach, which uses comparable land sales as a determinant or by the ground lease approach, which is based on the economic value generated by an improvement that represents the highest and best use of the property.

Because it is unusual to find recent sales of comparable vacant land slated for imminent hotel development, the sales comparison approach for land valuation is not likely to produce satisfactory results. When the existing or proposed hotel improvements represent the highest and best use of the property, the ground lease approach is the preferred procedure because it can be 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.

Over the past ten years, hotels have been routinely constructed on leased land. Lease terms do, of course, 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 cost approach.

14.03 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.

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 more difficult to accurately quantify, the results of the sales comparison approach become 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 unsupported 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.

14.04 **INCOME CAPITALIZATION APPROACH**

Appraisers 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.

The forecast of income and expense is expressed in current dollars as of the date of each forecasted year. The last 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. Therefore, such income and expense estimates from the stabilized year forward exclude from consideration any abnormal relation of supply and demand and any transitory or nonrecurring conditions that may result in unusual revenue or expenses for the property.

The conversion of the forecasted income stream into an estimate of value is accomplished by allocating anticipated net income before debt service and depreciation to mortgage and equity components based on market rates of return and loan-to-value ratios. The total of the mortgage component plus 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 for typical hotel financing are set forth, including interest rate, amortization term, and loan-to-value ratio.
2. A cash-on-cash equity dividend rate of return is established. Most hotel buyers base their equity investment decisions on a two- to five-year cash-on-cash equity dividend rate projection, which generally takes the form of a cumulative preferred rate of return to the limited or money partner.
3. The value of the equity component is calculated by first deducting the yearly debt service from the forecasted income before debt service, leaving the net income to equity for each forecasted year. The net income to equity as of the stabilized year is capitalized into a stabilized or residual value and discounted to the date of value at the equity dividend rate. The net income to equity for each of the intervening build-up years is also discounted to the date of value. The sum of these discounted values equates to the value of the equity component. Adding the equity component to the initial mortgage balance yields the overall property value. Although the amount of the mortgage, as well as the debt service,

is unknown, the loan-to-value ratio can be structured in a simultaneous equation that determines the total property value.¹

4. A proof of value is performed by allocating the total property value between mortgage and equity components and verifying that the previously determined rates of return can be precisely met from the forecasted net income.

The underlying reason for converting the forecasted net income of a property into an estimate of value is that investors typically purchase real estate with a small amount of equity (25 to 40 percent) and a large amount of mortgage financing (60 to 75 percent). The amounts and terms of available mortgage financing and the rates of return that are required to attract sufficient equity capital form the basis upon which the appraiser allocates the net income between the mortgage and equity components and then derives a value estimate.

[1] Mortgage Component

Data for the mortgage component are generally developed from statistics pertaining to actual hotel mortgages made by long-term permanent lenders. The American Council of Life Insurance, which represents 20 large life insurance companies, publishes quarterly information regarding the hotel mortgages issued by its member companies. Table 14.1 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 purposes of comparison.

A close mathematical relationship exists between the average interest rate of a hotel mortgage and the concurrent yield on an Aa utility bond. Through regression analysis, this relationship is expressed as follows:

$$Y = 2.7561 + .79279X$$

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 the Moody's Bond Record, is 9.8 percent, the above equation produces an estimated hotel/motel interest rate (Y) of 10.53 percent.

[2] Equity Component

The cost of the property not covered by first mortgage financing is normally met by an equity investor, who anticipates the receipt of all future benefits accruing to the equity position. These benefits include increasing annual dividends resulting from inflation, and, ultimately, equity build-up resulting from property appreciation and debt amortization.

¹ For a discussion of the equation, see *infra* 14.04[3]; see also Suzanne R. Mellen, "Simultaneous Valuation: A New Technique," *The Appraisal Journal*, April 1983, p. 165 for a detailed analysis of this technique.

TABLE 14.1
Typical Hotel and Motel Mortgage Rates

Year	Average ¹ interest rate	Moody's ² Aa utility bond
1987	9.94	9.77
1986	9.83	9.30
1985	12.27	12.06
1984	13.34	13.66
1983	12.93	12.84
1982	15.16	14.79
1981	14.53	15.30
1980	12.86	13.00
1979	10.83	10.22
1978	9.94	9.10
1977	9.79	8.43
1976	10.06	8.92
1975	10.34	9.44
1974	9.65	9.04
1973	9.10	7.79
1972	8.92	7.60
1971	9.70	8.00
1970	9.78	8.52

¹ Source: American Council of Life Insurance

² Source: Moody's Bond Record

The rate of return required by equity investors in the purchase of hotel properties must be based upon anticipated future earnings and cannot be accurately established solely from capitalization rates derived from sales and past operating history. This is particularly true in light of possible changes in the tax laws (e.g., lengthened depreciation schedules). Hotel appraisers continually review deal sheets pertaining to offerings of hotels and motels to stay informed regarding investor requirements. Public offerings provide the most supportable documentation for the rate of return required by hotel investors. A review of limited partnership offerings made subsequent to the passage of the Tax Reform Act of 1986, for example, indicates a typical range of guaranteed annual cash-on-cash returns of 9–12 percent to cumulative preferred annual cash-on-cash returns of 10–13 percent for equity investments in publicly traded limited partnership interests.

[3] Valuation of Components

The terms and loan-to-value ratio of current financing applicable to hotel properties can be fairly easily determined. However, the annual debt service and resultant net income to equity of a particular property cannot be calculated without knowing the total value of the property. In the past, property value was most often determined by forecasting net income available for debt service, and by calculating, through an iterative process, the amount of the mortgage that the net income was capable of supporting at an assumed interest rate and a specified loan-to-value ratio.

Property value can also be determined through a technique known as the simultaneous valuation formula. Given the known variables of equity investor yield requirements, two equations are set up to simultaneously solve for the unknown value, where

- NI = Net income available for debt service
 V = Value
 M = Loan-to-value ratio
 R_e = Annual equity dividend rate
 f = Annual debt service constant
 d_e = Annual equity dividend
 $1/S^n$ = Present worth of \$1 factor (discount factor) at the equity dividend rate
 $S = 1 + i$, where i equals the interest or equity dividend rate ($R_e = i$)
 n = Projection period in years

The annual cash flow to equity (equity dividend) is expressed as the forecasted net income less annual debt service payments in the following equation:

$$\begin{aligned}
 NI^1 - (f \times M \times V) &= d_e1 \\
 NI^2 - (f \times M \times V) &= d_e2 \dots \\
 \dots (NI^n - (f \times M \times V))/R_e &= d_en
 \end{aligned}$$

The value of the equity component is then expressed as the sum of the discounted annual cash flows in the following equation:

$$(d_e1 \times 1/S^1) + (d_e2 \times 1/S^2 + \dots + (d_en \times 1/S^{n-1})) = (1-M)V$$

Like terms are combined to express the sum of the discounted cash flow after debt service as the value of the equity component:

$$\begin{aligned}
 ((NI^1 - (f \times M \times V)) 1/S^1) + ((NI^2 - (f \times M \times V)) 1/S^2) + \\
 \dots + (((NI^n - (f \times M \times V))/R_e) 1/S^{n-1}) = (1-M)V
 \end{aligned}$$

This combined algebraic equation (the simultaneous valuation formula) is then utilized to solve for the value of the subject property, given the forecasted net income stream and known return requirements of the debt and equity components.

[4] Ten-Year Internal Rate of Return Calculation and Discounted Cash Flow Analysis

In recent years, real estate investors and lenders have found it worthwhile to project the expected yield on investments or loans over an assumed 10-year holding period. This sort of assessment is usually accomplished by a 10-year internal rate of return calculation and discounted cash flow analysis that considers all of the before-tax components of a real estate investment (i.e., annual income dividends, property appreciation, and debt amortization).

The internal rate of return calculation assumes a sale at the end of the 10-year holding period. The sales price is calculated by capitalizing the 11th year's net income by an overall rate of 11 percent. This assumes that a seller or potential purchaser at the end of the 10th year will look forward to the forecasted 11th year net income to determine a sales or purchase price. The 11 percent overall "going-out" rate compares with an overall "going-in" rate (stabilized net income in current dollars divided by the property's value) of 10.76 percent. An increase is made in the overall rate to account for the added age of the property and the risk of forecasting ten years into the future.

A modified internal rate of return is calculated for each value component (i.e., debt, equity, and total property). It presumes that the cash flow thrown off by the property to that position is reinvested in an alternate investment (e.g., government bonds) that yields the same rate of return. Obviously, the higher the internal rate of

return, the greater the risk of not being able to attain the same yield from an alternate investment.

The modified internal rate of return calculation allows the appraiser to determine what the total property and equity yields would be if the annual cash flows to each position were reinvested in an investment generating a safer market rate of return. The 10-year internal rate of return calculations are illustrated in the case study at the end of this chapter.

14.05 **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 if there is enough leeway to cover debt service during low points in the occupancy cycle.

14.06 **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 considered viable and 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.

CASE STUDY Property Valuation

COST APPROACH

The proposed Spring Valley project will be a newly constructed facility, so significant physical deterioration is not expected to occur for some time. In addition, the facility will be well-designed, so built-in functional obsolescence will not be a depreciation factor. Finally, there is no foreseeable reason for external obsolescence in the form of an impairment of the desirability or useful life of the subject property. Therefore, for valuation purposes, no overall deduction need be made to the estimated replacement cost for the property.

Replacement Cost

The following estimate of the replacement cost for property improvements, which includes buildings, parking facilities, landscaping, and signage, has been derived from a national reference source on replacement cost information. This estimate does not take into account the cost of replacing FF&E, opening costs, developer's costs, or any soft costs other than those for architecture and engineering.

Cost per square foot		\$76.72
Current cost multiplier	×	1.04
Local multiplier	×	<u>1.02</u>
Total building cost per square foot		\$81.39

Based on the recommended facilities, the total square footage of the proposed subject property should range between 170,000 and 190,000 square feet, or an average of 180,000 square feet. Multiplying the total area (180,000 square feet) by the total building cost per square foot (\$81.39) results in the total improvement cost estimate:

Total building area in square feet		180,000.00
Building cost per square foot	\$	<u>81.39</u>
Total improvement cost		\$14,650,000.00

The other costs that must be accounted for are as follows:

FF&E

Price per room	\$	15,000
Number of rooms	×	<u>300</u>
		\$4,500,000

Soft costs

Appraisal fees	\$	30,000
Financing fees		316,000
Interest during construction		1,291,000
Legal		30,000
Miscellaneous		91,000
Property taxes		50,000
Surveys		15,000
Fees and permits		<u>100,000</u>
Total soft costs		\$1,923,000

Opening costs

Preopening costs	\$	600,000
Operating reserve		1,200,000
Working capital		200,000
Initial franchise fee		<u>90,000</u>
Total opening costs		\$2,090,000

Developer's costs \$ 587,000

Land Value

The proposed subject property appears to represent the highest and best use of the property, so the ground lease approach has been used to value the land.

Actual long-term ground leases encumbering hotels were researched, and emphasis was given to rental formulas based entirely on a percentage of rooms revenue or a combination of rooms, food, and beverage revenue. Table 1 summarizes these findings, showing the hotel, its room count, and the rental formula used. The last two columns of the table show the yield when the ground rental formula of the listed hotel is directly applied to the forecasted revenues for the proposed subject property as of its stabilized year. The total ground rental is then expressed both as a dollar amount and as a percentage of rooms revenue.

The analysis of these and other hotel ground lease rental formulas indicates that economic ground rents for hotels similar to the proposed subject property typically range from 3 to 7.2 percent of total rooms revenue. This range is quite broad, but most of the formulas cluster around 3 to 5 percent of rooms revenue.

Based on the calculations using the comparable ground leases and taking into consideration the loca-

(continued on page 14-11)

HOTEL DEVELOPMENT OR ACQUISITION

TABLE 1
Long-Term Hotel Ground Leases

Location	Number of rooms	Ground lease structure	Rental based on forecast of 300-unit subject property stabilized year											
			Dollar amount	Percent of rooms revenue										
Marriott Hotel Tampa, Florida	312	3% rooms revenue 1% food revenue greater of 1% of alcoholic beverage revenue or \$96,000	\$332,360	3.7%										
Marriott Hotel Albuquerque, New Mexico	414	greater of 3.5% of rooms revenue or \$155,000 for the 1st ten years, and \$165,000 thereafter	314,475	3.5										
Marriott Hotel Denver, Colorado	302	greater of \$160,000 or 3% of rooms revenue escalating to 4% in the 7th year of initial term; if the hotel is expanded, percentage rent increases to 5% of annual rooms revenue	269,550	3.0										
Marriott Hotel Greensboro, North Carolina	302	2.25% of rooms revenue, plus 2% of gross alcoholic beverage revenue, plus 1% of food revenue against a minimum rental as follows: <table border="1"> <thead> <tr> <th>Year</th> <th>Minimum rent</th> </tr> </thead> <tbody> <tr> <td>1-3</td> <td>\$ 90,000</td> </tr> <tr> <td>4-6</td> <td>100,000</td> </tr> <tr> <td>7-9</td> <td>110,000</td> </tr> <tr> <td>10-term</td> <td>127,000</td> </tr> </tbody> </table>	Year	Minimum rent	1-3	\$ 90,000	4-6	100,000	7-9	110,000	10-term	127,000	284,163	3.2
Year	Minimum rent													
1-3	\$ 90,000													
4-6	100,000													
7-9	110,000													
10-term	127,000													
Marriott Plaza Venetia Miami, Florida	605	\$800,000 minimum rent against 4% of rooms revenue, plus 3% of food and beverage revenue for the first two years of operation; after that, minimum rent of \$1,000,000 against percentage	547,830	6.1										
Marriott Houston Med. Ctr. Houston, Texas	417	greater of \$160,000 or 3% of the 1st \$15,000,000 of rooms revenue, plus 3.25% of rooms revenue in excess of \$15,000,000	269,550	3.0										
Bahia Mar Hotel Ft. Lauderdale, Florida	297	greater of \$150,000 or 4% of total revenue	650,360	7.2										
Kauai Holiday Inn Waipouli, Kawaihau, Hawaii	311	3% of rooms revenue 1% of food and beverage revenue 10% of sublease and concession rentals	386,660	4.3										
Hilton Inn Airport El Paso, Texas	272	greater of \$5,000/month or: 5% rooms revenue 4% beverage revenue 2% food revenue 6% other income	645,830	7.2										
Marriott Inn Trumbull, Connecticut	320	\$200,000 or 3% of rooms revenue	269,550	3.0										
Marriott Hotel Huntsville, Alabama	290	greater of \$120,000 or 4% rooms revenue plus 2% beverage revenue	398,780	4.4										
Ramada Inn Fayetteville, North Carolina	136	greater of \$18,000 or 5% rooms revenue	449,250	5.0										

PROPERTY VALUATION

ational attributes of the proposed subject property, the appropriate economic ground rental formula is estimated to be 3 percent of total rooms revenue. This equates to the following economic ground rent:

Stabilized rooms revenue	\$8,985,000
Rental percentage	<u>.03</u>
Economic ground rent	\$ 269,550

Rental generated from a ground lease represents a low-risk flow of income. Tenant improvements typically amount to more than eight times the value of the land, so the risk of default is almost nonexistent. For hotel ground leases where rental is tied to rooms revenue, the landlord is also protected from the adverse effects of inflation. Based on these minimal risk factors and the current cost of long-term capital, an appropriate ground rental overall capitalization rate for the subject property would be 10.5 percent.

Applying the indicated capitalization rate to the subject property's economic ground rent results in the following estimate of land value:

$$\frac{\text{Economic ground rent}}{\text{Capitalization rate}} = \frac{\$269,550}{.105} = \$2,567,142$$

Estimated land value \$2,600,000

Land value for a lodging facility typically ranges between 10 and 20 percent of the total value. The above estimate of land value is 8.4 percent of the total property value indicated by the income capitalization approach. The estimate, which is slightly below the typical range, reflects the suburban nature of the subject property.

Combining the improvement cost, the FF&E cost, soft costs, opening costs, developer's costs, and land value produces the total replacement cost for the proposed Spring Valley hotel.

Improvements	\$14,650,000
FF&E	4,500,000
Soft costs	1,923,000
Opening costs	2,090,000
Developer's costs	587,000
Land value	<u>2,600,000</u>
Total replacement cost	\$26,350,000

To estimate the market value by the cost approach, the profit realized by the developer must be added to the total replacement cost. Assuming a developer would be satisfied with a profit equal to 17.5 percent of the total replacement cost, the market value by the cost approach would be:

Total replacement cost	\$26,350,000*
Developer's profit	× <u>1.175</u>
	\$30,961,250
Indicated market value by cost approach (rounded)	\$31,000,000

INCOME CAPITALIZATION APPROACH

Mortgage Component

Based on an analysis of the current lodging industry mortgage market, and adjusting for specific factors such as the property's location, local hostelry market conditions, age, and operating history, it appears that a 10.5 percent interest, 30-year amortization mortgage with a .109769 debt service constant would be appropriate for the proposed subject property. A mortgage lender would probably find it worthwhile to lend up to 75 percent of the subject's market value as determined by this appraisal.

Equity Component

Given the assumed 75 percent loan-to-value ratio, the age, condition and anticipated market position of the subject property, as well as the risk inherent in achieving the projected income stream, an equity investor will probably require a 10.5 percent average annual cash-on-cash return over a three-year build-up to a stabilized year of operations.

Valuation of Mortgage and Equity Components

The property's value can also be solved directly by using the simultaneous valuation formula. Given the known variables of equity investor yield requirements, two equations are set up with the following values assigned to the variable components for the subject property:

- M = 75% loan-to-value ratio
- R_e = 10.5% equity dividend rate
- f = .109769 debt service constant
- 1/Sⁿ = discount factor at equity dividend rate of 10.5%

	<u>Forecasted net income</u>
NI ¹ =	\$1,380,000
NI ² =	2,588,000
NI ³ =	3,679,000

The formula is then applied to the subject property's forecasted net income as follows:

Intermediary calculation

$$(f \times M \times V) = .109769 \times .75 \times V = .082327V$$

Expressing formula in terms of V

$$(1,380,000 - .082327V) \times .0904977 + (2,588,000 - .082327V) \times .8189840 + ((3,679,000 - .082327V)/1.105) \times .8189840 = (1 - .75V)$$

Like terms are combined and the equation is solved for V

$$\begin{aligned} 32,064,041 - .784062V &= (1 - .75)V \\ 32,064,041 - .784062V &= .25V \\ 32,064,041 &= 1.03406V \\ V &= 32,064,041/1.03406 \\ V &= \$31,007,844 \end{aligned}$$

Indicated market value by the income approach (rounded) \$31,000,000

Proof of Value

The simultaneous valuation formula calculates the value of the mortgage and equity components, which derive their desired rates of return from the forecasted net income. The following calculations prove this hypothesis:

	<i>Assumed terms</i>
Mortgage component	
Percentage of total value	75%
Interest (rate of return)	10.5%
Mortgage constant	109769
Equity component	
Percentage of total value	25%
Equity dividend (rate of return)	10.5%

The allocation of the indicated market value between the mortgage and equity components is as follows:

Mortgage component (75%)	\$23,250,000
Equity component (25%)	<u>7,750,000</u>
Indicated market value	\$31,000,000

The annual debt service is the mortgage component multiplied by the mortgage constant:

Mortgage component	\$23,250,000
Mortgage constant	<u>.109769</u>
Annual debt service	\$ 2,550,000

The net income to equity (equity dividend) is the forecasted net income less the debt service. Upon deducting debt service, the mortgage component's rate of return requirements are fulfilled, establishing the value of the mortgage component.

	1987	1988	Stabilized
Net income	\$ 1,380,000	\$2,588,000	\$3,679,000
Less: Debt service	<u>2,550,000</u>	<u>2,550,000</u>	<u>2,550,000</u>
Net income to equity	\$(1,170,000)	\$ 38,000	\$1,129,000

The value of the equity component is calculated by capitalizing the stabilized net income to equity at the equity dividend rate. This stabilized, or reversionary, value is then discounted to the date of value at the equity dividend rate. The net income to equity for each of the intervening build-up years is also discounted to the date of value. The sum of these discounted values equates to the value of the equity component.

Stabilized equity value

$$\frac{\$1,129,000}{.105} = \$10,752,000$$

The discounted value of the stabilized equity value and the net equity during the intervening build-up years are as follows:

Year	<i>Forecasted net to equity and stabilized equity value</i>	<i>Discount rate @ 10.5%</i>	<i>Discounted value</i>
1987	\$(1,170,000) ×	.905273	= \$(1,059,000)
1988	38,000 ×	.819520	= 31,000
Stabilized	10,752,000 ×	.819520	= <u>8,812,000</u>
			\$ 7,784,000

Value of the equity component (rounded) \$ 7,750,000

This proof demonstrates that the forecasted net income is exactly sufficient to pay the required debt service on a \$23,250,000 mortgage and provide a 10.5 percent cash-on-cash equity dividend on an \$7,750,000 equity investment. The sum of the \$23,250,000 mortgage component and \$7,750,000 equity component results in the \$31,000,000 indicated market value by the income approach.

TEN-YEAR INTERNAL RATE OF RETURN CALCULATION AND DISCOUNTED CASH FLOW ANALYSIS

The following cash flow analysis is based upon the ten-year projection of net income found in Table 2. The subject property's net income before debt service is projected forward for ten years, from 1990 through 1999, based on the forecast of income and expense. The ratio of net income before debt service to total revenue is assumed to remain constant from the stabilized year (1992) forward. An overall inflation

PROPERTY VALUATION

TABLE 2
Ten-Year Forecast of Net Income to Equity for Proposed Hotel (in thousands)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Number of rooms	300	300	300	300	300	300	300	300	300	300
Occupancy	59.0%	67.0%	72.0%	72.0%	72.0%	72.0%	72.0%	72.0%	72.0%	72.0%
Average rate	\$ 93.10	\$ 103.07	\$ 113.96	\$ 119.66	\$ 125.64	\$ 131.92	\$ 138.52	\$ 145.45	\$ 152.72	\$ 160.35
Rooms revenue	6,015	7,562	8,985	9,434	9,906	10,401	10,921	11,467	12,040	12,642
Net income before debt service	1,380	2,588	3,679	3,863	4,056	4,259	4,472	4,696	4,931	5,178
Debt service	2,550	2,550	2,550	2,550	2,550	2,550	2,550	2,550	2,550	2,550
Net income to equity	<u>(\$1,170)</u>	<u>\$ 38</u>	<u>\$1,129</u>	<u>\$1,313</u>	<u>\$1,506</u>	<u>\$1,709</u>	<u>\$1,922</u>	<u>\$2,146</u>	<u>\$2,381</u>	<u>\$2,628</u>

rate of 5 percent per year is applied to both revenue and expense; therefore, net income increases annually at 5 percent.

The internal rate of return calculation assumes a sale at the end of the ten-year holding period. The sales price is calculated by capitalizing the eleventh year's net income by an overall rate of 11 percent. This assumes that a seller or potential purchaser at the end of the tenth year will look forward to the forecasted eleventh year net income to determine a sales or purchase price. The 11 percent overall "going-out" rate compares with an overall "going-in" rate (stabilized net income in current dollars divided by the property's value) of 10.76 percent. An increase is made in the overall rate to account for the added age of the property and the risk of forecasting ten years into the future.

The net proceeds to equity upon sale of the property is determined by deducting sales expenses (brokerage and legal fees) and the outstanding mortgage balance:

Eleventh year net income	\$ 5,437,000
Overall capitalization rate	.11
Gross sales proceeds	49,427,000
Less: Brokerage and legal @ 3%	1,483,000
Outstanding mortgage balance	21,308,000
Net proceeds to equity	\$26,636,000

The total property yield (before debt service), yield to the lender, and yield to the equity position are as follows:

Position	Value	Projected yield (internal rate of return) over 10-year holding period
Total property	\$31,000,000	14.1%
Lender	23,250,000	10.5
Equity	7,750,000	20.0

Based on the quality of the proposed subject property, its location, competitive environment, and all factors impacting the economic viability of the project, these internal rates of return appear to be reasonable. The discounted cash flow procedure substantiating the yield to each position is shown in Table 3.

Modified Internal Rate of Return

The modified internal rate of return has been calculated for the subject property assuming a reinvestment rate of 12 percent. The modified internal rate of return for the total property and the equity position of the subject property over the assumed ten-year holding period are 13.6 percent for the total property value and 19.1 percent for equity value assuming a reinvestment rate of 12 percent.

TABLE 3
Internal Rates of Return for Proposed Hotel

Total property yield (IRR 14.1%)

Year	Net income before debt service		Present worth of \$1 @ 14.1%	Discounted cash flow
1990	\$ 1,380,000	×	.876063	= \$ 1,209,000
1991	2,588,000	×	.767487	= 1,986,000
1992	3,679,000	×	.672367	= 2,474,000
1993	3,863,000	×	.589036	= 2,275,000
1994	4,056,000	×	.516033	= 2,093,000
1995	4,259,000	×	.452078	= 1,925,000
1996	4,472,000	×	.396049	= 1,771,000
1997	4,696,000	×	.346964	= 1,629,000
1998	4,931,000	×	.303962	= 1,499,000
1999	53,122,000 ¹	×	.266290	= 14,146,000
Total property value				\$31,007,000

¹ 10th year net income before debt service of \$5,178,000 plus sale proceeds of \$47,944,000

(continued)

TABLE 3 (continued)

Mortgage component yield (IRR 10.5%)

Year	Debt service		Present worth of \$1 @ 10.5%	=	Discounted cash flow
1990	\$ 2,553,000	×	.905274	=	\$ 2,331,000
1991	2,553,000	×	.819521	=	2,092,000
1992	2,553,000	×	.741891	=	1,894,000
1993	2,553,000	×	.671614	=	1,715,000
1994	2,553,000	×	.607995	=	1,552,000
1995	2,553,000	×	.550402	=	1,405,000
1996	2,553,000	×	.498264	=	1,272,000
1997	2,553,000	×	.451066	=	1,152,000
1998	2,553,000	×	.408338	=	1,042,000
1999	23,861,000 ²	×	.369658	=	8,820,000
Value of mortgage component					\$23,256,000

² 10th year debt service of \$2,553,000 plus outstanding mortgage balance of \$21,308,000

Equity component yield (IRR 20.0%)

Year	Net income to equity		Present worth of \$1 @ 20.0%	=	Discounted cash flow
1990	\$ (1,173,000)	×	.833644	=	\$ (978,000)
1991	35,000	×	.694962	=	24,000
1992	1,126,000	×	.579350	=	652,000
1993	1,310,000	×	.482972	=	633,000
1994	1,503,000	×	.402626	=	605,000
1995	1,706,000	×	.335647	=	573,000
1996	1,919,000	×	.279810	=	537,000
1997	2,143,000	×	.233262	=	500,000
1998	2,378,000	×	.194457	=	462,000
1999	29,261,000 ³	×	.162108	=	4,743,000
Value of equity component					\$7,752,000

³ 10th year net income to equity of \$2,625,000 plus net sale proceeds to equity of \$26,636,000

The lowered yields to each position reflect the impact of a more conservative reinvestment rate of 12 percent. The yields to each position remain strong under this assumption and indicate the underlying strength of the investment.

Property Appreciation

Based on the discounted cash flow analysis, the value of the subject property is estimated to increase at an annual compound rate of 4.8 percent per year over the assumed ten-year holding period, resulting in a total property appreciation of 59 percent. This appreciation rate is conservative and reasonable when compared with the assumed annual inflation rate of 5 percent.

TABLE 4

Break-even Points for Proposed Hotel

	After debt service	Before debt service
Number of rooms	300	300
Occupancy	64%	44%
Average rate	\$113.96	\$113.96
Revenues		
Rooms	\$ 7,927	\$ 5,539
Food	4,050	3,348
Beverage	1,782	1,473
Telephone	403	295
Other income	511	437
Total	\$14,673	\$11,092
Departmental Expenses		
Rooms	\$ 1,949	\$ 1,757
Food and beverage	4,460	4,123
Telephone	383	344
Other income	314	292
Total	\$ 7,106	\$ 6,516
Departmental Income	\$ 7,567	\$ 4,576
Undistributed Operating Expenses		
Administrative and general	\$ 1,291	\$ 1,202
Management fee	440	333
Marketing	776	722
Property, operations, and maintenance	742	673
Energy	696	681
Total	\$ 3,945	\$ 3,611
Income Before Fixed Charges	\$ 3,622	\$ 965
Fixed Charges		
Taxes	\$ 479	\$ 479
Insurance	153	153
Reserve for replacement	440	333
Total	\$ 1,072	\$ 965
Net Income Before Debt Service	\$ 2,550	\$ 0
Debt Service	\$ 2,550	
Net Income After Debt Service	\$ 0	

Return Components

In evaluating the risk associated with an investment, it is useful to determine the portions of a property's value that are attributable to annual cash flow and reversionary proceeds upon sale. The larger the percentage of value attributable to reversionary proceeds, the greater the risk, because the projected sales price of a property and the resulting appreciation is at best uncertain at the end of the assumed ten-year holding period.

PROPERTY VALUATION

Based upon the ten-year discounted cash flow analysis in Table 3, a calculation shows that 58.8 percent of the property's estimated value is attributable to cash flow and 41.2 percent is attributable to property appreciation. These percentages, which typically fall within the range of 55 to 65 percent for cash flow and 35 to 45 percent for appreciation, are reasonable for a property of this nature.

Debt Coverage Ratio

The projected net income before debt service provides for a debt coverage ratio (net income divided by debt service) of 1.44 in the stabilized year of operation. Lenders active in hotel financing are currently requiring debt coverage ratios of between 1.25 and 1.45 in the stabilized year of operation. The subject's projected debt coverage ratio of 1.44 in the stabilized year is at the high end of this range and provides a reasonable margin of cash flow to cover annual debt service.

BREAK-EVEN ANALYSIS

The break-even occupancy level for the subject property has been estimated using the occupancy, average rate, and operating ratios for the property's stabilized year. The income and expense statement

shown in Table 4 sets forth the break-even points for the subject property before and after debt service, which is calculated as follows:

Mortgage component	\$23,250,000
Mortgage constant	<u>.109769</u>
Annual debt service	\$ 2,550,000

The proposed subject property will require a 64 percent occupancy to break even after debt service, and a 44 percent occupancy level to cover all operating expenses and break even before debt service. With a projected stabilized occupancy level of 72 percent a sufficient cushion exists to cover debt service during the normal cyclical occupancy trends experienced by area lodging facilities.

FEASIBILITY

The cost approach and income approach have established that the proposed Spring Valley hotel has a total replacement cost of \$26,350,000 and a total economic value of \$31,000,000. When the project is complete and has an economic value of \$31,000,000, the developer's profit will be 17.5 percent of the total replacement cost, which is a sufficient margin of profit, and so the proposed Spring Valley hotel can be deemed economically feasible.

PART III

**Hotel Management
and Franchises**

CHAPTER 15

Property Management

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15.01 **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, which can range from booking convention business or running a high-energy lounge to installing night audit financial controls or handling a defective proofing box. The skills needed to handle such problems can be acquired through college-level training and operational experience, but 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 appealing from the perspective of cost, 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 in order 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 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, possibly 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 duplicate. 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.

This range of experience and resources, available on an "as-needed" basis, is an important advantage gained by engaging a professional hotel management company.

[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 where 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. By leaving nothing to chance and having set methods 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 a similar conclusion, the number

of hotel properties managed by third party operators has grown significantly over the past 20 years. This trend is further substantiated by hotel lenders, who typically require that a competent hotel company be included in the project team.

15.02 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.

[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 following percentages of various revenues realized by the property:

	<i>Percentage of total</i>
Rooms revenue	25
Beverage revenue	10
Food revenue	5
Other income	20

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.

[2] Advantages and Disadvantages

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. Mortgage financing is easier to obtain in these situations and owners can often obtain 100 percent financing.
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, much of the existing business is often diverted to other hotels managed by the operator so 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.

On the other side of the coin, 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.

Generally, 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. In addition, leasehold interests create contingent liabilities on corporate balance sheets that can adversely affect the value of stock in publicly traded companies.

15.03 **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, while assuming a passive position with respect to operating decisions, assumes 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 kind of 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 providing operational expertise and name recognition. Chains such as Hilton International, Hyatt, Sheraton, Western International (Westin), and Intercontinental were among the hotel companies that used management contracts to expand their bases of operations worldwide.

Once hotel companies discovered 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. By the end of the 1980s, only a few hotel property leases are still in effect; those that remain date from the 1950s–1960s and are now nearing the ends of their terms.

15.04 **PROPERTY LEASES VS. MANAGEMENT CONTRACTS**

The following example 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).

TABLE 15.1
Assumed Occupancy and Average Room Rates

Year	Hotel A (Normal Occupancy Build-Up)		Hotel B (Low Occupancy Build-Up)	
	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 Table 15.1, 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 Tables 15.2 and 15.3. 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 percent (based on total revenue) has been deducted as well as a 2.5 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 following tables. The terms for these structures are based on typical provisions found in the marketplace. It should be noted that hotel property leases are no longer common so 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 as follows:

	<i>Percentage of total</i>
Rooms revenue	25
Beverage revenue	10
Food revenue	5
Other income	20

The actual dollar amounts yielded by this formula are shown in Table 15.4 for both hotels.

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.

Table 15.5 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

TABLE 15.2
Hotel A Projected Income and Expense

	Year #1		Year #2		Year #3		Year #4		Year #5		Year #6		Year #7	
Number of rooms	300		300		300		300		300		300		300	
Occupancy	58.00%		65.00%		70.00%		73.00%		73.00%		73.00%		73.00%	
Average rate	\$95.00		\$101.65		\$107.75		\$113.14		\$117.66		\$122.37		\$127.26	
	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross
Revenues														
Rooms	6,033	53.80	7,235	55.80	8,259	57.00	9,044	57.60	9,405	57.60	9,782	57.60	10,173	57.60
Food	3,370	30.00	3,732	29.70	4,050	27.90	4,318	27.50	4,491	27.50	4,670	27.50	4,857	27.50
Beverages	1,348	12.00	1,493	11.50	1,620	11.20	1,727	11.00	1,796	11.00	1,868	11.00	1,943	11.00
Telephone	263	2.30	294	2.30	322	2.20	344	2.20	358	2.20	373	2.20	388	2.20
Other income	208	1.90	227	1.70	245	1.70	260	1.70	270	1.70	281	1.70	292	1.70
Total	11,222	100.00	12,981	100.00	14,496	100.00	15,693	100.00	16,320	100.00	16,974	100.00	17,653	100.00
Departmental Expenses														
Rooms	1,541	25.50	1,678	23.20	1,801	21.80	1,908	21.10	1,984	21.10	2,063	21.10	2,146	21.10
Food and beverage	3,862	81.90	4,163	79.70	4,439	78.30	4,685	77.50	4,872	77.50	5,067	77.50	5,270	77.50
Telephone	292	111.00	312	106.10	331	102.80	348	101.20	362	101.10	377	101.10	392	101.00
Other income	133	63.90	141	62.10	149	60.80	157	60.40	163	60.40	170	60.50	176	60.30
Total	5,828	51.90	6,294	48.50	6,720	46.40	7,098	45.20	7,381	45.20	7,677	45.20	7,984	45.20
Departmental income	5,394	48.10	6,637	51.40	7,776	53.60	8,595	54.80	8,939	54.80	9,297	54.80	9,669	54.80
Undistributed Operating Expenses														
Administrative and general	1,053	9.40	1,117	8.60	1,178	8.10	1,236	7.90	1,285	7.90	1,337	7.90	1,390	7.90
Marketing	626	5.60	666	5.10	705	4.90	741	4.70	770	4.70	801	4.70	833	4.70
Property operations and maintenance	449	4.00	558	4.30	652	4.50	770	4.90	801	4.90	833	4.90	866	4.90
Energy	623	5.60	653	5.00	683	4.70	713	4.50	741	4.50	771	4.50	802	4.50
Total	8,751	24.60	2,994	23.00	3,218	22.20	3,460	22.00	3,597	22.00	3,742	22.00	3,891	22.00
Income before fixed charges	2,643	23.50	3,693	23.40	4,558	31.40	5,135	32.80	5,342	32.80	5,555	32.80	5,778	32.80
Fixed Charges														
Property tax	360	3.20	374	2.90	389	2.70	405	2.60	421	2.60	438	2.60	456	2.60
Insurance	120	1.10	125	1.00	130	0.90	135	0.90	140	0.90	146	0.90	152	0.90
Reserve for replacement	281	2.50	325	2.50	362	2.50	392	2.50	408	2.50	424	2.50	441	2.50
Total	761	6.80	824	6.40	881	6.10	932	6.00	969	6.00	1,008	6.00	1,049	6.00
Net income	1,882	16.70	2,869	22.00	3,677	25.30	4,203	26.80	4,373	26.80	4,547	26.80	4,729	26.80

TABLE 15.3
Hotel B Projected Income and Expense

	Year #1		Year #2		Year #3		Year #4		Year #5		Year #6		Year #7	
Number of rooms	300		300		300		300		300		300		300	
Occupancy	45.00%		48.00%		50.00%		52.00%		53.00%		54.00%		55.00%	
Average rate	\$95.00		\$101.65		\$107.75		\$113.14		\$117.66		\$122.37		\$127.26	
	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross	\$000	Percentage of gross
Revenues														
Rooms	4,681	50.70	5,343	52.10	5,899	53.20	6,442	53.80	6,829	54.10	7,236	54.30	7,664	54.60
Food	2,965	32.10	3,181	31.10	3,375	30.40	3,581	30.00	3,760	29.80	3,949	29.70	4,146	29.50
Beverages	1,186	12.80	1,272	12.40	1,350	12.20	1,432	12.00	1,504	11.90	1,580	11.90	1,658	11.80
Telephone	225	2.40	243	2.40	259	2.30	276	2.30	290	2.30	305	2.30	321	2.30
Other income	197	2.00	200	2.00	211	1.90	223	1.90	234	1.90	245	1.80	257	1.80
Total	9,244	100.00	10,239	100.00	11,094	100.00	11,954	100.00	12,617	100.00	13,315	100.00	14,046	100.00
Departmental Expenses														
Rooms	1,407	30.10	1,496	28.00	1,578	26.80	1,664	25.80	1,743	25.50	1,825	25.20	1,911	24.90
Food and beverage	3,600	86.70	3,807	85.50	4,002	84.70	4,208	83.90	4,400	83.60	4,601	83.20	4,810	82.90
Telephone	277	123.10	292	120.30	306	118.10	321	116.30	385	115.50	350	114.80	365	113.70
Other income	126	67.40	133	66.50	139	65.90	146	65.50	152	65.00	159	64.90	166	64.60
Total	5,410	58.50	5,728	55.90	6,025	54.30	6,339	53.00	6,630	52.50	6,935	52.10	7,252	51.60
Departmental income	3,834	41.40	4,511	44.20	5,069	45.70	5,615	47.10	5,987	47.50	6,380	47.90	6,794	48.40
Undistributed Operating Expenses														
Administrative and general	1,013	11.00	1,063	10.40	1,112	10.00	1,163	9.70	1,214	9.60	1,266	9.50	1,320	9.40
Marketing	597	6.50	628	6.10	657	5.90	689	5.80	719	5.70	750	5.60	783	5.60
Property operations and maintenance	370	4.00	440	4.30	499	4.50	697	5.80	729	5.80	762	5.70	796	5.70
Energy	614	6.60	641	6.30	668	6.00	696	5.80	725	5.70	755	5.70	786	5.60
Total	2,594	28.10	2,772	27.10	2,936	26.40	3,245	27.10	3,387	26.80	3,533	26.50	3,685	26.30
Income before fixed charges	1,240	13.20	1,739	17.10	2,133	19.30	2,370	20.00	2,600	20.70	2,847	21.40	3,109	22.10
Fixed Charges														
Property tax	360	3.90	374	3.70	389	3.50	405	3.40	421	3.30	438	3.30	456	3.20
Insurance	120	1.30	125	1.20	120	1.20	135	1.10	140	1.10	146	1.10	152	1.10
Reserve for replacement	231	2.50	256	2.50	277	2.50	299	2.50	315	2.50	333	2.50	351	2.50
Total	711	7.70	755	7.40	796	7.20	839	7.00	876	6.90	917	6.90	959	6.80
Net income	529	5.60	984	9.70	1,337	12.10	1,531	13.00	1,724	13.80	1,930	14.50	2,150	15.30

TABLE 15.4
Projected Rent

Hotel A (normal occupancy build-up) (\$000)							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Rooms	\$1,508	\$1,809	\$2,065	\$2,261	\$2,351	\$2,446	\$2,543
Food	169	187	203	216	225	234	243
Beverage	135	149	162	173	180	187	194
Other income	<u>42</u>	<u>45</u>	<u>49</u>	<u>52</u>	<u>54</u>	<u>56</u>	<u>58</u>
Total rent	\$1,853	\$2,190	\$2,478	\$2,702	\$2,809	\$2,922	\$3,039

Hotel B (low occupancy build-up) (\$000)							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Rooms	\$1,170	\$1,336	\$1,475	\$1,611	\$1,707	\$1,809	\$1,916
Food	148	159	169	179	188	197	207
Beverage	119	127	135	143	150	158	166
Other income	<u>37</u>	<u>40</u>	<u>42</u>	<u>45</u>	<u>47</u>	<u>49</u>	<u>51</u>
Total rent	\$1,475	\$1,662	\$1,821	\$1,977	\$2,092	\$2,213	\$2,341

TABLE 15.5
Division of Hotel A Net Income Under Property Lease (\$000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net income	\$1,882	\$2,869	\$3,677	\$4,203	\$4,373	\$4,547	\$4,729
Plus RE tax	360	374	389	405	421	438	456
Less rent	<u>1,853</u>	<u>2,190</u>	<u>2,478</u>	<u>2,702</u>	<u>2,809</u>	<u>2,922</u>	<u>3,039</u>
Net to tenant	\$ 389	\$1,053	\$1,588	\$1,906	\$1,985	\$2,063	\$2,146
Rent	\$1,853	\$2,190	\$2,478	\$2,702	\$2,809	\$2,922	\$3,039
Less RE tax	<u>360</u>	<u>374</u>	<u>389</u>	<u>405</u>	<u>421</u>	<u>438</u>	<u>456</u>
Net to landlord	\$1,493	\$1,816	\$2,089	\$2,297	\$2,388	\$2,484	\$2,583

TABLE 15.6
Division of Hotel A Net Income Under Management Contract (\$000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Basic fee	\$ 337	\$ 389	\$ 435	\$ 471	\$ 490	\$ 509	\$ 530
Plus incentive fee	<u>231</u>	<u>330</u>	<u>412</u>	<u>466</u>	<u>485</u>	<u>505</u>	<u>525</u>
Net to management company	\$ 568	\$ 719	\$ 847	\$ 937	\$ 975	\$1,014	\$1,055
Net income	\$1,882	\$2,869	\$3,677	\$4,203	\$4,373	\$4,547	\$4,729
Less management fee	<u>568</u>	<u>719</u>	<u>847</u>	<u>937</u>	<u>975</u>	<u>1,014</u>	<u>1,055</u>
Net to owner	\$1,314	\$2,150	\$2,830	\$3,266	\$3,398	\$3,533	\$3,674

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. The tenant is assumed to own the furniture, fixtures and equipment, so a reserve for replacement has not been deducted from the net to the landlord.

TABLE 15.7
Division of Hotel B Net Income Under Property Lease (\$000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Net income	\$ 529	\$ 984	\$1,337	\$1,531	\$1,724	\$1,930	\$2,150
Plus RE tax	360	374	389	405	421	438	456
Less rent	<u>1,475</u>	<u>1,662</u>	<u>1,821</u>	<u>1,977</u>	<u>2,092</u>	<u>2,213</u>	<u>2,341</u>
Net to tenant	\$ (586)	\$ (304)	\$ (95)	\$ (41)	\$ 53	\$ 155	\$ 265
Rent	\$1,475	\$1,662	\$1,821	\$1,977	\$2,092	\$2,213	\$2,341
Less RE tax	<u>360</u>	<u>374</u>	<u>389</u>	<u>405</u>	<u>421</u>	<u>438</u>	<u>456</u>
Net to landlord	\$1,115	\$1,288	\$1,432	\$1,572	\$1,671	\$1,775	\$1,885

TABLE 15.8
Division of Hotel B Net Income Under Management Contract (\$000)

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7
Basic management fee	\$ 277	\$ 307	\$ 333	\$ 359	\$ 379	\$ 399	\$ 421
Plus incentive fee	<u>96</u>	<u>143</u>	<u>180</u>	<u>201</u>	<u>222</u>	<u>245</u>	<u>269</u>
Net to management company	\$ 373	\$ 450	\$ 513	\$ 560	\$ 601	\$ 644	\$ 690
Net income	\$ 529	\$ 984	\$1,337	\$1,531	\$1,724	\$1,930	\$2,150
Less management fee	<u>373</u>	<u>450</u>	<u>513</u>	<u>560</u>	<u>601</u>	<u>644</u>	<u>690</u>
Net to owner	\$ 156	\$ 534	\$ 824	\$ 971	\$1,123	\$1,286	\$1,460

The terms of the management contract assume a basic management fee of three percent of total revenue plus an incentive fee equal to ten percent of house profit (income before fixed charges) after deducting the 3 percent base fee.

Table 15.6 shows how the net income for Hotel A is divided between the hotel company and 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 can be made for Hotel A by totalling the income to each party over a seven-year period assuming both a lease and management contract:

	<i>Management company</i>	<i>Property owner</i>
Lease	\$11,130,000	\$15,150,000
Management contract	6,115,000	20,165,000

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. Table 15.7 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.

Table 15.8 assumes a management contract structure for Hotel B and shows how the net income is shared between the hotel company and property owner.

Comparing each structure by totalling the income to each party over the seven-year period produces the following figures for Hotel B:

	<i>Management company</i>	<i>Property owner</i>
Lease	\$ (553,000)	\$10,738,000
Management contract	\$3,831,000	\$ 6,354,000

Under this scenario, it is apparent that 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 over \$550,000 during the first seven years of operation. For many of the smaller hotel companies, this degree of exposure is not acceptable.

In Table 15.9, the risk shifting aspects of a total property lease and a management contract are summarized by defining the economic benefit of a hotel investment as the total net income before debt service and listing the percentage of this benefit realized by the hotel company and the property owner.

As shown in Table 15.9, the property owner receives the greatest economic benefit, ranging from 58 to 105 percent, depending on the type of agreement and operating scenario, while the hotel company never receives more than 42 percent of the net income before debt service. Comparing the economic benefits to the hotel company under a lease and management contract, it becomes apparent that the potential upside benefit from the lease is limited while the downside risk is significant. In this example, the most a hotel company would realize under a total property lease is only 42 percent of the total economic benefits compared to either 23 or 38 percent from a management contract. At the same time, the hotel company is exposed to an actual cash loss with a property lease if the hotel experiences a slow occupancy build-up. The limited upside benefits afforded by total property leases have led hotel companies in recent years to avoid this type of structure and enter instead into either management contracts or property ownership.

15.05 TYPES OF HOTEL MANAGEMENT COMPANIES

[1] First-Tier and Second-Tier

The management companies that enter into management contracts with hotel owners are generally classified as either first- or second-tier. First-tier companies operate lodging facilities for third parties under management contracts and provide day-to-day operational supervision and property management as well national or regional customer recognition through their trade names. Hilton, Hyatt, Marriott, Sheraton, and Westin are examples of first-tier management companies. Second-tier management companies also operate lodging facilities for third parties and provide day-to-

TABLE 15.9
Economic Benefits

	Management company	Property owner
Lease		
Hotel A (normal occupancy build-up)	42%	58%
Hotel B (slow occupancy build-up)	(5)	105
Management contract		
Hotel A (normal occupancy build-up)	23	77
Hotel B (slow occupancy build-up)	38	62

day supervision and management. They do not, however, provide any customer recognition through their corporate name, but make use of franchise affiliations to generate customer identification. Examples of second-tier management companies are Interstate Hotels, Boykin Management, Southern Host, Brock Hotels, and Hospitality Equity Investors.

[2] Preopening and Technical Services

In addition to daily operations, management companies also frequently contract to provide preopening services and technical services. Preopening services are provided by the management company before the opening of a facility to the public. Typical services include a preopening plan and budget, personnel recruiting and training, sales and advertising, purchasing, and establishing an account system and controls. Preopening services may be used at both newly developed hotels and existing properties that change ownership. Fees for such services are generally separate from and in addition to those charged for management supervision.

Technical services are provided by hotel management companies during the planning, design, and construction stages of a new hotel development. These services include design and facilities planning, architectural assistance and review, interior design and lighting recommendations, and mechanical and food facilities installation. Technical services are also available for the expansion and renovation of existing properties. As is the case with preopening services, fees for technical services are generally separate from and in addition to fees charged for management supervision.

15.06 ADVANTAGES AND DISADVANTAGES OF MANAGEMENT CONTRACTS

Management contracts have certain advantages and disadvantages to both the hotel company and property owner. In order to negotiate and structure an equitable agreement, both parties should understand each other's motivations for entering into a management contract.

[1] Advantages for Operator

[a] Inexpensive, Rapid Expansion

Management contracts typically require very little in the way of capital outlay on the part of the operator, so their use can make possible inexpensive and rapid chain expansion with a low level of investment. In fact, on occasion, in order to secure a management contract, hotel companies contribute working capital in the form of a loan or some other small good faith investment. The management fee set by the contract is generally structured so the basic fee, which is a guaranteed flow of income computed as a percentage of total revenue, is more than sufficient to cover the hotel company's home office overhead and operating expenses. Unlike property ownership or a total property lease, a management contract rarely requires the operator to participate in operating deficits—the downside risk in this regard is assumed by the owner, not the management company. The lead time involved with develop-

ing new hotels is eliminated for operators willing to take over existing properties. Additional supervisory staff and some home office overhead is all that is required in order to do so.

[b] Low Downside Risk

Under a management contract, the hotel owner is financially responsible for all working capital, operating expenses, and debt service. The management company has no financial exposure and essentially covers its operating expenses and makes a small profit from the basic management fee and makes an even larger profit from any incentive fee.

[c] Critical Mass

While the actual operating expense and home office cost of providing hotel management services is minimal, a critical mass of properties under contract is necessary in order to cover the cost of key operational executives and home office and support staff and still generate acceptable profits. First-tier management companies also usually offer a computerized reservation system, so their fixed overhead is generally greater than a second-tier operator. The size of the critical mass varies depending on the class and types of hotels operated, along with the nature of the services offered by the management company. Typical ranges of critical mass for a first-tier company is 40 to 50 hotels under contract; for second-tier companies, the range is usually 10 to 15 hotels.

Luxury hotels require a greater critical mass than budget operations because home office support must be more extensive. Similarly, convention-oriented chains with extensive group marketing needs require a larger critical mass than chains catering primarily to commercial travelers.

[d] Quality Control

Management contracts allow hotel companies to maintain control of both physical and operational quality. Hotel companies, particularly the more well-known first-tier chains, are always concerned about maintaining a favorable public image. A hard-earned reputation can be tarnished quickly if a single property suffers from physical and managerial neglect, so a management contract provides the necessary level of quality control for a hotel operator. With an unrestricted management policy and an adequately funded reserve for replacement, a management company has almost total control of the quality and image of its properties. In a franchise relationship, on the other hand, where a hotel merely carries a chain identification and there is no central managerial control, it is much more difficult to maintain a uniform level of quality. Several hotel chains, including Hyatt, Westin, Four Seasons, and Red Roof Inns, follow a policy of not franchising in order to have total quality and operational control over their hotels.

[e] No Depreciation Expense

Management contracts are attractive to hotel companies because the cash flow they realize is often close to what ownership of a property would provide, yet they allow

the company to avoid the depreciation expenses for which a property owner is liable. Management fees paid to hotel companies are considered ordinary income for income tax purposes, but if a hotel company owns a hotel, the income it realizes is eroded by depreciation expenses required for both the improvements and personal property under current tax regulations.

Publicly held hotel companies find management contracts particularly rewarding because they can minimize the amount of depreciation expenses shown on their income statements, thus enhancing their price/earnings ratio and making their stock more attractive to investors. As a result, public companies such as Marriott, Hilton, Holiday Inns, and Ramada have been selling the hotels they own and operating them under management contracts. The company most committed to this tactic has been Marriott, which builds for its own account in order to realize a developer's profit and soon after completion sells the real estate to a partnership and takes back a long-term management contract yielding a high percentage of the cash flow.

[2] Disadvantages for Operator

[a] **Residual Benefits of Ownership Eliminated**

Any increase in the value of a hotel generated by the management company over the course of a management contract accrues to the benefit of the owner when the hotel is sold or refinanced.

During the 1970s, many hotel companies provided short-term management contracts to real estate investment trusts (REITs) in order to assist with their distressed foreclosures. Many of the management companies that successfully reestablished cash flow and economic value in problem hotels were rewarded by losing their contracts when the properties were sold to new owners.

In the future it is likely that at least some hotel management companies will attempt to capture a portion of the upside ownership benefits by taking part in any refinancing proceeds or gain on sale as additional compensation.

[b] **Minimal Input in Ownership Decisions**

Most management agreements put few restrictions on the owner's ability to transfer ownership to another party. An undercapitalized replacement owner, for example, can restrict cash needed to cover shortfalls and adversely affect the operation and quality of the property. Also, as with any relationship, a management contract requires cooperation from both parties; a difficult owner can make life miserable for a management company by imposing any number of unreasonable demands.

[c] **Dependence on Finances of Owner**

If the cash flow generated by a hotel operation is not sufficient to cover operating expenses and debt services, the hotel operator is totally dependent on the owner for providing necessary funds. No matter how thoroughly a management company investigates the creditworthiness of a hotel owner prior to entering into an agreement, adverse circumstances can quickly deplete anyone's financial resources. The risk to a hotel management company goes beyond the inconvenience of insufficient

operating capital or a deferral of needed furniture replacement; it could ultimately result in the loss of a management contract due to bankruptcy or foreclosure. Beside the negative effect on a management company's income and reputation, such a cancellation (on the part of a bankruptcy court or foreclosing lender) seldom involves payment of a cancellation fee to the management company.

[d] Contract Termination

Hotel management contracts often contain cancellation provisions that allow owners to terminate the agreement upon payment of a stipulated cancellation fee. While the hotel operator is generally well compensated in this event, the disruption in management deployment and public identity can be damaging, especially to a first-tier operator.

[3] Advantages for Owner

[a] Acquisition of Operational Expertise

Hotel management contracts provide owners with the essential operational expertise necessary for establishing and preserving the long-term profitability of their investment. At the same time, a management contract allows owners to keep such ownership benefits as cash flow, depreciation deductions, tax benefits, value enhancement, refinancing opportunities, and possession of the property after the contract expires.

[b] Immediate Name Recognition

Some chain affiliations are only available through management contracts. A management contract with a first-tier management company immediately gives the owner's hotel a national or regional identification, which in some cases is not available from a franchise. Chains such as Hyatt, Westin, Doubletree, and Four Seasons do not franchise and will only put their names on properties they manage.

[c] Quality Management

In recent years, hotel lenders and investors have become more knowledgeable about the industry. One aspect of this increased sophistication is the emphasis now placed on quality management as a key component of a successful hotel venture. In addition to evaluating the local market for transient accommodations, the area and neighborhood characteristics, and the actual real estate itself, hotel lenders and investors take great interest in the ability and financial track record of a proposed operator. Most lenders and investors require that an established hotel management company be put in charge of the day to day operations of any hotel in which they have an interest. Some even demand that a professional hotel asset manager supervise the hotel company. If the operator is a second-tier company, it generally must have a franchise affiliation in order to attract the necessary financing. While including a nationally known hotel company as part of the project team does not guarantee financing, it

does show positive interest on the part of the operator that can favorably influence the investment decisions of the lender.

[4] Disadvantages for Owner

[a] Loss of Operational Control

A management contract gives the operator total operational control of the property. If the management company operates the hotel in a competent manner, this loss of control is not a problem. However, if the property is mismanaged, the owner may find it very difficult to remove the incompetent operator. In recent years, a greater number of management agreements have included specific standards that allow owners to terminate operators who do not achieve certain levels of performance. However, even with stringent performance criteria, the process of removing a poor management company must be timely; the reputation of the hotel can be badly damaged if new management is not quickly in place.

[b] Liability for All Ongoing Expenses

The owner of a hotel under a management contract is financially liable for all costs and expenses including fixed charges and debt service. This means that even though the manager's neglect or incompetence may actually cause the financial loss, the owner is still ultimately responsible for funding the negative cash flow. For this reason, a well-structured management contract should contain incentives for the operator to maximize revenues and minimize expenses. Deferring a portion of the management fee to be paid as a percentage of a defined level of profit creates a financial incentive for an operator to manage efficiently. Essentially, through an incentive management fee, the management company's earnings become directly tied to the profits of the hotel. The actual contractual structure of the operator's incentive fee can often create greater or less incentive. For example, if an incentive fee is based on 10 percent of income before fixed charges and paid only if there is sufficient income after debt service, the operator would have a greater incentive to maximize revenue and minimize expenses than if the incentive fee was payable whether or not a positive cash flow was generated. This formula can be further modified to produce even greater operator incentive by requiring the management company to forever forfeit the incentive fee if the income after debt service is insufficient, rather than merely deferring and accumulating the fee until repayment can be made from future cash flows.

[c] Termination of Operator

Most management agreements are difficult for owners to terminate. First-tier management companies, concerned by adverse publicity from losing their identification within a particular market, will generally require a noncancellable contract that exceeds 15 years in length. Second-tier operators will usually accept a shorter relationship, but often insist on provisions limiting the owner's ability to terminate at an earlier date. The inability of an owner to unilaterally terminate a hotel management contract for poor performance can significantly increase its exposure to financial loss. To reduce these risks, management contracts should be written with specific performance standards tied to cancellation provisions. In addition, owners often

TABLE 15.10
Cost of Management Contract

Number of rooms	300
Occupancy	73%
Average rate	\$ 113.14
Total annual revenue	\$15,693,000
Income before fixed charges	5,135,000 ²
Income before debt service	4,203,000 ²
Debt service	2,415,000 ¹
Cash flow after debt service	1,778,000 ²
Basic management fee	471,000 ³
Incentive management fee	466,000 ⁴
Total management fee	\$ 937,000
Total management fee as a percentage of the cash flow after debt service	52%

¹ \$24,150,000 mortgage @ 10% constant

² Does not include a deduction for a basic or incentive management fee

³ 3% of total revenue

⁴ 10% of income before fixed charges after deducting the 3% basic management fee

negotiate an all-purpose contract buy-out clause that allows for the removal of the management company at any time upon payment of a stipulated amount.¹

[d] **Sale of Property**

The sale of a hotel property is sometimes more difficult if it must be sold subject to an existing management contract. Hotel companies rarely purchase hotels operated by other companies. An ongoing noncancellable contract reduces the number of possible buyers (by eliminating many hotel chains from consideration) and therefore increases the time required to find a qualified buyer. In addition, the sale of a hotel with management in place will often bring a lower price than if the property were to be sold without management. A buy-out provision gives an owner the option of selling the hotel subject to the existing agreement or purchasing the contract and selling the hotel unencumbered by management. (See Chapter 16 for a discussion of such provisions.)

[e] **Cost of Management**

The cost of management can absorb a substantial portion of the cash generated by a hotel. Simply put, quality hotel management is expensive. Depending on the operator and the terms of the management contract, the total management fee, expressed as a percentage of the cash flow after debt service, can be as much as 70 to 85 percent. Table 15.10 demonstrates the high cost of a typical hotel management contract.

The cash flow shown in Table 15.10 reflects that of a stabilized operation rather than a new hotel experiencing the normal build-up. If the occupancy level was lower, as in the case of a newly opened hotel, the total management fee could exceed the cash flow after debt service, meaning the owner would have to contribute addi-

¹ This need not always be the case, however. See 15.10[8] supra for an analysis of relative bargaining positions.

tional capital to the venture. To assist owners during start-up periods and provide lenders with an additional debt service cushion, most hotel management companies will subordinate their incentive fee to debt service. This means that if the income before debt service is insufficient to cover the mortgage payment, the management company would either forgo or defer their incentive management fee.

Table 15.11 shows the effect of a subordinated incentive management fee on the operating results of a new hotel during its second start-up year. The cash flow after debt service and a basic management fee is \$65,000, indicating the property owner has only \$65,000 to cover the \$330,000 incentive fee. If the incentive fee was not subordinated to debt service, the owner would have to pay \$265,000 out-of-pocket (\$330,000 – \$65,000). However, if the incentive fee is subordinated to debt service, the \$265,000 would not be paid, because the hotel is not generating a sufficient cash flow to cover debt service. Depending on how the incentive fee is negotiated, the \$265,000 might be either forgone or deferred.

[f] High Downside Risks

Owners of lodging facilities face downside risks that are due to the high amount of fixed costs associated with the operation of a hotel or motel. As occupancies drop, losses escalate rapidly because many of the fixed hotel expenses cannot be cut back. The use of property leases shifts this downside risk from the owner to the operator, but under a management contract, any negative cash flow is the responsibility of the owner.

[g] Operator May Favor Own Property

A conflict of interest always exists when a hotel company both owns and operates properties for its own account and operates hotels for nonrelated third parties. A hotel company generally receives a greater economic benefit from sending guests to their owned hotels rather than to properties they manage, so the possibility for unfair

TABLE 15.11
Effect of Subordinated Management Fee

Number of rooms	300
Occupancy	65%
Average rate	\$101.65
Total annual revenue	\$12,981,000
Income before fixed charges	\$ 3,693,000 ²
Income before debt service	2,869,000 ²
Debt service	2,415,000 ¹
Cash flow after debt service	454,000 ²
Basic management fee	389,000 ³
Incentive management fee	330,000 ⁴
Total management fee	719,000
Cash flow after debt service and basic management fee	\$ 65,000

¹ \$24,150,000 mortgage @ 10% constant

² Does not include a deduction for a basic or incentive management fee

³ 3% of total revenue

⁴ 10% of income before fixed charges after deducting the 3% basic management fee

practices is always present. Owners should be aware of this basic conflict and be sure that management agreements include provisions restricting possible abuse.

15.07 MANAGEMENT COMPANIES

Once an owner has decided to use the services of a hotel management company, a decision must be made as to whether a first- or second-tier operator should be selected. A first-tier hotel management company provides the owner with a publicly identifiable name (e.g., Westin, Sheraton, or Marriott) and management expertise. A second-tier management company has no "brand-name" image and therefore can only offer management expertise.

[1] Advantages of First-Tier Companies

[a] **Cost**

The cost of a first-tier management company is often less than that of a second-tier operator and the requisite franchise affiliation. Second-tier management companies provide no national identification, so the cost of a franchise affiliation must be added to the second-tier management fee in order to reflect the same benefits of a first-tier company. Table 15.12 illustrates the stabilized operating results of a typical 300-room hotel that will be used to demonstrate the cost of a first- and a second-tier management company.

For a hotel of this type, a first-tier hotel management company with a national chain name would typically charge a basic fee of 3 to 4 percent of total revenue (say 3 percent) plus an incentive fee of 10 to 15 percent of a defined profit. A second-tier hotel operator would have to obtain a national franchise affiliation in order to offer the same identity as the first-tier operator. The management fee typically charged by a second-tier operator is 3 to 4 percent of total revenue (say 3 percent). A normal franchise fee for a national identification ranges from 4 to 6 percent of rooms revenue (say 5 percent). The fees paid under both scenarios would be:

First-tier management company		
Basic fee:	3% of total revenue	\$471,000
Incentive fee:	10% of income before fixed charges	<u>466,000</u>
Total		\$937,000
Second-tier management company plus franchise		
Management:	3% of total revenue	\$471,000
Franchise:	5% of rooms revenue	<u>452,000</u>
Total		\$923,000

The total fees paid under both scenarios are almost identical, indicating no financial advantage of one tier over the other. However, any variance in these fee structures would swing the advantage to one of the tiers. For example, sometimes the 10 percent of income before fixed charges cost can be negotiated to 10 percent of income after fixed charges, reducing the incentive management fee to \$373,000 and thus making the first-tier scenario more cost beneficial. It is interesting to note that some second-tier operators believe their compensation should be commensurate with a first-tier operator, so they require an incentive fee in addition to the 3 percent basic fee; this

TABLE 15.12
Stabilized Operating Results: 300-Room Hotel

Occupancy 73%	Average rate: \$113.14
Revenues	
Rooms	\$ 9,044,000
Food	4,318,000
Beverage	1,727,000
Telephone	344,000
Other income	260,000
Total	<u>15,693,000</u>
Departmental Expenses	
Rooms	1,908,000
Food and beverage	4,685,000
Telephone	348,000
Other income	157,000
Total	<u>7,098,000</u>
Departmental income	<u>8,595,000</u>
Undistributed Operating Expenses	
Administrative and general	1,236,000
Management fee	471,000
Marketing	741,000
Property operations and maintenance	770,000
Energy	713,000
Total	<u>3,931,000</u>
Income before fixed charges	<u>4,664,000</u>
Fixed Charges	
Property taxes	405,000
Insurance	135,000
Reserve for replacement	392,000
Total	<u>932,000</u>
Income after fixed charges	<u>\$ 3,732,000</u>

almost always makes signing on a second-tier management company and a franchise affiliation less advantageous for a hotel owner.

This example also demonstrates the economic cost of the management and brand name components to the property owner. Both tiers show similar total costs, but it is useful to compare the second-tier component costs of management and franchise with the first-tier structure of basic and incentive fees. It is obvious that the 3 percent basic management fee represents the cost of obtaining management expertise and the incentive fee of 10 percent of income before fixed charges represents the additional cost of the brand name, national image, and reservation system. Understanding these costs is important when negotiating a management agreement and selecting a franchise identification.

[b] Corporate Identity

First-tier companies have a strong interest in running successful operations. Consequently, some chain affiliations, as previously noted, are only available by management contract; certain companies, such as Westin, Hyatt, Doubletree, Four Seasons, and Stouffers, do not franchise and will only allow their names to be used when operating under a management contract. The primary reason these companies have

for not franchising is the desire to maintain total control over the operational and physical quality of the property.

[c] More Efficient Operations

First-tier companies, perhaps because they are complete operating entities, tend to be more unified and seem to have a better ability to implement company managerial and operational philosophies than do second-tier companies operating under a franchise affiliation. For example, on-site first-tier management personnel are often more familiar with the chain's home office systems, procedures, and personnel and can take greater advantage of the various services offered than can second-tier personnel in a similar situation. A franchise affiliation tends to be more detached and the productive interaction between the property and home office is frequently reduced.

[d] Convention and Group Sales Capability

Convention and group sales require a very specialized form of marketing that necessitates a massive capital investment in order to gather information detailing the specific meeting requirements of associations, organizations, corporations, and groups. It takes years of effort to assemble this information into a usable format. Since the data are so specialized, only a few hotel chains, such as Marriott, Westin, Hilton, and Hyatt, have made the investment in this infrastructure and effectively use it for group sales. Most franchise organizations and second-tier hotel operators do not accumulate the information that would enable them to compete in the convention and group sales markets with first-tier companies.

[e] Ease of Financing

First-tier hotel management companies tend to be more "financible"; that is, lenders in the hotel field, as well as equity investors, are often more comfortable lending money to projects operated by recognizable, "brand-name" management companies. Whether the perception that a name operator reduces risk is correct or not, first-tier hotel management companies usually find it easier to acquire financing than do most second-tier operators.

[2] Disadvantages of First-Tier Companies

[a] Restrictions on Property Size

First-tier hotel management companies do not often manage smaller properties; most first-tier companies have size requirements for the hotels they will operate under a management contract. Generally, hotels of fewer than 250-300 units are considered too small by these operators. First-tier companies believe that their organizational structure and overhead cannot be sustained by such smaller properties. Exceptions are made, however, for factors such as desirable locations or unique property characteristics that would make a particular contract attractive to a management company.

[b] Restrictions on Financial Condition

First-tier hotel management companies are concerned about their image and the negative affect that adverse publicity might have on their name and reputation. For this reason, first-tier companies generally avoid involvement with financially distressed hotels because of the increased likelihood that their name might be associated with a bankruptcy or foreclosure.

[c] Restrictions on Contract Terms

The term of contract for a first-tier management company tends to be longer than that for a company in the second tier. Most first-tier companies require contract terms of at least 15 to 20 years; some of the major hotel chains want terms extending for more than 50 years. A first-tier operator is actually granting a license for the use of its name, so management contracts with first-tier operators incorporate many of the same provisions as a franchise agreement. First-tier lodging chains operating under a nationally recognizable trade name generally want to maintain a presence at a particular location for an extended period of time. A short-term contract, which would allow the removal of the trade name of the first-tier company from the property after a relatively short amount of time, might result in an appearance of instability and thus undermine the traveling public's image of the company.

[d] Restrictions on Terminations

Termination provisions are often more difficult to obtain from a first-tier hotel management company because it has its name, and therefore its reputation, prominently displayed on the hotels it manages. Given this stake, first-tier companies must be careful to present to their customers the appearance of long-term stability. Early contract termination generates adverse publicity for the operator, so management companies are reluctant to provide the property owner with any form of termination provision that might end a contract early. Over the past several years, the use of performance termination standards has become increasingly more accepted by both first- and second-tier companies. Generally tied to some specified level of profits, these performance criteria allow owners to terminate operators who fail to achieve satisfactory results. First-tier companies usually negotiate for the most liberal standard possible so that they will be able to hold onto a contract for a longer period of time. In some instances, an option to remedy a performance shortfall is negotiated that enables the operator to continue managing despite poor performance.

[e] Less Flexibility in Negotiations

First-tier hotel companies tend to have more rigid requirements than do second-tier companies when it comes to the specific terms of a management contract. Provisions such as a reduced length of term, performance cancellations, contract buy-out, and exclusive operating territories are more difficult to obtain. This inflexibility might be attributable to the general sense that first-tier hotel companies have a stronger bargaining position and can impose stricter terms on less experienced owners.²

² This need not always be the case, however. See 15.10[8] *supra* for an analysis of relative bargaining positions.

[f] Difficulty of Negotiations

The actual negotiating process between a first-tier hotel company and a property owner can be longer and more difficult than that involving most second-tier operators. Large hotel companies usually use experienced mid- to upper-level executives to perform the actual negotiating, and while these employees have the authority to develop the specific terms of an agreement, the final structure is generally subject to the approval of a higher level executive committee. Often this committee will want to make changes to the agreement, and the negotiating process must then be resumed. Second-tier hotel companies are generally smaller and usually less formal in their negotiating procedures, so property owners can often deal directly with the company's decision maker, facilitating the approval process considerably.

[g] Operating Information Difficult to Obtain

Some of the most critical information needed to fully evaluate the ability of a hotel management company is actual operating data (specifically, profit and loss statements) from properties similar to the hotel under consideration. Without these statements, a property owner cannot verify that the management company is capable of running an efficient operation. Most hotel companies that have proven track records find little difficulty in allowing owners to confidentially review their financial statements. First-tier management companies tend to be more restrictive than second-tier companies in releasing operating information and other data pertaining to their management ability. Again, this seeming lack of cooperation may be attributable to a sense of superior bargaining power, but it should not be permitted to lead to refusal of an owner's legitimate request for necessary information.

[3] Advantages of Second-Tier Companies**[a] Flexibility in Negotiations**

Second-tier management companies are basically less strict in their overall requirements than are first-tier companies. In particular, they are more likely to accept shorter contract terms, agree to more demanding performance criteria, and allow more reasonable buy-out provisions. This flexibility, in addition to a general willingness to quickly structure management contracts and take over a wide variety of operations, causes them to be preferred by lenders looking for interim hotel management after a foreclosure.

[b] Individual Attention

Smaller management companies are likely to give properties more individual attention. Most second-tier hotel management companies are smaller than first-tier operators, so they often can provide a hotel with more individual high-level management attention. This ability is important for distressed hotels that require specialized work-out experience (i.e., experience with improving poor operating performance) not typically available from most property-level general managers. Unique properties facing unusual markets and/or competition can also benefit from smaller management companies that are capable of providing intensive expertise.

Second-tier hotel management companies are thus more likely to manage the more unique hotels: those that are, for example, small, distressed, in specialized

markets or in secondary locations. First-tier hotel companies do not generally become involved with such properties, because they do not fit their quality level or style of operation. As a result, they tend to pass up opportunities involving distressed hotels or those properties where the chance for success is either limited or in doubt. One change that has taken place recently with larger chains is that their minimum size requirements have begun to shrink as increased competition forces them to downscale their products and consider penetrating the secondary and tertiary lodging markets.

[4] Disadvantages of Second-Tier Companies

[a] Financing More Difficult to Obtain

Most second-tier management companies are not as attractive to lenders as first-tier operators. Lenders and institutional investors usually try to minimize their exposure to risk by always using the services of a "name brand." They believe that if a known hotel company is operating their property, they cannot be blamed for selecting an incompetent operator should the project encounter financial difficulties. This sense of security is not wholly justified, because some first-tier hotel management companies have actually performed quite poorly in the past.

[b] Perceived Risk

The perceived risk of using a second-tier management company is higher for much the same reason as the lack of available financing. First-tier hotel companies have a name recognition benefit that gives them a low-risk image. Whether or not this is justified, it does create the perception that second-tier operators will make a project more risky. Higher perceived risks are more difficult to finance and generally increase the cost and decrease the availability of both debt and equity capital.

[c] Possible High Cost

As previously mentioned, the services of a second-tier hotel management company, combined with a national franchise, can sometimes cost more than a first-tier operator that provides both operational expertise and name recognition in one package. In addition, some second-tier management companies believe that they can structure a management fee formula on the same basis as a first-tier operator. The resulting compensation is often not at all commensurate with the benefits provided.³

[d] Lack of Financial Strength

Second-tier hotel companies do not always have the necessary financial strength to make meaningful investments in a property or to guarantee operating results. The current investment climate, in which tax benefits have been greatly reduced, has caused many property owners to require that hotel management companies make some form of capital contribution in order to obtain a management contract. This investment can take many forms, including preopening services; initial inventories

³ For a discussion of the possible high cost of second-tier management companies in comparison to first-tier companies, see 15.07[1][a] supra.

and operating supplies; working capital; furniture; fixtures; and equipment; operating losses during start-up; and debt service guarantees. The net worth of the smaller second-tier hotel companies often does not allow this type of investment and therefore they have a difficult time obtaining a financial interest in property. In addition, many owners believe that an operating company should have a monetary commitment in the property in order to have a sufficient incentive to do well.

15.08 **MANAGEMENT COMPANY OPERATING PHILOSOPHIES**

In order to properly evaluate hotel management companies, property owners should be familiar with the two basic operating philosophies found in the industry. Management companies generally have either a highly centralized management structure or use a decentralized organizational approach. Both philosophies can produce desirable results, but the manner in which the results are achieved will be markedly different. For this reason, property owners should select the type of company whose methods most easily lend themselves to the characteristics of their individual properties.

[1] **Centralized Management**

An example of a highly centralized hotel management company is the Marriott Corporation. Marriott employs thousands of people to supervise the management of its hotels and restaurants. All aspects of Marriott's hotel management system are contained in manuals that cover every conceivable eventuality. These reference guides provide on-site management with information regarding topics such as how to prepare a prime rib dinner from a standardized recipe, what to do in the event of a bomb scare, where to purchase operating supplies, and how to update a marketing plan for the next accounting period. This sort of centralized operating philosophy leaves little to chance or human error, because virtually everything involving the operation of a hotel has already been thought through and the proper solution set forth in clear language. Employees on the property level, particularly those with minimum skills or experience, are given very little latitude in the interpretation of the policies set forth in the procedure manuals. The end result is a highly structured and standardized hotel operation in which individual creativity is minimized. This type of philosophy promotes tight operating controls, because anything outside of the norm, such as high food or labor costs, is readily apparent from financial statements or other control systems. The most significant drawback to a highly centralized hotel management philosophy is that it can be difficult to modify procedures in order to meet local conditions or customs.

Marriott Corporation has one of the most centralized hotel operating systems in the industry. The massive layer of operational control, which has been developed over the past 30 years, has enabled Marriott to expand rapidly while maintaining a consistent product and an extremely profitable company.

[2] **Decentralized Management**

On the opposite end of the spectrum is another respected, highly successful hotel management company, the Hyatt Corporation, which runs its hotels in a very decen-

tralized manner. In the Hyatt system, on-site managers are given a broad latitude in forming property-level operating systems and procedures. Hyatt does provide general guidelines from their home office, but managers are allowed wide discretion regarding the manner in which they operate their property. The primary advantage of a decentralized operating philosophy is that it encourages individual creativity, which can be beneficial in the hospitality industry. Hyatt employees are encouraged to constantly modify and update their methods in order to meet the changing needs and expectations of the market.

Most hotel management companies tend toward decentralized management. Hotel owners should be aware, however, that some operators employ this type of structure out of necessity, if they do not have the personnel and resources to develop and implement even a partially centralized format. These companies often operate without any set system, even on the property level, so general managers must establish and implement all operating policies. Hotel companies that fall into this category cannot provide the services normally expected from a professional hotel management company and should be compensated accordingly.

15.09 SERVICES PROVIDED BY MANAGEMENT COMPANIES

When selecting a management company and negotiating the management fee to be paid to it, the owner should be aware of the services that are normally provided by most hotel companies and be able to tell when the services that a particular company offers are unique. The following list contains the various services that are usually offered by most companies.

- Management supervision
- Implementation and maintenance of systems, procedures, and controls for:
 - Accounting and bookkeeping
 - Audit and control procedures
 - Budgeting
 - Marketing
 - Purchasing
 - Advertising and promotion
 - Maintenance
 - Personnel
 - Employee training
- Selection, training, and supervision of all employees
- Establishment of all prices and charges
- Preparation of monthly and annual financial statements
- Applications for and maintenance of all licenses and permits
- Negotiation for and granting of all concessions and leases
- Negotiation of service contracts
- Purchase of inventories, supplies, and equipment
- Establishment of bank accounts
- Maintenance of insurance policies
- Institution of any necessary legal action
- Supervision of building repair and maintenance and replacement of furniture, fixtures, and equipment
- Preparation of budgets and operating plans
- Planning and implementation of advertising, promotion, and marketing

First-tier hotel management companies generally provide significant additional services that generally include

- Regional or national trade names and identification
- Trademarks, logos, trade phrases, and service marks
- Centralized reservation systems
- Chain and group advertising programs
- Frequent guest programs

There are a number of unique services that are offered by some management companies, such as

- Centralized purchasing with group discounts
- Centralized personnel and recruiting
- Centralized reservations
- Centralized marketing and promotion
- Property tax representation
- Insurance assistance and package rates
- Energy management systems
- Preventive maintenance systems
- Centralized accounting
- Centralized employee education and training
- Labor relations assistance
- Site and building engineering assistance
- Architectural design
- Interior design
- Convention and group sales
- Frequent guest programs
- National and regional sales offices
- Preopening services
- Technical services
- Auditing
- Market demand studies

15.10 **MANAGEMENT COMPANY SELECTION PROCESS**

Selecting a hotel management company with the specific capabilities necessary for running a particular property is one of the key steps in a hotel investment. While location, product, and image of the facility are important ingredients, the ability of the on-site and supervisory management is what holds the operation together and makes it work. The following section describes the selection process for finding, negotiating, and retaining the hotel management company best suited for a particular project.

[1] **Analysis of Market Study**

The first step in selecting a hotel management company is to analyze the findings of the market study for the project in order to determine the type, class, and market position of the subject property. The findings of the market study that bear most closely on the selection of a management company are

- Current and future demand for transient accommodations, including probable demand growth rates
- Characteristics of demand, including market segmentation, rate categories, average length of stay, seasonality, special requirements, and facility needs
- Current and future supply of transient accommodations (competition)

- Characteristics of supply, including market segments, rate categories, facilities, location, image, and reputation

Several basic characteristics of the subject property can be determined from these areas of the market study. In turn, these characteristics are used to determine the sort of management company best suited to the property. The following characteristics are analyzed in this regard.

- Market segment.* The primary and secondary market segments (i.e., commercial, meeting and convention, and leisure) that are expected to be captured by the facility with an estimate as to what percentage each segment will represent as part of the whole. Information pertaining to the potential future growth of each segment and the expected competition is also useful. The data serve as a basis for determining the facilities and amenities needed to attract the intended market segment.
- Class of facilities and level of service.* Competitive lodging facilities operating within the market should be investigated to determine the level of services offered (i.e., economy, standard, first, luxury). The market position best suited for the subject property's particular location and the correct class for the subject property can be established based on this information. In addition, the level of services and types of amenities must also be defined in order to create a complete and competitive project.
- Extent of facilities.* The facilities (e.g., food, beverage, meeting and banquet, recreational, amenities, and shops) within a hotel project must be as carefully evaluated as the number of guest rooms. Building more facilities than are actually needed will reduce profit potential. Too few facilities will not satisfy the market and could reduce the competitive standing of property.
- Room count or size of hotel.* Many factors go into establishing optimum size. For example, site and zoning restrictions can place limits on the permitted number of buildable units. Market related supply and demand considerations will also either push the size upward or will hold it down depending on future expectations. Finally, economic influences such as land values, construction costs, a property's critical mass, and economies of scale will affect the final room count.

The purpose of this stage of analysis is to define broad project parameters, rather than specific guidelines. The actual layout and design of the subject property should be done in conjunction with the hotel management company ultimately retained to manage the project. The management company will be responsible for generating profits, so the hotel should be specifically planned to fit its mode and style of operation.

[2] Selection of First- or Second-Tier Company

To narrow the search for a management company, the owner should decide as early in the selection process as possible whether a first-tier or second-tier operator would be the most appropriate choice to manage the subject property. In some instances, the owner may choose a first-tier company, but find that a suitable candidate is not available. If this happens, the owner must be prepared to quickly turn to a review of possible second-tier operators.

[3] When a First-Tier Company Is Chosen

If the owner decides to use a first-tier management company or franchise affiliation, the first step that should be taken in order to choose a particular operator or franchise is to determine what operators and franchises are already in the market. Generally, companies not currently represented are the most likely candidates, but a particular company should not be ruled out if it is active in the market; occasionally, a company will make a move in favor of better projects.

The owner should look for operators or franchises that have a high level of recognition and market identification in the segments and class determined to be best suited for the subject property by the market study. A commercially-oriented chain, for example, would not be likely to have the marketing infrastructure to succeed with a convention hotel. Owners should look for operators and franchisors with similar properties situated in feeder cities that have established reputations and identifications to the local residents who are likely to travel to the area of the subject property.

[4] When a Second-Tier Company Is Chosen

If a second-tier company is the best choice to manage a property, the owner should look for an operator with a proven ability to manage hotels with a market orientation and class similar to the subject property. Another feature that is desirable for a second-tier company (though not as important as it is for first-tier companies) is representation in feeder cities.

Owners should bear in mind that some franchises are available only to certain operators. Marriott, for example, will grant franchises only to a select group of approved operators. In any event, owners should give preference to second-tier operators that have actual experience operating under the specific franchise selected for the property. An operator who is familiar to the franchisor can sometimes expedite the franchise application process.

The key to the entire selection process is to match the various proposed elements of the subject property, that is, size, class, image, location, market segments served and facilities offered, with the operator that has the most experience and best track record in handling these elements in a profitable manner.

[5] Consultation With Project Team

Before narrowing down the field of candidates, the owner should consult with members of the subject property project team and ask for their suggestions. This step is particularly important if the project investors can be identified at this stage. Experienced hotel investors can have definite opinions as to which operator would be best suited for a project, and, as a result, considerable time can be saved if their input is solicited early in the selection process. However, owners should not select a hotel operator purely on an investor's recommendation and without performing the necessary review and due diligence process.

[6] Request for Proposal

A request for proposal (RFP) is a document, prepared by a hotel owner, that is sent to management companies to solicit interest in managing the project and to request specific information that would be helpful in selecting the most qualified operator. Responding to the RFP is a time-consuming process for a hotel company, so the number of RFPs actually sent should be limited to those chains that are under active consideration. The initial number of RFPs ought to be held to five or less. If some of the companies do not respond, additional operators can be substituted at a later date. The recommended content of the RFP is described in the following sections. A sample RFP is contained in Exhibit 15.1 at the end of this chapter.

[a] **Company Profile**

The profile should contain a description of the present status of the company and its management's plans for the future. The profile should also contain information regarding the number of properties currently under contract, their locations, chain affiliations, facilities, amenities, ages, market orientations, number of years under contract, the identities of the owners, and, finally, whether the operator has an equity interest. The same information should be given for properties not currently under contract that the hotel company has managed over the past five years. The operator should describe the circumstances of the management agreement terminations.

Information should also be provided that focuses on the expansion plans of the company over the next three to five years. This information should detail the number of hotels currently under consideration or development, their locations and types, and the identity of the owners. An explanation of the way in which the operator intends to expand its management capabilities to handle the additional properties should also be provided.

The following questions will help the property owner to determine the experience and expertise of the hotel management company.

- Does the management company currently manage hotels that are similar to the subject property?
- Will their hotels complement the subject property?
- If the management company has lost management contracts, were the terminations due to factors beyond the control of the operator, or to some form of mismanagement?
- If the management company is not showing growth, is there an identifiable reason?
- If the management company is showing aggressive growth, does it have the capability to absorb and handle the additional properties?

All of this information should be readily available from the candidate management company. There might be some reluctance to provide the names and addresses of current owners during the RFP stage of the assignment, but such references should definitely be secured before any contract negotiations begin. The most difficult information to obtain is the listing of contracts lost over the past five years. Obviously, this information can be of great importance during the selection process and the owner should not begin contract negotiations unless the operator furnishes this information. Any inability to obtain this information should immediately terminate a management company from further consideration.

[b] Operating Performance

One of the most important issues in the hotel management company selection process is whether a particular management company can make money for the owner. Many hotels seem to be operated solely for the pleasure of their guests; they provide comfortable accommodations, good service, and extensive amenities. Unfortunately, even though guest satisfaction may be high, the operators are too often incapable of controlling costs and generating a reasonable profit. An even worse situation occurs where an operator lacks the marketing and sales expertise to simply achieve an adequate occupancy rate. Unfortunately, a number of well-known hotel chains are simply incompetent management companies. These companies must be quickly identified during the selection process so that no time is wasted on management candidates that are incapable of producing reasonable profits.

The most efficient method of evaluating the operational expertise of a hotel management company is to examine the actual financial performance of properties they operate. The RFP should require the disclosure of the complete financial statements for at least three hotels that the owner believes to be comparable to the subject property. The management company can provide input as to which hotels might be considered comparable, but the owner should ultimately determine which statements should be evaluated. The refusal of the hotel management company to cooperate fully in the operating performance review should definitely be considered a "deal breaker." Hotel operators with poor financial track records and unsatisfied clients will offer any number of excuses for unavailability of comparable income and expense information. Competent operators generally have little difficulty in supplying such information.

[c] Qualifications of Key Personnel

A hotel management company is, of course, no better than the actual staff that provides management services. The RFP should request information pertaining to the qualifications of the staff, and in particular, key management personnel. Problems such as high turnover and difficulty in recruiting qualified individuals are cause for concern. Any individuals whose employment is critical to the continued success of the management company should be identified. In addition to evaluating the home office personnel, an attempt should be made to identify the general manager who will operate the subject property.

[d] Central Services

The various off-property services provided by the hotel management company are called central services. These include accounting, reservations, engineering, architectural design, labor relations, insurance, purchasing, and the like. The owner should identify and compare the services offered by each operator and determine whether they are included in the management fee or are charged back separately to the property. The cost of some central services, such as reservation systems, are charged back to the individual properties within the chain on a pro-rata formula basis. For these expenses, the RFP should request the basis for the computation of the pro-rata share and the actual amount charged for each of the past three years.

[e] Reimbursable Expenses

Reimbursable operator expenses are the various expenses that are incurred in the operation of the property but are not included in the management fee and that are therefore reimbursable to the management company. For example, the travel expense incurred by the management company's home office personnel when visiting a property is often a reimbursable expense chargeable to that property. Reimbursable expense policies differ from one management company to another so the RFP should seek information that will identify all operator expenses that are not included in the management fee. This data is necessary in order to accurately compare the relative costs of the management companies under consideration.

[f] Sales and Marketing

One of the most important considerations in the selection of a hotel management company is the ability of a company to generate business through various sales and marketing programs. The RFP should solicit information that would document past experience in sales and marketing and provide descriptions of the current structure of this function. Some of the components of a sales and marketing structure include: central and regional sales offices, a reservation system, frequent guest programs, a convention and group sales data base, marketing organization, and various public relations and publicity functions. The RFP should also request information regarding any anticipated future changes in the operator's sales and marketing structure. Requesting a sample marketing plan used at one of the operator's hotels often provides insight as to how well this function is handled on a property level. In addition, the RFP should request that the operator develop a brief marketing plan for the subject property.

[g] Accounting and Bookkeeping Systems

The RFP should ask for a description of the accounting and bookkeeping systems used by the operator. If it is a centralized system, the basis for the cost allocation should be outlined.

[h] Operating Projections

The preparation of a 10-year projection of income and expense (including management fee) for the subject property should be stipulated in the RFP. The purpose of this request is twofold. First, the projection establishes a basis for judging the hotel company's future management performance. A performance standard can be established from these projections and incorporated into the management contract, with termination provisions keyed directly to projected operating levels. Second, it pinpoints the operator's anticipated earnings from the management contract. This information is useful when negotiating the fee structure portions of the agreement.

Most operators faced with a request for a 10-year projection of income and expense will probably comply reluctantly. It is important for the hotel owner that a hotel management company commit to a set of operating projections, so a refusal to agree to this request should be considered a "deal breaker." For the operator, the projections clearly have a catch-22 quality. If the operator is optimistic in projecting profit, it might look like a favorable choice when compared to other management companies, but at the same time, if the owner ties the performance cancellation

clause to this set of optimistic projections, the operator could quickly lose the contract. On the other hand, if the operator is overly conservative in the projection of income and expense, the owner could use the dollar amount of the projected management fee (which would probably be low) as the basis for estimating what the hotel company would be looking for as overall compensation. The projection of income and expense prepared by the management company should be checked against the actual operating performance shown in the financial statements of the comparable hotels to verify that the results are achievable. The quality of these projections is often a good indication of the skills and expertise of the management company.

[i] References

The RFP should specifically require a list of references from current owners, previous owners who have terminated their contracts, accountants, legal representatives, banks, and suppliers. The owner should use these references to verify the integrity, ability, and ethics of each hotel company. In addition, the owner should run the usual credit checks and undertake the normal due diligence necessary before entering into a long-term business relationship with another party.

[j] Financial Statements and Budgets

The financial strength of a management company, particularly one that may be making a financial commitment to the project, is an important consideration in the selection process. In order to verify this information, the RFP should require the submission of copies of audited financial statements for the past several years along with any available operating budgets and projections.

[k] Miscellaneous Information

The following miscellaneous information should be required by the RFP:

- Description of any existing or pending litigation against the management company
- Description of the company's operating manuals
- Outline of the company's supervisory infrastructure
- Description of the company's personnel, training, and recruiting practices
- The availability of group or blanket insurance through the company

[l] Management Contract Provisions

Most hotel management companies have standard management agreements that they submit to owners with their proposal. These agreements tend to be very one-sided in favor of the operator and should be considered only the opening offer. To demonstrate a level of expertise, it is sometimes advisable for the owner to develop a management contract that is to be submitted to the operator with the RFP. If this is not possible, the RFP should contain some of the important provisions that the owner would want specifically addressed in the agreement accompanying the operator's proposal. These provisions should address:

- Operating term
- Operator's contribution of capital
- Management fee and central services costs
- Termination by owner
- Personnel
- Budgeting and spending limitations
- Financial reporting requirements
- Restrictive covenants
- Condemnation and insurance proceeds

[m] Additional Material

Owners should try to generate a high level of interest in their projects through their RFPs so that hotel management companies will feel compelled to respond in a complete and timely manner. Furthermore, if the operator can be convinced that the hotel represents a viable investment as well as an important addition to its chain, the owner will often be able to negotiate a more favorable contract.⁴ In order to create this required favorable impression, the following additional items should be included with the RFP.

[i] Market study and appraisal. A professionally prepared market study and appraisal will provide the operator with most of the information that is needed to evaluate project economics and feasibility. This study should contain many of the basic factors, such as location, access and visibility, description of the improvements, analysis of the local economy, demand for transient accommodations, identification of competitive lodging facilities along with their average rates and occupancies, projection of income and expense, and estimate of market value. It is important to include a full income capitalization approach valuation because economic feasibility can only be determined by proving that the hotel's economic value is greater than the total project cost.

[ii] Project description and current status. The operator should be given a complete project description and a report of its current status. Depending on the stage of development, this information will include: survey and legal description, title reports, zoning rights, building permits, plot plans, property tax bills, architectural and engineering drawings, renderings, models, specifications, facility description, interior design plans, purchasing documents, cost estimates, construction contracts, ground and equipment leases, mortgage loan documents, service contracts, union contracts, liquor licenses, occupancy and use licenses, partnership agreements, insurance policies, and photographs of the property and improvements. For existing hotels the following additional items should be included: descriptions of the improvements, furnishings, and mechanical equipment, including ages and conditions and any plans for renovations or upgrades. This information should be provided initially in summary form with full documentation to follow once the field of potential management companies has been narrowed. The operator should also be informed of where the project currently stands in the development process. The RFP should contain a brief historical summary of important events relative to the project so the operator can ascertain its current status.

⁴ See 15.10[8] *supra* for a discussion of the bargaining process.

[iii] **Description of project team and owner.** One of the primary concerns of most hotel management companies when reviewing their potential involvement in a proposed project is whether the hotel will ultimately be developed. Many proposed hotels never open for business, so operators must be careful not to expend too much time and effort on properties that have little chance for success. A poor project selection not only is costly but also can result in lost opportunities by temporarily restricting the operator's ability to participate in other, more viable projects. In order for a management company to commit their time and future management services to a proposed hotel project, its management must be completely comfortable with the skills and track record of the project team and owner. The RFP should contain a complete résumé for all of the members of the project team, including the architect, building manager, interior designer, engineer, special consultants, and financial partners. The qualifications and past accomplishments of the owner should be given particular emphasis, especially if they include previous hotel development experience. In addition to this background information, a reference list is generally helpful.

[iv] **Operating history.** If the subject property is an existing hotel, the owner should include the operating results for the past three to five years in the RFP. These statements should be made in accordance with the Uniform System of Accounts for Hotels⁵ and should contain full supporting schedules. In addition to the profit and loss data, the owner should provide other useful financial information, such as average rate and occupancy by month, current year's budget, summary of recent capital improvements, property tax bills, summary of existing financing, ownership structure, partnership agreements, and so forth. Any extraordinary event or occurrence that might have had an impact on the financial information should be explained.

Before mailing the RFPs, the hotel management companies should be contacted to identify the persons who are responsible for handling new management contracts. If possible, this person should be provided with a summary of the project, the reasons for the selection of their management company for an RFP, and an outline of the RFP process and schedule.

As noted previously, Exhibit 15.1 contains an example of an RFP. The first paragraph of the letter contains two important items that should also be included in any RFP. The first item is a cut-off date that gives the operator a deadline for submitting its proposal. The date should allow ample time to answer the questions thoroughly. The second item is a request for confidentiality in regard to all information related to the project. This serves as a reminder that the owner has included proprietary information that should have a limited distribution.

[7] Review of Responses to Requests for Proposals

After several weeks the hotel companies will respond to the RFPs sent out by the owner. Prior to this time, however, the owner should expect numerous telephone calls seeking clarification of the questions asked on the RFP. Once the submissions begin to arrive, they must be organized and evaluated by the owner in order to narrow the field and select two or three companies with which contract negotiations can be started.

⁵ Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYS, Inc., 1986.

The easiest way to start the selection process is to eliminate the companies that have obvious deficiencies. The first to be eliminated should be those who either do not respond to the RFP or refuse to provide any important item of information. Hotel companies that are slow to respond or that are late in submitting their answers should also be considered for elimination. The second area of deficiency that warrants automatic termination at this stage are those management companies that do not operate their hotels in a profitable manner. If the requested operating statements show any inability to either maximize revenues or minimize expenses, the operator is not worth further consideration. Owners should not make exceptions that lead to the start of negotiations with an incompetent operator on the basis of hopes that the company will have better results with the subject property; this seldom happens.

If eliminating companies with these deficiencies does not reduce the field of candidates to the desired number, a rating system should be used to identify the most desirable candidates. Table 15.13 contains such a system, which consists of a series of questions whose answers consist of responses to an RFP supplemented by some investigation into the background, structure, and integrity of the management company. Each question has several possible responses, which are assigned a value that ranges from -4 to +4. The total of all of the values for the responses chosen represents the overall rating of the management company. The top two to three hotel management companies represent the best choices for entering formal contract negotiations. It should be noted that the individual rating numbers have been selected to reflect a typical hotel and typical operator. If the owner has any unique requirements in a management company, the values for specific responses can be adjusted upward or downward depending on the circumstances. Questions that do not apply to either the property or the management company should, of course, be eliminated.

TABLE 15.13
Hotel Management Company Initial Selection Rating System

Characteristic	Score
Comparing the size of the hotels managed by the operator to the subject, most are:	
Larger	- 1
The same size	0
Smaller	- 1
Comparing the chain affiliations of the hotels managed by the operator, most are:	
Same affiliation	1
Similar affiliation	0
Dissimilar or no affiliation	- 1
If the operator manages other hotels in the same market area, are these considered to be:	
Directly competitive	- 4
Somewhat competitive	- 2
Non-competitive	1
Experience of the management company:	
New company—limited experience	- 1
Moderate experience	0
Established—extensive experience	2
Management company's financial resources (ability to invest funds in the property):	
Limited—no investment potential	- 1
Moderate—token investments	0
Strong—meaningful investments	2

(continued)

TABLE 15.13 (continued)

Characteristic	Score
Operator shows willingness to invest funds in the property as a loan (double amounts if funds are contributed as equity):	
Initial inventories	1
Working capital	1
Pre-opening expenses	2
FF&E	3
Debt service guarantees	3
Management company has extensive experience in one of the following specialized areas that would directly benefit the operation of the subject property:	
Destination resort operation	2
Major convention operation	2
Unique market	1
Major food and/or beverage operation	2
Development assistance	2
Opening new hotel	2
Distressed property (turnaround)	2
Bankruptcy	2
Unions	1
Operating in secondary cities	1
Property ownership	2
Management company appears to be flexible in accommodating the following specialized needs of the owner:	
Short-term contract	2
Termination buy-out provision	2
Management company's ability to generate profits (based on actual performance):	
Normal—competent management	0
Better than average	5
Exceptional operating ability	10
Management company offers:	
Ability to obtain specialized identification	2
Ability to obtain financing	4
Feeder city representation	2
Track record of success	2
Management company has exceptional expertise or offers specialized services in the following areas:	
Centralized reservation system	2
Centralized sales and marketing	1
Regional sales offices	1
Convention and group sales	1
Frequent traveler program	1
National advertising program	1
Top-level personnel	1
Financial systems and controls	1
Other specialized services	1
Personnel relations	1
Development capability	1
If management company is a first-tier operator, its identity is:	
Wide-spread	2
Positive	1
Management company has the following deficiencies:	
Poor references	-3
Lost contracts (deduct for each loss)	-1
Limited home office structure	-1

TABLE 15.13 (continued)

Characteristic	Score
High management turnover	-2
No growth plans	-1
Excessive growth plans	-1
Will not subordinate incentive fee	-3
Unwilling to provide restrictive covenant	-3
Fee based entirely on percentage of total revenue	-3
Response to RFP showed professional effort in:	
Preparing operating budget	1
Preparing sample marketing plan	1
Gut feeling:	
You can get along with this company	3

[8] Bargaining Positions

Once the number of management companies has been reduced to a manageable two or three, the bargaining positions of each party should be assessed in order to determine their basic negotiation strategies. The key to this exercise is to determine which party has the strongest position. Generally, the party with the strongest position will be able to negotiate an agreement that is favorable to itself. If the relative bargaining positions are understood, however, the final outcome can sometimes be altered in favor of the weaker position. The following sections outline the various elements that can produce a strong operator bargaining position or a strong owner bargaining position.

Strong operator position

1. The property serves a specialized market that requires unique expertise possessed by operator.
2. The market is served by few national names not already in use. Many market areas have representation from most of the major hotel chains. Those operators offering an identification not already in use have a competitive advantage.
3. The operator is willing to take over distressed properties (e.g., those involved in bankruptcies, foreclosures, union problems, or that have poor reputations)
4. The operator is willing to accept contracts containing special requirements, such as: short operating terms, unique franchise and lender requirements (subordination, special approvals, and notices), cancellation or buy-out provisions.
5. Few other operators are interested in the hotel.
6. A limited opportunity exists for the operator to obtain additional management contracts from the owner.
7. The operator has other hotels in feeder cities.
8. The operator has a strong track record of success.
9. The operator is willing to engage in a joint venture, invest capital, or make performance guarantees.

10. The operator is able to secure financing for owner.
11. The operator has specialized expertise or services such as: centralized reservations, national and regional sales offices, successful frequent traveler programs, national advertising, strong home office support staff with complete management supervision system in place, ability to provide a wide range of in-house support services (e.g., property tax consulting, interior design, engineering, and development counseling).

Strong owner position

1. The hotel has a highly visible location that would provide the operator with extensive local exposure. This is a form of free advertising and promotion for the management company, particularly if it is a first-tier operation.
2. The subject market has strong barriers to entry against new development. Therefore, the operator may not have another opportunity to enter the market. New York City is currently an example of a very strong hotel market in which it is difficult to develop new lodging facilities because of high construction costs. Almost every national or international hotel chain would like to have representation in New York City, but few are able to enter this market.
3. The property is a famous existing hotel. Some hotels are landmarks to the traveling public. Properties such as the Ritz-Carlton in Boston, the Plaza in New York City, the Madison in Washington, DC, the Drake in Chicago, the Royale Orleans in New Orleans, the Arizona Biltmore in Phoenix, the Bel Aire in Los Angeles, the Stanford Court in San Francisco are examples of hotels that would be most attractive to any hotel management company.
4. The owner has a strong track record of other successful hotels. Hotel management companies like to team up with owners and developers who are likely to create many hotel projects. If the operator can anticipate the possibility of obtaining several contracts from the same owner over a period of time, a favorable package deal can often be negotiated.
5. The owner has a strong financial statement. The owner's ability to finance new projects as well as maintain existing properties is important to hotel management companies.
6. The owner does not require capital from management company. If the owner has a strong financial position and does not require capital from the management company, the pool of potential operators is greatly enlarged. Many excellent hotel chains are either unable or unwilling to make capital investments in projects they manage for third parties, so an owner's need for capital would eliminate these operators from consideration.
7. Many other management companies are interested in the subject property. Some highly desirable hotels are often sought after by several hotel chains.
8. Opportunity exists to obtain other management contracts. One management contract often leads to others. If the operator can see the potential for more business, the owner often picks up some bargaining power.

9. The management company is new and has limited experience and resources. Any time an operator has less to offer than competing hotel companies, the owner gains leverage in contract negotiations. New hotel companies, or those with limited resources or home office infrastructure, are more likely to offer an owner a more favorable contract.

[9] Basic Negotiation Strategy

Prior to actually presenting an opening offer, both the owner and operator should determine their basic negotiation strategy for the major terms of the contract. Although hotel management contracts contain numerous clauses and provisions, there are usually 14 major terms that form the basis of the agreement and are primary issues in the negotiations. The following list describes these 14 major terms and the basic objective of the owner and operator in negotiations concerning them.

1. Contract term

- *Owner*—Obtain a contract term for as short a period as possible with renewals at the option of the owner.
- *Operator*—Obtain a contract term for as long a period as possible with renewals at the option of the operator.

2. Management fee

- *Owner*—Base the fee solely on a percentage of net income after debt service and a minimum return on equity. Attempt to minimize the amount of this percentage.
- *Operator*—Base the fee solely on a percentage of total revenue. Attempt to maximize the amount of this percentage.

3. Reporting requirements

- *Owner*—Require extensive written financial reporting and frequent budget updates and meetings with owner.
- *Operator*—Minimize as much as possible the reporting of operating results and budgets to owner.

4. Approvals

- *Owner*—Structure contract so owner has the right to approve all aspects of hotel operation.
- *Operator*—Structure contract so operator has total discretion with no approvals of any sort required from owner.

5. Termination

- *Owner*—Ensure owner's right to terminate management contract immediately upon written notice.
- *Operator*—Under no circumstances allow the operator to be terminated before the expiration of the contract.

6. Operator's investment in the property

- *Owner*—Stipulate that operator buy right to manage hotel (i.e., invests capital or services) or make performance guarantees to obtain the management contract.
- *Operator*—Stipulate that operator have no investment in the property.

7. Operator's home office expenses

- *Owner*—Make all home office expenses of operator reimbursable from management fee, with no expenses to be charged to property.
- *Operator*—Stipulate that the pro rata share of all of operator's home office expenses plus all direct expenses be chargeable to the property.

8. Transfer of ownership

- *Owner*—Ensure that owner may transfer ownership of hotel to anyone at any time.
- *Operator*—Ensure that owner cannot transfer ownership of property without operator's approval and that operator is allowed right of first refusal.

9. Exclusivity

- *Owner*—Establish owner's right to develop or own any hotel managed by operator.
- *Operator*—Establish operator's right to manage any hotels developed or owned by owner.

10. Insurance and condemnation proceeds

- *Owner*—Exclude operator from participation in any insurance or condemnation proceeds.
- *Operator*—Stipulate that operator be entitled to a pro rata share of all insurance and condemnation proceeds.

11. Hotel personnel

- *Owner*—Ensure that all hotel personnel will be employees of operator.
- *Operator*—Ensure that all hotel personnel will be employees of owner.

12. Reserve for replacement

- *Owner*—Agree to fund capital replacements (furniture, fixtures and equipment) on an as-needed basis.
- *Operator*—Establish the right to establish a reserve for replacement funded by the owner that is as large as possible.

13. Restrictions

- *Owner*—Stipulate that operator not own, manage, or franchise another hotel within the same market as the subject.
- *Operator*—Refuse restrictions on ownership, management, or franchising by the operator in the same market as the subject.

14. Indemnity

- *Owner*—Ensure that operator will indemnify owner for all actions against operator.
- *Operator*—Ensure that owner will indemnify operator for all actions against operator.

[10] Opening Offers

As with any form of negotiations, the opening offer must be carefully planned in order to

- Establish positions on major issues.
- Leave room to negotiate so that compromise can be demonstrated without too large a concession.

- Make the other party realize that they are dealing with an organization familiar with hotel management contracts.
- Ensure that the other party will not find the opening position so unreasonable that they lose interest in negotiating further.

Hotel companies generally make opening offers in the form of an actual management contract. These are usually generic documents that are modified slightly to incorporate specific information (e.g., name of owner and address of property) regarding the project under consideration. The owner should consider the sample contract presented by the hotel company as merely an opening offer and not necessarily a model of the final agreement. The owner should treat it as merely a checklist of provisions to be covered in the final document. Hotel owners rarely put together their opening offer in a contract format. However, developing an actual owner's contract, which may incur some legal expense, is an interesting negotiating ploy that focuses the operating company directly on the issues of ownership concern. It essentially forces the hotel company to react to the owner's opening offer rather than the opposite. This approach tends to strengthen the owner's initial bargaining position.

Using the 14 major contract provisions described in the preceding section, hypothetical opening offers have been developed for both an owner and an operator. These opening offers assume the following:

- The operator is a first-tier management company
- The hotel owner has several other hotel properties
- The project is clearly feasible and is a desirable opportunity for a hotel management company
- The bargaining power of both sides is equal

Owner's Opening Offer

1. Ten-year term with two 5-year renewals at Owner's option.
2. Management fee—For years 1–5: 100% of cash flow after debt service and after 8% return on Owner's equity. For years 6–10: 65% of cash flow after debt service and return on Owner's equity. For renewal years 16–20: 50% of cash flow after debt service and return on Owner's equity.
3. Operator will provide Owner with the following reports:
 - Monthly statement of income and expense with full supporting schedules, monthly balance sheet, monthly change in financial position, and written critique of operations by general manager and home office vice president of operations within 15 days of the end of the month.
 - Annual statement of income and expense in accordance with the Uniform System of Accounts, balance sheet, change in financial position, audited by independent auditor with cost charged to management company. Written critique of operations by general manager and home office vice president of operations. Annual reports due within 60 days of the end of the fiscal year.
 - Operator will prepare each month a 12-month updated budget showing cash needs on a month-by-month basis.
 - Operator will be available to meet with Owner at any time.

- Operator will submit to Owner for approval an annual budget containing full income and expense projections with full supporting schedules, payroll and manpower forecasts 90 days prior to the commencement of the fiscal year. Included in the budget will be a marketing plan, capital expenditure budget, engineering report, and plans from each department head.
4. Owner approval is required for the following:
 - Annual budgets
 - All expenditures of \$5,000 or more for non-capital expenses and \$10,000 or more for capital items
 - Changes of key operating personnel
 - All initial salaries, raises, and labor negotiations
 - All changes in room rates and other charges
 - All expenditures not covered in annual budget
 - All initial operating policies and subsequent changes
 5. Owner shall have the right to terminate management contract upon written notice.
 6. Operator will fund all pre-opening expenses, initial operating supplies, and working capital and purchase all furniture, fixtures, and equipment. Operator will guarantee sufficient net income to pay debt service.
 7. All Operator home offices expenses will be reimbursed from the management fee—no expenses will be charged to the property.
 8. Owner may transfer ownership of the hotel to anyone at any time.
 9. Owner has the right to develop and/or own any hotel managed by Operator within the market area.
 10. Operator will not participate in any insurance or condemnation proceeds.
 11. All hotel personnel will be employees of Operator.
 12. Owner will fund capital replacements (FF&E) as needed.
 13. Operator cannot own, manage, or franchise another hotel within the same market as the subject without Owner's consent.
 14. Operator will indemnify Owner for all actions against Operator.

Operator's Opening Offer

1. Twenty-five-year initial term with three 10-year renewals at Operator's option.
2. Management fee based on 5% of total revenue for years 1–3, increasing to 6% for years 4–6, and 7% for year 7 to the end of the contract.
3. Operator will provide Owner monthly financial statements within 40 days of the end of the month and an annual statement within 120 days of the end of the year. An operating budget will be prepared within 30 days of the commencement of the year.
4. No approvals required or arbitration procedure.
5. Termination by either party for bankruptcy and other similar circumstances is allowed.
6. No investment by Operator.
7. Owner will pay the pro rata share of Operator's home office expenses.

8. Property cannot be transferred without Operator's approval, and Operator has the right of first refusal on all transfers.
9. Operator has option to manage any hotels developed or owned by Owner within the state.
10. Operator will receive a pro rata share of all insurance and condemnation proceeds.
11. All hotel personnel will be employees of Owner.
12. Operator will establish a reserve for replacement funded by Owner in an amount equal to 5% of total revenue.
13. No restrictions on ownership, management, or franchising.
14. Owner will indemnify Operator for all actions against Operator while performing under this agreement.

As previously noted, the opening offer of the operator generally takes the form of an actual management contract. The opening offer of the owner is usually an oral or written reaction to the opening offer of the operator—more of a counter-offer. As suggested previously, owner bargaining power can be gained if its opening offer is presented to the operator in contract form rather than as a reaction to the opening offer of the operator.

[11] First Fall-Back Position

Once both opening offers have been tendered, the two parties must evaluate each other's bargaining posture and develop a first fall-back position. Only rarely will one side have the power to force their opening offer on the other party, so a counter-offer must usually be made that approaches the position of the other side. Continuing from the previous opening offers, the following first fall-back positions represent what the hotel owner and operator would be likely to present.

Owner's First Fall-Back Position

1. Fifteen-year terms with two 5-year renewals at Owner's option.
2. Management fee of 3% of total revenue plus 5% of income before fixed charges subordinated to debt service and an 8% return on Owner's equity noncumulative.
3. Same as opening offer except:
 - Monthly reports will be due within 20 days.
 - Audited annual reports will be an operational expense.
4. Owner approval required for the same items as Owner's opening offer except:
 - No approval required for non-capital expenses if the total for an expense category does not exceed the budgeted amount.
 - No Owner approval required if raises are less than CPI.
 - All expenditures of more than \$10,000 that are not contained in the annual budget.
5. Owner may terminate management contract for the following reasons:
 - Net income for any two years is insufficient to cover debt service plus an 8% return on Owner's equity.

- Owner pays termination fee or the equivalent of the previous 12 months' management fee.
- 6. Operator will fund all pre-opening services provided by Operator. Operator will provide a working capital loan repaid from cash flow after debt service and an Owner's return.
- 7. Operator's out-of-pocket travel expenses can be charged to the property as an operating expense.
- 8. Owner may transfer ownership of the hotel to anyone at any time, but Operator has the right of first refusal.
- 9. Owner has option to develop any hotels managed by Operator within the market area.
- 10. No change from opening position.
- 11. All executive level personnel will be employees of Operator and all other personnel will be employees of the Owner.
- 12. Owner will establish a reserve for replacement that will be funded out of cash flow after debt service based on 2½% of total revenue.
- 13. Operator cannot own, manage, or franchise another hotel within x miles of the subject property and only after the subject has achieved x% occupancy for three consecutive years.
- 14. Operator will indemnify Owner for all actions of Operator that represent negligence, misconduct, and fraud.

Operator's First Fall-Back Position

1. Twenty-year initial term with three 5-year renewals at Operator's option.
2. Management fee based on 3% of total revenue plus 10% of income before fixed charges.
3. Monthly statements within 30 days, annual statement within 90 days, and operating budget within 45 days.
4. Some approvals but subject to the clause "approvals cannot unreasonably be withheld."
5. Performance termination if debt service is not covered for three consecutive years starting in the fifth year unless Operator can show in arbitration that it was beyond its control.
6. Operator will make a working capital loan at prime plus two points repaid from cash flow before debt service.
7. Owner will pay the salaries and travel of home office personnel when they visit the hotel.
8. Operator can set a standard for permitted transfers. Transfer permission "cannot unreasonably be withheld." Right of first refusal remains.
9. Operator has right to manage Owner's hotels within the city.
10. Operator has a right to sue insurance company or municipality for insurance or condemnation proceeds.
11. Position unchanged.
12. Reserve for replacement equal to 4% of total revenue.
13. Operator can own, manage, or franchise a hotel in the same market if it does not adversely affect the subject.

14. Owner will indemnify Operator for all actions against Operator while performing under this agreement unless such actions represent gross negligence, willful misconduct, fraud, or breach of trust.

The first fall-back positions are generally transmitted to the other party in letter format, referring to the actual provisions in the written contract and suggesting the proper wording to be used to make it agreeable.

[12] Second Fall-Back Position

After the initial counteroffers (first fall-back positions) have been exchanged and reviewed, both parties establish a counter-counteroffer, or second fall-back position. It is at this point that the real bargaining power of each side becomes evident. Generally, the party with the most apparent bargaining power will concede little between the opening offer and the first fall-back position. If the apparent bargaining power is real rather than merely apparent, there will be little movement by the stronger party in the establishment of the second fall-back position. This example assumes that both parties have equal bargaining power, so equal movement will be shown by each in the development of a second fall-back position.

Owner's Second Fall-Back Position

1. Fifteen-year term with one 5-year renewal at Operator's option and one 5-year renewal at Owner's option.
2. Management fee of 3% of total revenue plus 10% of income before fixed charges subordinated to debt service and an 8% return on Owner's equity non-cumulative.
3. No change from item 3 in Owner's first fall-back position.
4. Owner approval required for the same items as Owner's first fall-back except:
 - No approval required for non-capital expenses if the total for an expense category does not exceed the budgeted amount by more than 10%.
 - No approval required for raises of less than 6%.
5. Owner may terminate management contract for the following reasons:
 - Net income for any two consecutive years is insufficient to cover debt service. Operator has the option to fund the difference.
 - Owner pays termination fee of double the previous 12 months' management fee.
6. Operator will provide a working capital loan at prime repaid from cash flow after debt service.
7. No change from item 7 in Owner's first fall-back position.
8. Owner may transfer ownership of hotel with Operator's approval, and such approval cannot unreasonably be withheld. Operator has the right of first refusal.
9. Operator must consider Owner for the next hotel development in the market area.
10. No change from item 10 in Owner's first fall-back position.

11. All hotel personnel will be employees of Owner.
12. Owner will establish a reserve for replacement based on 2½% of total revenue.
13. Same as first fall-back position, except the number of miles from the subject property is reduced and the number of years at x% occupancy is reduced.
14. No change from item 14 in Owner's first fall-back position.

Operator's Second Fall-Back Position

1. Twenty-year initial term with two 5-year renewals at Operator's option.
2. Incentive fee subordinated to a specific hotel of debt service cumulative at prime plus two points.
3. Monthly statements within 20 days; no other changes.
4. Disputes over certain approvals go to arbitration (e.g., budget).
5. Performance same but starts the third year.
6. Working capital loan repaid from cash flow after debt service.
7. Property to pay home office travel expenses only.
8. No change from item 8 in Operator's first fall-back position.
9. Eliminate.
10. No change from item 10 in Operator's first fall-back position.
11. No change from item 11 in Operator's first fall-back position.
12. Reserve for replacement equal to 3% of total revenue.
13. Operator may own, manage, or franchise another hotel in the same market anytime after the subject has achieved an annual occupancy of x%.
14. No change from item 14 in Operator's previous position.

EXHIBIT 15.1

Sample Request for Proposal From Hotel Management Company

[Date]

[Hotel Company]

[Address]

[City, State, Zip]

Re: [Name of Hotel]

[City, State]

REQUEST FOR PROPOSAL

Dear :

In accordance with our recent conversation pertaining to the possibility of your hotel management company assuming the operational responsibilities for the above-captioned hotel, I have enclosed some descriptive information about the property. Please submit by March 15, 198X your response to this request for proposal (RFP) so we can select an operator and commence negotiations toward an agreement. We request that the enclosed descriptive project material be kept confidential and we will do likewise with your response and supporting data. Answer the questions as completely as possible and provide any supportive information that will assist in evaluating your proposal.

Company Profile

- Total number of properties and rooms that your management company currently operates. List each property and provide the following information: name, chain affiliation, location, room count, description of food, beverage, meeting, and other facilities, age, market orientation (i.e., commercial, convention, resort, highway, airport, etc.), and the number of years under your management. Indicate whether you have an ownership interest in the property.
- Describe your expansion plans for the next three years. How many hotels and rooms do you anticipate managing over the next 12, 24, 36 months? What is the geographic distribution of these properties? If you are projecting additional properties, describe the growth in your home office and regional offices to handle this expansion.
- Indicate the names and locations of all the properties you operated over the past five years that you currently do not manage. State the reason why your contract was terminated.

Operating Performance

Of the properties that you manage, select three that are most comparable to our hotel from the viewpoint of size, facilities, occupancy, average rate, and market segmentation. To aid in evaluating your operational efficiency, please provide us with full income and expense statements (including supporting schedules) for the past three years, occupancy and average rate by month for the past 36 months, and the most recent budget and marketing plan. Please include your comments on each operation explaining any unusual events or circumstances affecting these statements.

Qualifications of Key Personnel

Provide biographical profiles of the key members of your management organization. Include: description of their current position with an outline of duties and responsibilities, previous positions with your organization, past work experience with other organizations, education, and specialized training.

If possible, please identify the general manager that will be assigned to our property and provide qualifications.

Central Services

Describe the central services provided by your management company. Indicate: type of service, personnel assigned to this service, whether the cost is included in the management fee, basis for allocating the specific cost, and the amount of allocation for each of the past three years.

Examples of central services include:

Accounting (centralized)	Property Tax Representation
Auditing	Labor Relations
Marketing (off property)	Personnel
Reservations (off property)	Training and Education
Engineering	Purchasing
Architectural	Insurance
Interior Design	Others

Reimbursable Expenses

List all expenses incurred in the operation of the property that are not included in the management fee and are reimbursable to the management company.

Sales and Marketing

Describe your sales and marketing organization with particular emphasis on the following areas:

- Outline the current structure of the central and regional marketing organization. What changes to this structure are planned during the next five years? What are the strongest and weakest areas of your overall marketing strategy?
- Reservation System—Type of system, number of hotels serviced, number of reservations and room-nights generated during each of the last three years, expected number of reservations and room-nights for our property, basis for allocating reservation expense, and the actual cost for each of the last three years.
- Advertising Program—Outline the chain and group programs, basis for allocating expenses, and the actual cost for each of the last three years.
- Convention and Group Sales—Location and staffing of sales offices, volume of group sales (room-nights) for each of the last three years, basis for allocating expenses, and the actual cost for each of the last three years.
- Frequent Guest Program—How does it work? What have been the results? Basis for allocating expenses, and the actual cost for each of the last three years.
- Provide a sample marketing plan for one of your hotels.

Based upon the enclosed descriptive project information, along with your knowledge of the local hotel market, develop a brief marketing strategy addressing your plans to increase our property's rooms revenue and food and beverage revenues. Include a description of the sources and composition of the expected demand.

Accounting and Bookkeeping Systems

Describe your accounting and bookkeeping systems at both the property and home office levels. Is the accounting system centralized or is it provided on the property level? Is the system computerized or hand-posted? Describe in general terms your audit and control procedures.

Estimate the conversion and installation cost of your system into our hotel.

Miscellaneous Information

- Describe the types of operating manuals and their basic content, as well as corporate operations support information for areas such as front office, food and beverage service, food and beverage cost control, housekeeping, engineering, and so forth.
- Outline the supervisory infrastructure used to guide and control your managed properties on both the corporate and property level. Address specifically the administrative, managerial, and supervisory framework you plan for our property.
- Discuss your personnel training and recruiting practices. Prepare a staffing schedule for the subject property.
- Do you offer blanket insurance? If so, what does it cost?

Operating Projections

Prepare a ten-year projection of income and expense assuming you take over the operation on June 1, 198X. Include your normal management fee (basic and incentive) and reserve for replacement. Assume property taxes will be \$_____ and insurance expense is \$_____. Provide the basis for the estimated occupancy, average room rate, and food and beverage revenues.

References

Provide the names, addresses, and telephone numbers of three owners who currently utilize your management services. Also provide the same information for three owners who formerly utilized your management services.

Financial Statement and Budgets

Submit audited financial statements for your hotel operating company and all related parent and subsidiary companies covering the last three years.

Submit the current operating budget for the management company.

Management Contract Provisions

Submit a copy of the management contract you intend to use for this hotel. The following provisions should be specifically addressed:

Term. Initial and renewal terms will be negotiated. Renewal terms will be at the option of the owner.

Operator's Contributions. We believe that the operator should have a capital investment in the property.

Management Fee and Central Services Costs. The fee structure should provide incentive to maximize revenues and minimize expenses. The largest portion of the fee should be based on a percentage of a defined net income. This portion of the fee should be subordinated to debt service. The method of allocating the central services costs must be specified in the contract. Any charges must have owner approval.

Termination by Owner. Owner must have the right to terminate the agreement if specific operating performance is not achieved. Owner should be able to terminate the agreement by paying a specific cancellation fee.

Personnel. All employees will be the employees of the operator with payroll expenses reimbursed to operator by the owner. Owner will have the right of approving the general managers for the subject property.

Budgeting and Spending Limitations. Operator is required to submit an annual budget containing full income and expense projections with supporting schedules and payroll and manpower forecasts. Owner has the right to approve or disapprove the annual

operating budget and the capital improvement budget. Owner must approve all capital expenditures of more than \$10,000.

Financial Reporting Requirements. Owner has right to inspect the property, books, and records at any time. Owner will require an annual audit by an independent accounting firm—the cost will be assumed by the property. Operator will submit to the owner.

- Monthly statements of income and expense with full supporting schedules
- Monthly balance sheet
- Monthly changes in financial position
- Monthly written discussion of the previous month's operating results

Operator will meet with owner at least quarterly to discuss the previous quarter's operating results and the financial plan for the future.

Restrictive Covenant. The operator will be prohibited from operating, owning, or franchising another lodging facility within a defined geographic area.

Condemnation and Insurance Proceeds. Operator will not participate in any condemnation awards or casualty insurance proceeds.

We look forward to your reply to this request for proposal and appreciate your attention to this matter.

Very truly yours,

CHAPTER 16

Hotel Management Contracts and Related Documents

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16.01 INTRODUCTION

The proper execution of a management contract between the hotel owner and the management company is a vital step in the development of a successful hotel venture. The management contract spells out the basic relationship between the owner and the operator. For example, it might specify who is responsible for the provision of operating capital, the payment of property taxes, or the employment of the general

manager and other key executives. Great care should be taken in putting together the management contract, since an agreement that is overly favorable to one party can result in a contentious relationship between the owner and the operator, with potentially disastrous results for the hotel.

This chapter discusses the basic provisions that are found in management contracts, as well as some of the more common variations.¹ Included in this discussion are such topics as fee structures, contract termination, operator expenses, owner approvals, and other significant areas relating to management contracts. The chapter also includes a discussion of the annual plan and the budget approval process, two areas that are usually set forth in great detail in the management contract.

16.02 **CONTRACT TERM**

The term of a management contract is the length of time that the agreement is to remain in effect. Both a commencement date and a termination date are usually specified in this provision. The commencement date may be either a specific date or it may be as of a certain occurrence, such as the date the hotel officially opens for business. Whatever the certain occurrence may be, the parties to the contract must be careful to define it clearly (e.g., what does "officially open for business" really mean?).

The contract term may comprise an initial term and one or more additional renewal terms that extend the total length of the agreement.

Ideally, owners want an initial term that is as brief as possible, and the option of numerous short renewal terms. This arrangement permits the owner to tie the operator to the contract for an extended period of time, but also allows the owner to terminate the contract upon relatively short notice should the management company prove ineffective or the owner want to sell the property unencumbered by a management contract.

The contract term provision affects the hotel operator by limiting the period during which the property can be operated and a management fee collected. A hotel company generally incurs start-up costs when taking over new contracts, so the company needs a term long enough to recoup the initial one-time expenses. In addition, most management fees are structured so that they reward profitable operating results, and as a result it may take an operator several years to achieve the level of profits needed to earn a reasonable amount of compensation. For first-tier hotel management companies, the length of the contract term has additional importance because of their public name recognition. Such companies are interested in demonstrating a stable, long-term commitment to a market area in general and a property in particular, so they will usually negotiate for the longest initial term possible.

The contract term, from an owner's point of view, is directly related to two other important provisions: termination for nonperformance and contract buy-out. If the owner is able to negotiate a satisfactory provision for quickly terminating an incompetent operator along with buying out the contract for a reasonable price, then the length of the contract term becomes less important.

¹ A variety of sample management contract clauses, taken from actual agreements, can be found in Appendix 3.

First-tier hotel companies generally insist on long initial contract terms due to the high start-up costs associated with such agreements. Therefore, contracts with first-tier operators usually run for an initial term of between 20 and 30 years. On the other hand, second-tier operators are typically more willing to accept shorter agreements. Contracts with these operators commonly specify an initial term of between 10 and 20 years.

It should be noted that second-tier operators encompass a broad variety of management companies, ranging from small firms with several executive employees to large, highly structured organizations similar to many first-tier chains. The length of term that these operators agree to often varies considerably from one contract to another. When economic downturns occur and there is an increase in lender workouts handled by second-tier management companies, it is not unusual to see, on average, six-month to two-year contract terms, which enable the lender-owner to quickly sell the property, unencumbered by a management contract, in the event a buyer is found. On the other hand, some large, established second-tier operators with all the attributes and bargaining power of first-tier companies will not enter into agreements that have initial terms of less than 20 years.

Renewal terms extend the contract for a stated period beyond the initial term. The renewal term is typically structured as a contract extension option that may be exercised by either the operator or owner acting alone or in agreement. The renewal term need not contain the same provisions (e.g., the management fee) as the initial term.

Most management contracts include some form of renewal provision. In most cases, the agreement allows for a specified number of renewal terms. The permitted number of renewals is usually between one and three, while the length of the terms is commonly from five to ten years. Some agreements allow for an unlimited number of renewals on a more frequent basis, usually yearly.

The primary difference in the renewal terms for first- and second-tier hotel operators is that first-tier companies are generally less likely to offer such terms, and if they do, they run for longer periods of time—in terms of the individual renewals as well as the total of all renewals. First-tier operators are more likely to control the option to renew than are owners, but renewals generally are a matter of agreement between the two parties.

16.03 **MANAGEMENT FEE**

A management fee is the compensation a hotel company receives for providing the various services called for in a management contract. For first-tier hotel companies, the management fee covers both their management services and the value of their chain identity; second-tier operators are compensated for their management services alone. The calculation of the management fee is usually tied to one or more financial indicators, such as revenue or profit.

From an owner's point of view, the management fee represents an operating expense—something that should be controlled and minimized. However, management fees can be treated as an incentive and thus become an ownership tool for fostering profitable operations. One of the primary goals of hotel owners is to receive maximum net income from the hotel operations. The ability and efforts of the management company have a direct impact on whether the hotel is able to realize this goal.

[1] Basic Fee

Under the arrangement known as the basic fee, the management fee is determined solely by a percentage of revenue, creating an incentive for the operator to increase marketing efforts and other activities that increase sales volume. The drawback to this arrangement is that the basic fee provides no incentive to minimize operating expenses. If the entire management fee is in the form of a basic fee, the operator can theoretically increase marketing and sales efforts to the point where the highest possible revenues are reached, but any margin of profit is eliminated.

[2] Incentive Fee

In another type of management fee, known as the incentive fee, the fee paid to the management company is based on a specified percentage of a defined net income, usually determined by sales volume and expense control. Therefore, incentive fee rewards the operator for efficient, profitable management.

Hotel owners generally want to have all or at least most of the management fee calculated as an incentive fee. In addition, owners want this compensation based on a defined net income that appears as low in the hotel's income statement as possible; This is why it is referred to as a low level line item.

For example, consider a 300-room hotel that is currently operating at a 73 percent stabilized occupancy with an average rate of \$113.14, as shown in Table 16.1. The format shown here is standard for such income statements.

Assume the hotel will be operated by a first-tier management company and the owner believes that 5½ percent of total annual revenue, or \$863,000, is fair compensation for the services and chain identity of the management company. The owner is willing to pay 3 percent of total revenue (\$471,000) as a basic fee, but wants the remaining portion of the total fee (\$392,000) paid on an incentive basis and calculated as a percentage of a defined profit, such as one of the standard profit line items shown in Table 16.1: Income Before Fixed Charges, Income Before Debt Service, or Income After Debt Service. (In addition to the use of these standard line item definitions, many other definitions can be developed, such as "Income Before Fixed Charges but After Reserve for Replacement" or "Income After Fixed Charges but Before Property Taxes.")

The following percentages of standard line items are needed to yield the required additional management fee of \$392,000.

<i>Line item</i>	<i>Required management fee</i>		<i>Line item amount</i>		<i>Required percentage</i>
Income before fixed charges	\$392,000	÷	\$4,664,000	=	8.4%
Income before debt service	\$392,000	÷	\$3,732,000	=	10.5%
Income after debt service	\$392,000	÷	\$1,317,000	=	29.7%

In other words, if the incentive fee is calculated as a percentage of Income Before Fixed Charges; it would have to be 8.4 percent of the line item in order to yield the required \$392,000. If the calculation is made using Income After Debt Service, the necessary percentage would be 29.7.

From an owner's viewpoint, the incentive fee should be calculated as far down the income statement as possible. For example, any payment from the Income After

TABLE 16.1
Hotel Income Statement

	(\$000)	Percentage of Total Revenue
Number of rooms: 300		
Stabilized occupancy: 73%		
Average rate: \$113.14		
<hr/>		
Revenues		
Rooms	\$ 9,044	57.6
Food	4,318	27.5
Beverage	1,727	11.0
Telephone	344	2.2
Other income	260	1.7
Total	<u>15,693</u>	<u>100.0</u>
Departmental Expenses		
Rooms	1,908	21.1*
Food and beverages	4,685	77.5*
Telephone	348	101.2*
Other income	157	60.3*
Total	<u>7,098</u>	<u>45.2</u>
Departmental Income	<u>8,595</u>	<u>54.8</u>
Undistributed Operating Expenses		
Administrative and general	1,236	7.9
Management fee	471	3.0
Marketing	741	4.7
Property operations and maintenance	770	4.9
Energy	713	4.5
Total	<u>3,931</u>	<u>25.0</u>
Income Before Fixed Charges	<u>4,664</u>	<u>29.8</u>
Fixed Charges		
Property taxes	405	2.6
Insurance	135	0.9
Reserve for replacement	392	2.5
Total	<u>932</u>	<u>6.0</u>
Income Before Debt Service	<u>3,732</u>	<u>23.8</u>
Debt Service	2,415	15.4
Income After Debt Service	<u>\$ 1,317</u>	<u>8.4</u>
*Percentage of departmental revenue		

Debt Service line erodes only the return on equity rather than funds available for operating expenses, fixed charges, and debt service. A similar result can be achieved by calculating the incentive portion of the management fee using an item before debt service, but paying it only if there are sufficient funds to cover debt service, which is known as subordinating the incentive fee to debt service.

[3] Owner and Operator Requirements

From the operator's point of view, the management fee represents compensation for services rendered. The fee must be enough to both cover the management company's operating expenses and provide an adequate profit.

Operators understand the need of owners to receive the maximum net income possible from hotel operations, but they also realize that in some instances they have little control over operating results. In over-built markets or depressed economies, even the best management companies find it difficult to generate suitable profits. In such situations a management company might be unfairly penalized if its entire fee is calculated as a percentage of a defined profit. The same is true for new hotels, where a period of occupancy build-up and initial operating losses are expected.

To protect themselves from these uncontrollable external factors, management companies seek to have the bulk of their fees calculated as a percentage of revenue (usually total revenue), which may decline somewhat when adverse conditions affect the property, but is never totally eliminated.

Most management companies are able to cover their actual operating (i.e., home office and supervision) expenses with the basic portion of the fee. Expressed as a percentage of total hotel revenue, the operating expenses to the management company generally range from 1½ to 2½ percent. A basic fee of 3 percent of total revenue will cover all of the operator's costs and leave a small profit. The incentive portion is therefore largely profit for a second-tier operator and profit and identity compensation (e.g., for trademarks and public image) for a first-tier operator.

It must be recognized that a sizable portion of the total operating costs for a management company are incurred during the initial part of the contract term. During the start-up phase for a newly opened hotel or the takeover phase for an existing property, the operator must devote a significant amount of supervisory time to institute new systems, procedures and controls. This phase also entails greater efforts in recruiting, training, marketing, purchasing, and accounting. Some management companies will even temporarily relocate skilled personnel from other properties to insure a smooth opening or takeover. In order for a contract to be attractive to an operator, there should be some reasonable expectation that these initial costs can be recovered over the contractual term.

[4] Risk Compensation

Operator's naturally view the incentive portion of a management fee with much greater uncertainty than the basic portion. While the owner would like the incentive fee calculated using a line item near the bottom of the income statement (e.g., Income After Debt Service), the operator's risk of not receiving adequate incentive fee compensation increases significantly as the line item used for the calculation descends on the property's income and expense statement. Essentially, if the incentive fee calculation is based on Income Before Debt Service, the risk is similar to that of a mortgagee. Moving the calculation down to Income After Debt Service alters the risk so that it resembles what is experienced by an equity investor (that is, the incentive fee is based only on money remaining after debt service). To compensate the management company for assuming this greater risk, either a greater percentage of the line item specified or some form of incentive fee accrual would reasonably be expected by the operator in order to be sure of an adequate compensation over the term of the agreement.

As shown in the previous section, different percentages are required of each line item to produce the desired incentive fee. This percentage can be adjusted for risk (i.e., the likelihood that the line item will not generate a sufficient incentive fee) through a probability and income sensitivity analysis. The first step in such an analysis is to determine the probability of the subject hotel achieving a certain operating level (occupancy) at any given point in time. A review of the local market shows that

over a 20-year period the area-wide occupancy varied from 53 percent to 83 percent. A factor representing the probability that a specific level of occupancy will be achieved in any given year is assigned to each occupancy level over this range so the total of all probabilities equate to 100 percent. A projection of income and expense is then made for each level of occupancy and the net incomes in question (i.e., Total Revenue, Income Before Fixed Charges, Income Before Debt Service, and Income After Debt Service). Using the 300-room hotel from Table 17.1 as a basis, the following table shows the assigned occupancy probabilities along with the various line item incomes can be calculated at each occupancy level.

<i>Assumed occupancy levels</i>	<i>Probability factors</i>	<i>Total revenue (\$000)</i>	<i>Income before fixed charges (\$000)</i>	<i>Income before debt service (\$000)</i>	<i>Income after debt service (\$000)</i>
53%	1.00	\$12,119	\$2,139	\$1,296	(\$1,119)
55	2.00	12,477	2,394	1,542	(873)
57	4.00	12,835	2,644	1,783	(632)
59	5.00	13,191	2,897	2,027	(388)
61	6.00	13,549	3,149	2,270	(145)
63	9.00	13,906	3,401	2,513	98
65	11.00	14,624	3,654	2,757	342
67	12.00	14,621	3,907	3,001	586
69	12.00	14,978	4,159	3,245	830
71	11.00	15,335	4,412	3,489	1,074
73	8.00	15,693	4,664	3,732	1,317
75	7.00	16,051	4,916	3,975	1,560
77	6.00	16,407	5,169	4,219	1,804
79	3.00	16,765	5,421	4,462	2,047
81	2.00	17,122	5,674	4,706	2,291
83	1.00	17,480	5,928	4,951	2,536
	100.00				

Assuming that both the owner and operator agreed that a fair total fee expressed as a percentage of total revenue would be 5½ percent, the calculation of the most probable total fee would be as follows:

<i>Assumed occupancy levels</i>	<i>Probability factors</i>	<i>Total revenue (\$000)</i>	<i>Total management fee (total rev. × 5.5%) (\$000)</i>	<i>Weighted average (probability × fee) (\$000)</i>
53%	1.00	\$12,119	\$667	\$ 7
55	2.00	12,477	686	14
57	4.00	12,835	706	28
59	5.00	13,191	726	36
61	6.00	13,549	745	45
63	9.00	13,906	765	86
65	11.00	14,624	785	69
67	12.00	14,621	804	96
69	12.00	14,978	824	99
71	11.00	15,335	843	93
73	8.00	15,693	863	69
75	7.00	16,051	883	62
77	6.00	16,407	902	54
79	3.00	16,765	922	28
81	2.00	17,122	942	19
83	1.00	17,480	961	10
	100.00			\$814

The first three columns in this table are taken from the previous table. The management fee is calculated by multiplying the Total Revenue at each occupancy level by the assumed total fee percentage of 5½ percent. The most probable total fee is determined by first multiplying the total fee at each occupancy level by the assigned probability factor and then adding the results together. In this example the most probable total management fee is \$814,000.

Assuming that the total fee is to be calculated by using a basic fee of 3 percent of total revenue and an incentive calculation representing the remainder, the split between the basic and incentive components is calculated as follows:

$$\frac{\text{Basic fee percentage}}{\text{Total mgmt. fee \%}} = \frac{3.0\%}{5.5\%} = 54.55\% \text{ (basic component)}$$

$$\frac{\text{Incentive fee percentage}}{\text{Total mgmt. fee \%}} = \frac{2.5\%}{5.5\%} = 45.45\% \text{ (incentive component)}$$

Most probable total management fee	\$814,000
Basic component percentage	.5455
Basic component	\$444,000
Most probable total management fee	\$814,000
Incentive component percentage	.4545
Incentive component	\$370,000

This calculation shows that the operator would expect to receive on an average a total annual management fee of \$814,000 that would be divided between a basic component of \$444,000 and an incentive component of \$370,000.

Using the same probability factors, a similar calculation can be made to determine the incentive fee percentage required to yield the \$370,000 incentive management fee component. The incentive fee percentage is determined through an iterative process, which takes the line item net income at each occupancy level and multiplies this amount by the probability factor and an assumed incentive fee percentage. The grand total of each of these calculations is compared to the required incentive component of \$370,000, and if it differs, the incentive fee percentage is adjusted until equality is obtained. The result is an incentive fee percentage that takes into account the dollar amount of the incentive fee component along with the various probabilities that over a period of time different occupancy operating levels will be achieved. The following tables show the end results of the iterative process for each line item net income.

Income Before Fixed Charges

<i>Assumed occupancy levels</i>	<i>Probability factors</i>	<i>Income (\$000)</i>	<i>Incentive fee percentage</i>	<i>Probability × net income × incentive fee percentage (\$000)</i>
53%	1.00	\$2,139	9.18%	\$ 2
55	2.00	2,394	9.18	4
57	4.00	2,644	9.18	10
59	5.00	2,897	9.18	13
61	6.00	3,149	9.18	17
63	9.00	3,401	9.18	28
65	11.00	3,654	9.18	37
67	12.00	3,907	9.18	43
69	12.00	4,159	9.18	46
71	11.00	4,412	9.18	45

Income Before Fixed Charges (cont'd)

73	8.00	4,664	9.18	34
75	7.00	4,916	9.18	32
77	6.00	5,169	9.18	28
79	3.00	5,421	9.18	15
81	2.00	5,674	9.18	10
83	<u>1.00</u>	5,928	9.18	<u>5</u>
	100.00			\$370

Income Before Debt Service

<i>Assumed occupancy levels</i>	<i>Probability factors</i>	<i>Income (\$000)</i>	<i>Incentive fee percentage</i>	<i>Probability × net income × incentive fee percentage (\$000)</i>
53%	1.00	\$1,296	11.85%	\$ 2
55	2.00	1,542	11.85	4
57	4.00	1,783	11.85	8
59	5.00	2,027	11.85	12
61	6.00	2,270	11.85	16
63	9.00	2,513	11.85	27
65	11.00	2,757	11.85	36
67	12.00	3,001	11.85	43
69	12.00	3,245	11.85	46
71	11.00	3,489	11.85	45
73	8.00	3,732	11.85	35
75	7.00	3,975	11.85	33
77	6.00	4,219	11.85	30
79	3.00	4,462	11.85	16
81	2.00	4,706	11.85	11
83	<u>1.00</u>	4,951	11.85	<u>6</u>
	100.00			\$370

Income After Debt Service

<i>Assumed occupancy levels</i>	<i>Probability factors</i>	<i>Income (\$000)</i>	<i>Incentive fee percentage</i>	<i>Probability × net income × incentive fee percentage (\$000)</i>
53%	1.00	(\$1,119)	46.90%	\$ 0
55	2.00	(873)	46.90	0
57	4.00	(632)	46.90	0
59	5.00	(388)	46.90	0
61	6.00	(145)	46.90	0
63	9.00	98	46.90	4
65	11.00	342	46.90	18
67	12.00	586	46.90	33
69	12.00	830	46.90	47
71	11.00	1,074	46.90	55
73	8.00	1,317	46.90	49
75	7.00	1,560	46.90	51
77	6.00	1,804	46.90	51
79	3.00	2,047	46.90	29
81	2.00	2,291	46.90	21
83	<u>1.00</u>	2,536	46.90	<u>12</u>
	100.00			\$370

The following is a summary of the line item incentive fee percentages calculated before and after adjustment for the probability of different occupancy levels and their effect on line item net income.

<i>Line Item Net Income</i>	<i>Incentive Fee Percentage Before Risk Adjustment</i>	<i>Incentive Fee Percentage After Risk Adjustment</i>
Income before fixed charges	8.4%	9.2%
Income before debt service	10.5%	11.8%
Income after debt service	29.7%	46.9%

The key to any type of risk analysis is the assignment of the probability factors. The weighted average occupancy level (the sum of the occupancy levels multiplied by the probability factors) used in this example was 68 percent, compared to the subject's stabilized occupancy of 73 percent used to calculate the incentive fee percentage before risk adjustment. As the weighted average occupancy level decreases from the stabilized level, the size of the risk factor will increase, with the largest increases occurring in the line items closer to the bottom of the income statement.

A second and distinctly separate procedure for reducing the exposure of a management company to the risk of not receiving adequate incentive fee compensation is to incorporate an accrual mechanism into the incentive fee structure. Under this type of arrangement, the incentive management fee is calculated as either a percentage of Total Revenue or a percentage of a high level line item such as Income Before Fixed Charges, but payment is subject to the availability of funds at a lower level line item, such as Income After Debt Service. Payment is made when enough cash is available to pay the incentive fee. If sufficient cash is not available, the portion of the incentive fee not paid is deferred and accrues until such time as funds are available to pay the fee. Under this arrangement, the incentive fees become a liability that will generally be paid over time, so the risk adjustment previously described is substantially reduced. Essentially, the operator only loses the time-value of the money owed. To reduce the risk even further and decrease the effect of the lost time-value of money, a number of management contracts stipulate that the deferred incentive management fee must accrue with interest.

This accruing procedure allows the operator to calculate the incentive fee component on a more easily achievable higher-level line item and provides assurance that over time the compensation will most likely be received. Owners also benefit from this arrangement by having a potentially significant operating expense deferred until adequate funds are available for payment. Lenders generally require this form of subordination to assure that monies will be available to cover debt service.

16.04 **FINANCIAL REPORTING**

The complete, accurate, and timely reporting of financial operating results is one of the most important services provided by a hotel management company, because it is the only real measure available to a hotel owner to evaluate the performance and effectiveness of the management company. Management contracts should detail (1) the types of financial reports that the operator must prepare, (2) how they should be prepared, and (3) when they should be submitted. Financial reports must be organized in a uniform manner and in sufficient detail so that results can be quickly evaluated and any deficiencies immediately spotted; they must be accurately compiled by

knowledgeable accountants and audited periodically; and they must be issued in a timely manner. Every day a report is delayed reduces the opportunity for correcting a problem. Owners and operators must communicate financial information quickly in order to manage effectively.

The first requirement of a financial reporting system is a uniform accounting procedure that allows for easy comparisons between financial reports within the same property, along with the operating results of other, similar hotels. To facilitate these comparisons, the hotel industry has adopted the *Uniform System of Accounts for Hotels*,² which is a standard chart of accounts detailing exactly how each item of revenue and expense should be posted. This system allows the comparison of operating statistics among one or more properties.

For example, assume Hotels A and B are located in the same market area, serve similar customer segments, and both follow the *Uniform System of Accounts for Hotels*. The respective management companies for the hotels report the following statistics pertaining to the operating expense account entitled "Administrative and General":

<i>Unit of comparison</i>	<i>Administrative & general</i>	
	<i>Hotel A</i>	<i>Hotel B</i>
Dollars per available room	\$3,723	\$4,120
Dollars per occupied room	\$5,728	\$5,493
Percent of total revenue	8.6%	7.8%
Percent of rooms revenue	15.4%	13.7%

Based on the unit of comparison, dollars per available room, Hotel A appears to have Administrative and General expenses under better control. This conclusion, however, is not supported by the rest of the data, which show Hotel B performing better in dollars per occupied room, percentage of total revenue, and percentage of rooms revenue. The reason for this is that Hotel B probably has a somewhat higher level of occupancy and is managing the Administrative and General expense category more efficiently.

The types and formats of financial reports prepared by the hotel company should be investigated during the operator selection process to ensure that sufficient financial data will be generated and that it will be presented in a usable format. Some of the financial reports typically provided by the management company include daily, monthly, annual, and miscellaneous reports.

- Daily reports* should provide information regarding revenues and occupancy and should include details of all authorized complimentary rooms.
- Monthly reports* should include an income and expense statement with full supporting schedules calculated on the accrual method and statistical data that details revenues by outlet, occupied rooms by market segments, food and beverage covers by outlet, and labor utilization by department. These reports should provide data for the current month, current month's budget, current year-to-date, current year-to-date budget, last year's month, and last year's year-to-date budgets, and in addition should provide a balance

² Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.). HANYC, Inc. (1986).

sheet, identification of sources and uses of funds, details of capital expenditures, and a Manager's summary and overview of operations.

- Annual reports* must contain an income and expense statement, a balance sheet, and documentation of the sources and uses of funds, all of which should be audited.
- Optional reports to be issued at the request of the owner* include information regarding the aging of accounts receivable, schedules of payables, and schedules of supplies and inventory, as well as reports on occupancy, labor utilization, and insurance claims.

All financial reports should be prepared by the operator either locally on the property or centrally at the hotel company's central offices. The operator should maintain a strong control system in order to prevent theft and embezzlement and to ensure that all transactions are properly accounted for and reported. The entire system, along with all financial reports, should be audited at least annually, and more often if accounting problems are expected.

All financial reports need to be prepared on a timely basis in order to have the greatest value to the owner and operator. In most instances, the following schedule is adequate:

<i>Type of report</i>	<i>Deadline for submission to owner after period end date</i>
Daily reports	1 day
Monthly reports	15 days
Audited annual reports	45 days
Optional reports	Various

Financial reporting provisions are useful for both hotel owner and operator. Complete, accurate, and timely financial operating data is necessary for both parties because the information is critical for evaluating and improving operating efficiencies.

Hotel owners should be aware that significant costs are involved in preparing financial reports and should refrain from needlessly burdening an operator with unnecessary requests for information. The level of financial reporting detailed in this section should not, however, negatively affect any competent hotel management company, which should have accounting systems and procedures in place that can handle normal requirements. If, during the negotiation process, the operator has any difficulty in agreeing to provide this level of financial reporting, there is then reason to question the overall competency of the company.

The bargaining power of either party should not play a part in determining the scope and quality of a financial reporting system. If, during the negotiation process, either the owner or the operator is not fully satisfied with the financial reporting requirements proposed by the other party, all attempts should be made to rectify the situation. If a satisfactory solution is unobtainable, it is probably best to look elsewhere for a deal.

16.05 **ANNUAL PLANS**

All well-run businesses prepare budgets, plans for future operations, and evaluations of past performance in order to facilitate financial planning and control costs. Such planning and analysis is especially important for lodging facilities operated by hotel management companies.

Given the terms of the management contract, the owner either will have no input in the budgeting process or, at the other extreme, will have the opportunity to exert a great deal of control over the operation through a strict review. Generally, the owner will have some power to approve the budget.

Under normal circumstances, a management company will submit an annual plan to the owner that comprises a number of budgets, reports, and plans detailing the expectations of the management company for the subject property over the following 12 months. Annual plans normally include a forecast of income and expenses, a capital expenditure budget, a repair and maintenance budget, a marketing plan, and reports on engineering systems, leasing plans for commercial space, staffing, and salaries.

[1] Forecast of Income and Expense

Perhaps the most important element of an annual plan is a month-by-month forecast of income and expense. This forecast should include full supporting schedules of each revenue and expense category. All standard budget items, including reserves for replacement, property taxes, equipment leases, and debt service, should be projected.

[2] Budgets for Capital Expenditure and Repair and Maintenance

The capital expenditure budget should contain a detailed listing of all necessary expenditures. Each entry in the listing should provide a full description of the expenditure, a concise explanation of why it is necessary, and an identification of the aspect of the property it will improve. In addition, the listing should include the manner in which the cost will be funded and a time frame for its occurrence. The repair and maintenance budget should contain the same sort of information as the capital expenditure budget, except that the items listed in it will relate to expenses contained in the repair and maintenance category of the income and expense statement.

[3] Marketing Plan

The marketing plan should be a comprehensive description of the operating company's marketing efforts on behalf of the subject property. The plan should contain the following:

- An analysis of the current status of the market position of the hotel, including:
 - Average rates and occupancies of all competitive hotels, including their market segmentations and the levels of food, beverage, and banquet competition that they generate.
 - Identification of new competition, either proposed or under construction.
 - An assessment of the economic health of the market area and its possible future effect on transient visitation and food and beverage demand.

- Descriptions of any other factors that could affect the local hotel and restaurant markets and that would be important for developing a marketing strategy.
- An analysis of the current status of any marketing efforts in progress, including:
 - A description of all marketing programs underway and an evaluation of their effectiveness.
 - The number of room-nights already on the books, broken down by month and market segment.
 - The reservation report from hotel chain or franchise system.
 - An analysis of food, beverage, and banquet marketing efforts.
- An overview of long-term marketing strategy for the next three to five years.
- A description of the marketing program for next 12 months, detailing:
 - Plans for enabling the short-term marketing program to meet the goals of the long-term strategy.
 - Marketing efforts, by month, for advertising and promotion, and staffing requirements for these areas.
 - Budget requirements, divided by month and broken down to show the exact manner in which the funds will be spent.
 - Projections of room-nights captured, by month, broken down by market segment, along with expected average rate.
 - Projections of food, beverage, and banquet covers, by month, by outlet, along with average checks.

[4] Other Reports

Among the other reports that the hotel management company must prepare and update annually for the owner are the following: (1) an engineering status report; (2) a leasing plan for commercial space; and (3) a staffing and salary report. The first of these, the engineering report, is issued by the engineering department and details the status of all engineering systems within the property and any expected maintenance or alterations that will be required over the next 12 months. The leasing report describes the status of any leased space on the property for which tenant leases will expire during the next 12 months. In addition to describing the current rent roll, the report should provide information regarding the market rent for similar leases in the local market area. The staffing and salary report should provide an analysis of current and contemplated staffing requirements along with recommendations for adjustments in pay scales and employee benefits. This report should also contain a review of the pay and benefit practices of other hotels in the market area.

16.06 BUDGET APPROVAL PROCESS

The budget approval process is the procedure by which hotel budgets are prepared, submitted to the owner, reviewed, modified, and put into effect. It is also the means by which the owner exerts influence over the expenditures of, and thus

the operation of, the hotel. This process is generally clearly defined in the management agreement.

The budget approval process generally begins about four months before the start of a new operational year, and, much like an annual plan, is put together by the hotel department heads and is supervised by the general manager. Most operators have a multi-step approval process that takes the proposed plan up their corporate ladder. The property owner generally has no input in the process during this initial preparation phase.

Once the annual plan has made it through the internal approval process of the management company, it is submitted to the property owner, usually within 60 to 90 days of the start of a new operating year. The property owner should require ample time to review the plan, develop a critique, and resolve any differences before the point in time when the budgets become effective. In practice, however, the owner approval process differs widely from one contract to another. In some cases, the owner is merely given a copy of the final annual plan and it becomes effective immediately with no approval required. This extreme gives the owner no input in the operation of the hotel or control over the management company. A procedure more oriented to the owner's interest allows the owner an opportunity to review the annual plan, make comments, and either approve certain specific aspects of the plan or the entire plan. This method can, and often does, result in disagreements.

The manner in which budgetary disagreements are resolved ultimately determines the degree of influence that the property owner can wield. In most management contracts that provide for owner approval of the annual plan, if the owner and operator cannot agree on one or more specific terms, the terms that both parties do agree on go into effect on the date required to implement the new plan. In lieu of the provisions that cannot be agreed upon, the terms from the preceding annual plan are used after they are automatically adjusted by a factor such as the Consumer Price Index (CPI). This procedure allows for the continued operation of the property under some form of budget while providing additional time for the parties to resolve their differences.

If, after a stated period of time (30–60 days), the parties still cannot agree on the annual plan, some contracts will give the deciding vote to one of the parties involved. Obviously, the so-called approval process under these types of management contracts are meaningless for the party that does not have the veto power.

[1] Arbitration Procedures

A more equitable arrangement for resolving disputes involving annual plans is some form of arbitration. Arbitration procedures have several clear advantages over litigation. Such matters can be settled relatively quickly because there is no wait for time in a court calendar, and all decisions are final, so there can be no appeal. Arbitration proceedings are not public hearings, so confidential information can be discussed without risk of its release to the public. The arbitrator can be chosen on the basis of specific experience and expertise in the area of the dispute. Last, but not least in significance, is that an arbitration hearing does not require legal representation or extensive preparation, so it is much less expensive than litigation.

The only occasional disadvantage to an arbitration proceeding is that it can take 15 to 30 days to organize and conclude. While not approaching the time involved in a court case, even this delay can sometimes create operational problems when important budget provisions are involved.

To make the arbitration process as efficient as possible, one or more of the following conditions should be incorporated into the clause that provides for such a procedure in the management contract:

- A definition of the specific qualification requirements of the arbitrator (e.g., a national hotel consultant with 15 years of experience).
- Time limits on the process (e.g., 5 days to select an arbitrator, 5 days to hear the case, and 3 days to render a decision).
- The use of the "best offer" approach: both parties are required to put their best offer on the table during the arbitration, and the arbitrator then must accept one offer and reject the other. By eliminating the option of "splitting the difference," the parties will come closer to an agreement.
- The use of a plan, provided by the American Arbitration Association (AAA), for conducting the entire arbitration process. This service is available for a nominal fee and is well worth using.

[2] Ownership Control

The extent of control by the owner of the final form of the annual plan has a bearing on the operation of the hotel. For example, if the owner has veto power over important expenditures, it can maintain a certain amount of financial control over the management company and ultimately gains a greater say in the overall operation.

The fact that the approval of the owner is necessary for implementing the annual plan does not by itself result in ownership control. To accomplish this, specific restrictions that prevent the management company from operating in variance with the budget must be established. For example, if the owner turns down a guestroom refurbishment program proposed in the annual plan, but the operator can circumvent the disapproval by merely increasing the property operations and maintenance expenditures (even if doing so exceeds the approved budgeted amount) and thereby accomplish the same upgrade, then the threat of a budget rejection carries little weight.

Control over the annual plan is one of the key provisions owners should attempt to secure when drafting a management agreement. Veto power over the use of funds can often swing operational control away from the operator and to the owner. First-tier management companies will seldom, however, allow owners to have such power over annual plans. Occasionally, first-tier companies will permit arbitration, but not for every item in the budget. For example, they might arbitrate a disagreement over how much should be spent on newspaper advertising, but would demand total control over funds derived from the reserve for replacement. Second-tier operators, who generally have much less bargaining power, are much more likely to allow greater ownership participation.

As stated previously, the budget process usually commences about four months prior to the start of a new operational year when the operator prepares and delivers to the owner the proposed annual plan. The timing of this delivery is important. The owner must have sufficient opportunity to thoroughly review the findings and recommendations contained in the plan and must have enough additional time to negotiate any necessary changes. The lead time for submitting the annual plan to the owner can range from 30 to 120 days. In general, second-tier operators must submit their plans slightly earlier than first-tier operators.

Once the annual plan is approved, the management company must operate within its budgetary limits. However, certain circumstances, such as unforeseen events and emergencies, may cause the operator to exceed such limits. Many management contracts have some form of restriction on spending over and above the amounts specified in the annual plan. In some instances, the agreement requires the owner's approval for any expenses in excess of the budgeted amount. Other agreements specify a percentage (usually between 5 and 25 percent) by which the operator may exceed a budgeted amount without owner approval. A specific dollar amount (e.g., \$50,000) can be used in place of a percentage, but such an amount must be regularly revised to account for inflation.

16.07 **OWNER APPROVALS**

Some hotel management contracts require virtually no approvals from hotel ownership; others contain numerous opportunities for owners to provide input into the decisions involved with managing a lodging facility. As with budgets, most operators prefer to restrict any provisions requiring any form of approval and owners generally attempt to exert as much control over management in the form of approvals as possible. The following list contains some of the elements of a hotel operation that may be subject to approval by the owner.

- Expenditures for non-capital expenses (generally, those exceeding a specified level)
- Expenditures for capital items (generally, those exceeding a specified level)
- Plans to renovate the facility
- Expenditures not covered in the annual plan
- Use of the operator's central services, the cost of which is not included in the normal management fee
- Use of outside consultants
- Expenditures for service contracts
- Changes in room rates and food and beverage pricing
- Leases and concessions
- Plans to dispose of property
- Initial salaries, raises, benefits, and labor negotiations
- Changes in key operating personnel
- All initial operating policies and subsequent changes
- Selection of a depository bank
- Size of the working capital account
- Withdrawal of funds from operating accounts
- Credit policies
- Insurance coverage
- Use of insurance or condemnation proceeds
- Legal proceedings
- Assignment of the management contract by the operator

In most instances, the approval process is one-sided; that is, the owner is required to approve a request from the operator rather than the operator approving a request from the owner. As a result, any approvals contained in a management contract usually create an advantage for the owner.

Most first-tier hotel companies provide the owner with very few opportunities to review and approve their actions. Second-tier operators are generally more accommodating in allowing for owner approval of some of the operational elements outlined above. As with the budget approval process, the more control an owner can exert over a management company, the greater say it has in the hotel's overall operation.

16.08 **TERMINATION OF AGREEMENT**

When two parties enter into an agreement such as a hotel management contract, the implicit belief is that the relationship will continue for the full term. Often it does, but occasionally one of the participants fails to meet its contractual obligations and the agreement must be terminated. To protect both parties from these types of situations, hotel management contracts often incorporate specific provisions that allow one or both of the parties to terminate the agreement. Circumstances that can trigger termination by the owner include

- Bankruptcy of the operator
- Failure to achieve specific level of performance (usually a defined profit)
- Operator buy-out
- Operator's material breach of the contract
- Operator's misconduct or fraud (such as misappropriation or diversion of funds)
- Operator revocation of license
- Operator termination of the franchise
- Cessation of operator activity in the hotel business
- Condemnation or casualty

Events that can bring about termination proceedings by the operator include

- Bankruptcy of the owner
- Owner's material breach of the contract
- Owner revocation of license
- Owner's failure to provide adequate funds (or nonpayment of the operator)
- Mortgage or lease default
- Condemnation or casualty
- Foreclosure

The key to any termination clause is that it allow for the rapid and conclusive removal of the party at fault. A drawn-out termination by either the owner or the operator is to be avoided as it can have a devastating effect on the current and future operating results of the property.

[1] Bankruptcy

Although most management contracts permit either party to terminate the agreement in the event the other enters into bankruptcy, it is usually the bankruptcy court that ultimately decides whether the operator will continue or be replaced, since the court can override the terms of the contract. Any time a hotel is involved in a bankruptcy, its reputation suffers, and the long-term negative effect can often be difficult to overcome.

[2] Material Breach of Contract

The material breach of one or more contract provisions by one party usually allows the other party to terminate the agreement. In most instances, notification of the breach must be sent to the party within 10 to 20 days of the breach; the party then has 30 to 45 days to cure the breach. If the breach is not cured, the other party may then terminate the contract immediately, or in some cases must again notify the party at fault that the termination is effective. This extensive notification procedure is necessary to protect the rights of the party at fault, but it does draw out the process, which can negatively affect the hotel operation.

[3] Revocation of License or Franchise

Most management contracts contain provisions protecting licenses and franchise documents by holding either party to be in default for causing a license or franchise to be revoked. Both the owner and operator should monitor this provision carefully to ensure that a potential default caused by the other party is corrected before final action takes place. Notice of a default in any critical license or franchise should be sent to both parties so corrective action can be taken.

[4] Condemnation or Casualty

The taking of a hotel through eminent domain or by some form of destructive casualty generally permits either the owner or operator to terminate the agreement. A partial taking or casualty produces several issues that must be addressed when the management contract is drafted:

- At what point is a hotel rendered unusable by a partial taking or casualty?
- Does the owner or operator decide whether the facilities should continue to be operated?
- Is the operator entitled to a portion of the condemnation award or insurance proceeds?
- Is the operator entitled to collect a contract termination fee in the event the property is rendered unusable by a condemnation or casualty?

Some contracts allow either the owner or operator to determine whether the hotel has been made unusable, while others set forth certain criteria for reaching this conclusion. Some contracts, for example, cite circumstances such as those in the follow-

ing list, that would render a hotel inoperative and thereby allow either the owner or the operator to terminate the agreement.

- The cost of necessary repairs exceeds 85 percent of the hotel's replacement cost.
- The food and beverage facilities are rendered unusable during the last 18 months of the contract term.
- Fifty-five percent of the guestrooms are destroyed within the last five years of the contract term.
- Forty percent of the guestrooms are destroyed within the last four years of the contract term.
- Thirty percent of the guestrooms are destroyed within the last three years of the contract term.
- Twenty percent of the guestrooms are destroyed within the last two years of the contract term.
- Ten percent of the guestrooms are destroyed within the last year of the contract term.
- More than 30 percent of the hotel is destroyed by an uninsured casualty.

In most instances, operators will attempt to reopen a lodging facility that has been partially condemned or destroyed by a casualty. When negotiating the contract, owners should be aware of this inclination and insist that the agreement be worded in such a way so as to prevent the rebuilding of a facility when doing so does not represent the best use of the condemnation or insurance proceeds.

[5] Operator's Failure to Achieve Performance Levels

One of the most important provisions from an owner's point of view is a performance clause that sets specific operating standards that the management company must meet in order to remain as the operator of the property. Generally, the best measure of operating performance is profitability. Owners invest in hotels in order to realize profits, and the ultimate test of the management company is whether profits are actually made. A well-written performance clause protects the hotel owner from an incompetent operator, while at the same time assuring the management company that it will not be terminated for circumstances beyond its control. Among the important issues that should be addressed in a performance clause are the following:

- Performance criteria should be clearly defined so that both the owner and operator understand the specific goals. Stating, for example, that the hotel must be operated in "a profitable manner" does not provide the operator with a specific level of performance.
- The failure to achieve the desired level of performance should be recognizable early enough to prevent the hotel from suffering undue financial hardship from an incompetent operator. The performance criteria should also, however, address the possibility that the operator is a competent manager but external circumstances, such as a declining economy or overbuilt market, makes the performance level impossible to reach.

- The performance criteria should take into account unique circumstances, such as that a new hotel typically experiences a period of build-up, during which both occupancy and profits grow; that a seasonal hotel is often less profitable than one that operates year-round; and that unions, high energy costs, excessive property taxes, and difficult maintenance problems are unpredictable elements that will often reduce profits.
- The termination process should provide the operator with an opportunity to remedy the lack of performance by contributing or lending the necessary funds to the owner in order to correct the deficiency and bring the level of performance in line with the stated criteria.
- The performance criteria should reflect the fact that a management contract generally runs for an extended period of time and as the financial structure of the property (i.e., financing, equity and ownership) changes, the intended performance provisions should remain intact. For example, if the performance criteria establishes a level of profit after debt service, and at some time in the future the mortgage is restructured, thereby reducing the annual payments, the operator will directly benefit because the margin of profit will automatically rise through no effort on the part of the operator.

Setting specific performance criteria often becomes one of the key elements in the management contract negotiation process. The operator generally opens discussions by stating that any form of operator performance criteria is inappropriate and unnecessary. The owner generally counters with provisions that permit swift operator removal for any deficiency in performance. The final contract, which will reflect the bargaining power of each party, will be the result of some compromise between these two opening positions.

From the owner's point of view, the easiest way to establish appropriate criteria for operating performance is to use the income and expense projections developed by the operator during the request for proposal (RFP) stage of the management company selection process. Owners assume that if the management company was attempting to sell its services based on such projections then it should be willing to have them used as a performance standard. Management contracts that use this approach typically set forth a defined level of profit, such as income before debt service, and list by year the minimum dollar amount that the operator must generate in order to conform with the performance standard. Other performance criteria sometimes used in hotel management agreements include:

- Revenue figures from a market study performed by a hotel appraisal firm.*
- The income after debt service realized by the subject property.* This performance standard requires the operator to generate a net income that covers, at a minimum, the debt service for the property. The specific amount of debt service should be set forth in the contract, because with floating loans, refinancing, and subordinate mortgages the actual payments may vary over the life of the contract.
- Specified return on equity funds.* This criterion is similar to the income after debt service standard except that the operator must generate a sufficient profit to not only cover debt service but also provide a minimum return on equity. In the event that additional equity funds must be invested in the property, such as monies to cover initial cash shortfalls, this type of clause allows the owner to impose a higher standard on the operator.

- Room rate multiplier.* This performance standard requires the level of gross operating profit to be not less than a certain multiple (e.g., 150) of the average rate per occupied room multiplied by the number of rooms in the hotel. This criterion is based on an industry rule of thumb that states that the value of a hotel can be estimated by multiplying the average room rate of the property by the number of guestrooms by 1000. Care must be taken when using this formula that the multiple that is chosen is appropriate for the type of property.
- Percentage of gross operating profit.* This standard establishes the right of the owner to terminate the agreement if a certain percentage (e.g., 80 percent) of the gross operating profit does not equal a certain percentage (e.g., 15 percent) of the equity funds invested in the hotel.
- Percentage of an approved budgeted amount.* This standard is based on an approved operating budget and holds that the operator must achieve a certain percentage of a stipulated profit line in the budget, such as 80 percent of the gross operating profit. The key to this criterion is the budget approval process and how much input the owner has in establishing a realistic level of performance. The advantage of this procedure is that the performance criteria can be adjusted on a yearly basis (through the annual budget approval process) to reflect local market and operating cost conditions.

Performance criteria generally do not become effective for two to four years after the opening of a hotel. This delay is particularly important for newly opened properties, whose operating performance is difficult to judge during the first few years as the business builds up. In addition to a delay for the start-up period, most performance clauses allow a new operator two to three years to achieve the necessary level of profit. A typical performance clause will, for example, state that the owner may terminate the agreement if the operator fails to achieve a positive income after debt service after three consecutive years. Often, the management company must fall short of the performance standard for two or more consecutive years before the owner can terminate for poor performance. In general, performance standards start later and require more consecutive years of nonperformance for first-tier operators than for second-tier operators.

If an operator agrees to a performance termination clause, it usually insists on receiving the right to cure. A right to cure clause allows the management company to provide the capital necessary to make up any difference between the hotel's actual level of performance and the performance level set forth in the management contract. by advancing the needed capital, the operator is allowed to continue managing the property until another performance test is made (usually one year later). The monies funded by the operator may take one of two forms: they may be treated as merely cash advanced with no provision for repayment, or they may be loaned by the operator (with or without interest) to be repaid at some future date. Any repayment of funds advanced by the operator to meet a performance criteria is generally subordinated to debt service as well as a return on equity funds.

To protect the operator from external circumstances that could adversely affect a hotel's operating performance and thereby subject the management company to termination, some contracts contain an arbitration provision that allows the operator to prove that the failure to meet the performance standard was due to causes or conditions beyond the operator's control.

[6] Operator Buy-out

A buy-out clause enables the hotel owner to terminate the management contract at any time for any reason by merely paying a specified dollar amount. This provision is important to owners for several reasons:

- It allows the hotel to be sold unencumbered by a management contract, generally permitting a quicker sale and usually producing a higher selling price.
- An incompetent operator can be removed in less time than that usually provided for in performance termination clauses.
- Occasionally, an owner may find it advantageous to buy out the operator and manage the property independently, thereby saving the management fee.

Although a buy-out clause can greatly benefit the owner, such provisions are rarely available from first-tier operators. Hotel chains with a recognized trade name are often reluctant to enter into agreements that could be easily terminated by the owners and possibly create adverse customer publicity.

The actual termination charge reflects the value of the management contract to the operator. Theoretically, the amount of the payment should approximate the discounted value of the anticipated management fee income over the contract's remaining term. Typical termination charges range from two to four times the total management fee paid to the operator over the previous 12-month period. This calculation equates to a 25 to 50 percent discount rate, which is generally appropriate for gross rather than net income to the management company.

The termination charge can also be based on a sliding schedule, such as the following:

Years 0-10	No termination
Years 11-15	200% of total fee for prior 12 months
Years 16-17	100% of total fee for prior 12 months
Year 18+	No fee

This schedule takes into account the greater cost of termination, in terms of lost profits and start-up costs, to the operator in the early years of the contract. A specific dollar amount (e.g., \$75,000) can be used in place of a percentage, in both a standard fee provision and a sliding schedule, but such an amount must be regularly revised to account for inflation.

[7] Operator Misconduct or Fraud

Any operator misconduct, including fraud or the misappropriation of funds, constitutes a major breach of trust and warrants the operator's immediate termination. Care must be taken to determine that such an occurrence was attributed to the operator rather than to an employee acting without the management company's knowledge or approval. Individual breaches should be insured against by appropriate fidelity bonds.

[8] Cessation of Operator Activity in the Hotel Business

Management contracts can sometimes extend for 30 to 50 years, so owners usually seek to protect themselves from operators who become significantly less active in managing hotels and, by doing so, reduce the benefits of being part of a lodging chain. Some contract clauses allow the owner to terminate if the operator ceases to manage a specified number of hotel properties. Other clauses stipulate a dollar volume amount that hotel operations must represent as a percentage of the company's total revenue.

[9] Owner's Failure to Provide Adequate Funds

Under a management agreement the operator generally has no responsibility to provide operating capital for the hotel. All funds either come from the property's cash flow or are contributed to the operation by the owner. To provide adequate management services, the hotel company must have access to sufficient financial resources to pay bills and other liabilities. Lack of necessary funds puts undue pressure on the operator, making it difficult to manage effectively. In addition to their concern regarding access to sufficient capital to operate the property, management companies obviously want assurance that owners have the resources necessary to pay their management fees.

Adequate funds are typically defined in the management contract as a specific dollar balance that is to be maintained in the property's operating bank account. When cash drops below this pre-established level, the owner must deposit more funds or the agreement goes into default.

[10] Mortgage or Lease Default Including Foreclosure

Provision for termination because of a mortgage or lease default is often tied in with the operator's right of termination in case of the owner's failure to provide adequate funds. Operating under the threat of either a lender foreclosure or a landlord eviction is difficult for a hotel management company. Such situations not only result in adverse publicity, they also have a damaging effect on the staff, suppliers, and customers. As with a bankruptcy, the reputation of the management company, particularly first-tier chains, can be quickly tarnished, affecting the image of the entire company.

Most operators want the option to remove themselves from such circumstances. At the same time, lenders also want the option to either remove the operator or continue under the same management in the event of foreclosure on the owner's mortgage. Depending on the negotiating power of the respective parties, the clause providing for termination because of a mortgage default can be written to favor either the hotel operator or the lender.

16.09 OPERATOR INVESTMENT IN PROPERTY

Many hotel owners attempt to negotiate some form of financial commitment to the property on the part of the management company in the belief that having the operator financially tied to the success of the project will create additional incentive to

manage in a profitable manner. This practice is more common with first-tier operators than with second-tier operators. Hotel management companies generally pursue one of the following options if an investment in the property is required:

- Deferred incentive management fees.* The deferral or outright forgiveness of all or a portion of the incentive management fee is actually a form of capital investment on the part of the operator. Most management companies are willing to accrue the incentive portion of the fee in instances where cash flow is insufficient to cover debt service. If this portion accrues at interest and is ultimately repaid some time in the future, then the actual cost to the operator is minimal. If the deferred incentive fee accrues without interest, the operator loses the time value of money but generally receives full payment at some point in the future. Occasionally, fee structures are negotiated that stipulate that any unpaid incentive fee will not accrue and that the operator forfeits all monies owed. This structure is the most likely one to induce a meaningful investment from the operator.
- Preopening services.* Owners are often able to negotiate reduced charges for the pre-opening services of operators in the case of a new hotel.
- Working capital.* All hotels require working capital to purchase inventories and operating supplies and to fund other types of start-up costs. This money often comes from the hotel management company.
- Initial operating fund.* This fund is used for operating supplies, inventories, and house banks and cash. The operator is not usually responsible for maintaining working capital balances. These costs typically range as follows:

<i>Class of hotel</i>	<i>Amount per room</i>
Economy	\$1,100 to \$1,500
Standard	\$1,500 to \$2,600
First	\$2,300 to \$3,200

- Furniture, fixtures, and equipment (FF&E).* Occasionally, the operator will fund the purchase of part or all of the hotel's FF&E. This outlay can represent a significant investment on the part of the operator. FF&E costs typically range as follows:

<i>Class of hotel</i>	<i>Amount per room</i>
Economy	\$ 5,200 to \$ 9,100
Standard	\$ 9,800 to \$17,000
First	\$13,800 to \$30,900

- Outright payment of key money.* In some highly desirable hotel markets such as New York City, hotel management companies sometimes pay what is known as key money to obtain the right to put their name on and manage a hotel. In effect, the company purchases the management contract for the hotel.
- Other operator investments.* Management companies sometimes provide funds in the following formats: reduced fees, group purchasing advantages, and profit guarantees.

The fact that a management company is willing to make a capital contribution is sometimes meaningless when the form of the contribution does not expose the operator to any monetary loss. For example, if the contribution of capital takes the form of a loan that is repaid over time with interest, the operator has not really made a significant investment. This may also be the case even if the loan does not accrue interest, in that the operator has lost nothing other than the time value of money. Only when the operator actually contributes capital (in the forms described above), with the expectation of receiving a return *pari passu* to the other equity funds, can the investment be considered meaningful. The usual forms of operator capital contributions are as follows:

- Loan of capital.* The operator contributes capital in the form of a note that is repaid with interest, generally out of cash flow. The note is usually unsecured and subordinated to mortgage debt service.
- First take-out of equity.* The operator receives all of the property's cash flow after debt service until the equity contribution is recovered. The owner then receives the cash flow until the remainder of the equity investment is recovered. Any subsequent cash flow is divided according to an agreed upon percentage.
- Outright equity contribution.* The operator and owner enter into a joint venture partnership and split all cash flow after debt service in accordance with an agreed upon percentage.

While a capital contribution on the part of the operator may sound appealing to an owner, it can represent very expensive money. From the owner's standpoint, if capital is urgently required for the operation of a property, the most reasonable form of capital contribution by a management company is, first, the subordination of management fees and, second, the loan of capital. The primary advantage for an owner in obtaining funds from the operator in the form of a loan is that the overall cost is relatively low. Interest on the funds loaned is usually tied to the prime rate or a specified percentage in excess of that rate (generally no more than 2 percent), but amortization based on cash flow can be very rapid. An operator's capital contribution in the form of equity, which carries no stated rate of return, can also be costly. Since many operators have limited resources to invest in hotel properties they generally seek cash-on-cash returns on their equity of 12 to 20 percent.

16.10 OPERATOR EXPENSES

Hotel management companies generally incur two types of expenses during the process of operating hotels either for their own account or for third parties. These expenses are known as home office expense and system reimbursable charges.

[1] Home Office Expenses

Home office expense includes all the costs of operating the home and regional offices of the management company. These consist of salaries and benefits for executive personnel and support staff, office operating expenses such as rent, office equipment, telephone and supplies, and administrative expenses including insurance, bookkeeping, and legal, which are limited to the administration of the management

company rather than the hotel properties themselves. Depending on the size of the management company and the types of management services provided, the extent of the home office expense may range from modest to extensive.

[2] System Reimbursable Charges

System reimbursable charges are expenses paid by the hotel owner for centralized services provided by the management company. Centralized services include system-wide advertising, national and regional sales offices, reservation accounting, management information and purchasing systems, and education and training programs. Most first-tier management companies offer extensive centralized services, while second-tier operators generally have limited capabilities.

[3] Payment of Expenses and Charges

Home office expenses are typically included in the management fee and are not charged or allocated to any of the properties under contract. These costs represent the normal overhead expense of operating a hotel management company. While home office costs are not usually allocated among the chain's hotels, some operators will charge individual properties the travel expense when home office personnel make periodic visits. Occasionally, the salaries of these individuals may also be charged to a hotel when specialized services are being performed.

When negotiating a management contract, the hotel owner should request a detailed description of the home office expenses that will be included in the management fee and those that will be charged to the property. Some operators attempt to allocate a portion of the normal home office overhead to individual properties through excessive charges for home office services. This procedure allows hotel companies to offer fee structures that appear extremely competitive but, when the total costs are calculated, are often economically unattractive.

System reimbursable charges are generally allocated to all the properties within the system according to a specified formula. Some of the methods currently in use include:

- Percentage of revenue.* The cost of a centralized reservation system is often allocated on the basis of a percentage of revenue—usually rooms revenue, which reflects three important operational variables: the property's room count, occupancy, and average room rate. This method can be somewhat unfair to hotels that do not receive an adequate share of reservations from the centralized system but nevertheless must pay the formulated portion of this expense.
- Per available room.* Allocating centralized services on the basis of the room count in the subject property divided by the total room count in the chain is a common procedure that is simple to administrate and does not involve communicating confidential information such as occupancies and average room rates. It can, however, produce an allocation that is more unfair than the percentage of revenue method because it does not account for the actual operating performance of a property. For example, using the per available room basis of allocating centralized advertising, a 300-room hotel operating at 75 percent occupancy with a \$100 average rate would

pay the same amount as a 300-room hotel with a 60 percent occupancy and a \$85 average rate. Furthermore, this method also does not take into account the actual usage and benefit an individual hotel might or might not receive from the centralized advertising program.

- Per service received.* This method of allocation tends to produce the fairest results because it divides the centralized costs based on actual usage and benefit derived. For example, the cost of centralized reservations may be allocated on the basis of \$4.50 per reservation received. Properties that obtain a greater number of reservations from the system pay a larger share of the centralized costs. Care must be taken when using this allocation method to make some provision for no-shows, that is, reservations made and thus charged to the property that represent customers who either subsequently cancel or do not show at the property. Administration of this method of centralized expense allocation is obviously more difficult.

The methods used by a hotel management company to allocate system reimbursable charges are generally preestablished by the management company and subject to negotiation for individual management contracts. The property owner should request documentation as to the management company's historical allocation procedures and costs for these charges so that projections can be made for the subject property.

16.11 **TRANSFER OF OWNERSHIP**

The ability of both the hotel owner and the hotel operator to easily transfer ownership (i.e., by the owner selling the hotel or the operator selling the management company) is desirable because it allows the selling party to actually realize the value of the enterprise. Any prohibitions that make a sale more difficult can reduce the obtainable value. There is good reason for establishing conditions to a transfer, however, because the party remaining after a sale is dependent on the abilities and resources of the new owner for future success. To protect the hotel owner and operator, many management agreements incorporate specific restrictions on the transfer of ownership. There are basically two types of such restrictions: approval requirements and the right of first refusal.

The remaining party can receive protection through a variety of approval requirements to which both the parties buying and selling must adhere in order for the transaction to take place. Generally, the more protection the remaining party receives, the more restrictive the transfer process becomes. Transfer approval requirements can generally be divided into three levels depending on the degree of restrictiveness imposed by the remaining party: those that give the remaining party total veto power; those that establish specific approval criteria; and those that stipulate that approval cannot be unreasonably withheld.

A total veto provision gives absolute power to the remaining party to either accept or reject the buyer proposed by the seller. This level obviously provides the greatest protection to the remaining party, but it can seriously inhibit the marketability of the enterprise should the veto be used in an unreasonable manner.

Some management agreements incorporate specific approval criteria that must be met before a transfer is approved. Depending on whether the transfer is made by the owner or operator, the criteria can relate to items such as net worth, integrity,

experience, references, or possible conflicts of interest. By establishing specific approval criteria, both the seller and a qualified buyer are able to move towards a transaction knowing that they will be approved by the remaining party.

A common provision in management agreements is that a specific approval cannot be unreasonably withheld. While this stipulation might provide some comfort to the prospective buyer and seller, the interpretation of "unreasonably" can subject the entire transaction to ruinous litigation.

In addition to specific approval requirements on the transfer of ownership, most hotel management contracts contain a right of first refusal. Under a right of first refusal, the party to remain with the hotel has the right to match the offer made by the buyer and accepted by the seller. This provision not only allows the remaining party to acquire a full interest in the property, but alleviates the need to invoke one of the approval requirements in the event the remaining party does not want to become a partner with the potential buyer. While the right of first refusal should not take the place of specific transfer approval requirements, it provides another form of protection.

A right of first refusal can by itself inhibit the sale of a hotel. Potential buyers, knowing that they may not ultimately succeed in purchasing a property because of the rights vested in the remaining party, may not spend the time and effort necessary to pursue the transaction. This may limit the number of potential buyers, which can in turn adversely affect the marketability of a property.

An important component of a right of first refusal provision is the length of time the remaining party has to consider matching the offer of the buyer. Naturally, the seller wants this time period to be kept to a minimum while the remaining party wants as much time as possible to review the offer and secure necessary financing. The length of time allowed to consider such offers generally ranges from 45 to 90 days, but in most instances, the remaining party is permitted 60 days to consider an offer.

While the transfer of ownership is generally not an immediate concern when a hotel management agreement is drafted, the structure of these provisions can have a significant impact on both the residual value of the property and the ongoing relationship of the parties to the agreement. Care must be taken to view a transfer from the standpoint of all parties involved in order to achieve an equitable contractual structure.

16.12 **EXCLUSIVE RIGHT TO DEVELOP OR OPERATE**

Most hotel developers and operators are interested in new opportunities to develop or manage properties. One way to generate new business is to enter into management agreements that give the management company the exclusive right to operate all the hotels of the owner and the owner the right to develop all of the hotels operated by the management company.

While this type of provision generally does not extend beyond the local market area, it provides a way for reducing the adverse effect of competition. However, such a provision must be carefully considered, because as circumstances change, business relationships that are appropriate today may not be so in the future.

An exclusive right to develop or manage should be structured more as an option than as a right. If the developer decides not to build another hotel for the operator, then the operator should be free to pursue other opportunities within the market area.

If the operator believes it is not suited to operate a particular type of hotel for the developer, then the developer should be permitted to find an alternative.

16.13 **INSURANCE AND CONDEMNATION PROCEEDS**

After a casualty or condemnation, the property owner is generally compensated for the loss by either the insurance company or the condemning authority. In the event of casualty, depending on the type of insurance coverage, the owner usually receives the replacement cost of the property destroyed, so that the damaged hotel can be reconstructed. In a condemnation, the compensation is typically based on the market value of the property taken. Business value is rarely considered by either the insurance company or the condemning authority, with the exception of insurance that covers a business interruption.

Most hotel operators want management contract provisions that require insurance and condemnation proceeds to be used to reconstruct the hotel. Some management companies, however, want to receive a portion of any insurance or condemnation proceeds as compensation for the loss of management fee income along with the other benefits of operating the hotel. For example, an agreement may stipulate that the operator receive a portion of the residual compensation left after the property is rebuilt, calculated by taking 20 percent of the fraction of which the numerator is the number of years remaining in the management contract and the denominator is the number of years in the hotel's remaining useful life, and multiplying this percentage by the residual compensation. Although management companies with strong bargaining positions are sometimes able to obtain these types of provisions, the sharing of insurance or condemnation proceeds is usually not justified unless the insurance company or condemning authority makes an unusual special award for a business-related loss.

Hotel owners generally insist on retaining all the proceeds from an insurance or condemnation award. If this right is unacceptable to the operator, a compromise provision is sometimes agreed to that allows the management company to make its own claim for compensation, but only if the owner can be satisfied that such a claim may be made separately and any award would not adversely affect the timing or amount of the proceeds to which the owner is entitled.

Although a destructive casualty or condemnation is an unlikely occurrence during the life of a management contract, any clauses relating to these events become extremely important if in fact the property is destroyed or taken. Both parties must be aware of how insurance or condemnation compensation is calculated so an agreement can be properly structured.

16.14 **EMPLOYEES**

One of the major issues in management contract negotiations relates to whether the personnel employed in the hotel are to be employees of the owner or of the management company. Owners generally want the workers to be employees of the operator and operators want the owner to be the employer. The basis of this issue is primarily liability; the employer is directly responsible for withholding taxes and social security and, ultimately, making timely payments to the IRS. Sometimes, when cash flow is tight, the money for these federal taxes is diverted to other, more pressing uses. If

the cash flow does not recover in time to allow the fulfillment of the government obligations, the employer becomes subject to penalties, interest, and even criminal prosecution. In addition to this employee tax liability, an employer faces various types of personnel liabilities, such as employee theft, assault, discrimination, and negligence.

Under most hotel management contracts the hotel owner is usually responsible for providing any funds needed to cover cash flow shortfalls, so most operators contend that they should not be the employer when they do not have total control over the availability of capital. On the other hand, since the operator usually has direct responsibility over employee hiring practices and should be in a position to monitor the quality and integrity of the personnel, many owners feel that the operator should be the employer.

From the perspective of the management company, another cause for concern regarding the employee issue arises when a company finds itself in a hotel ownership position on a short-term basis. For example, when a lending institution forecloses on a hotel and becomes the employer of the property's personnel, it may be forced to provide pay and benefits equal those received by other employees of the bank. These benefits can be very expensive and are not a desirable option for a short-term owner.

Occasionally, the management company will request that top-level personnel be employed by the operator while all others work for the owner. This agreement allows top management to participate in the chain's benefit programs while restricting the inclusion of all other employees. It also provides the operator additional control over the key executives.

16.15 **RESERVE FOR REPLACEMENT**

A reserve for replacement is a fund set up to accumulate capital for the periodic replacement of FF&E. Hotel FF&E should generally be replaced on an average of once every eight to ten years, so the reserve for replacement must be of adequate size to meet these requirements. Hotel owners that are also operators usually do not actually establish a fund for this purpose, but rather contribute capital at the time that FF&E replacements are required. Depending on the owner's financial situation at the time FF&E funds are needed, they may come from the hotel's cash flow, additional borrowings, or new equity contributions. Occasionally, these sources of funds are not available and the FF&E replacements must be postponed.

A hotel management company has a vested interest in maintaining the hotel in top physical condition, so it does not want to be in a position where adequate funds are not available to make necessary replacements. A worn-out facility negatively affects profitability as well as the image and reputation of the operator. To provide protection against such an occurrence, hotel management companies generally require that an actual reserve for replacement fund be established, coupled with contractual obligations for regularly depositing capital. The management company typically opens a separate reserve for replacement bank account and administers its activity. Deposits are made by the operator directly from cash flow (or from ownership short-fall capital if cash flow is insufficient). Withdrawals from the fund are to be used only for replacement of FF&E and generally only with the approval of the operator. Depending on how the budgeting process is structured, FF&E replacement may require ownership approval or it may be at the operator's sole discretion.

Many different formulas are used to establish the amount of money that must be contributed each year to the reserve for replacement fund. The primary objective of any of them is to create a fund that adequately covers future replacement needs without needlessly putting aside too much money. The following list describes some of the formulas used for this purpose by hotel management companies.

- Percentage of revenue.* Most hotel management contracts base the annual reserve for replacement contribution on a specified percentage of total revenue. This advantage of this formula is that it automatically adjusts for different factors, such as varying occupancy levels, changes in average room rates, increases or decreases in food and beverage volume, and external inflationary factors. For example, if a hotel experiences higher levels of occupancy, the total revenue increases and the reserve for replacement based on a percentage of revenue follows suit. The reserve fund grows more rapidly and replacements can be made sooner to offset the effects of the greater use.

The actual percentages used in this formula generally range from 1 to 5 percent of total revenue (rooms, food, beverage, telephone, and other income). Some contracts call for a fixed percentage that stays constant over the life of the agreement, while others use differing percentages that increase periodically. The fixed percentage formula works well for both new and existing hotels. The step percentage is generally used for new properties.

- Annual fixed dollar amount.* Some management contracts specify that a fixed dollar amount be contributed to the reserve for replacement fund on an annual basis. The size of the annual contribution is calculated by estimating the total future replacement cost in today's dollars and dividing this amount by the number of years remaining until the replacement is required. In order to adjust for inflation, a factor based on the Consumer Price Index (CPI) is usually incorporated into the calculation. The difficulty with this approach is estimating the number of years between replacements. A particularly successful hotel with a high occupancy may require an FF&E replacement long before the originally scheduled date. If this occurs, the fund would not be sufficient to complete the necessary replacements. This method is rarely used alone. Instead, it is commonly used in conjunction with the percentage of revenue method.
- Negotiated yearly amount.* Some management contracts structure the reserve for replacement contribution on the basis of an annual amount negotiated between the hotel owner and operator. However, most operators want a more definite formula that provides assurance that an adequate reserve fund will be available to make necessary replacements.

Because items of FF&E have a relatively short life, contributions to the reserve for replacement fund must be made annually starting with the first year of operation. Some owners of new hotels attempt to negotiate a formula that incorporates a waiting period, thinking that early contributions are unnecessary because the FF&E is in new condition. If this approach is used, it is likely that there will not be sufficient capital in the fund when short-life replacements must be made. What must be realized is that even though FF&E has an average useful life of eight to ten years, many of the components have lives that are much shorter. The following table shows the typical useful lives of various FF&E components:

<i>Item</i>	<i>Years of Useful Life</i>
Furnishings	
Lobby	5-12
Restaurant	5-12
Guestrooms	
Casepieces	8-15
Mattresses	5-18
Carpet	
Lobby	3-6
Corridor	2-4
Guestrooms	4-8
Drapes	4-8
Bedspreads	3-6
Kitchen equipment	8-25

As this table shows, FF&E replacement could start as early as the second year for a new hotel. Additional replacements are then necessary almost every year thereafter. Replacement is an ongoing process, so the accumulated dollar amount in the reserve fund is generally minimal; this means that a sinking fund arrangement (i.e., the use of segregated assets and their proceeds to fund the replacement) is inappropriate because the yearly fund balance is probably insignificant and the compounding interest benefit does not generate any appreciable growth.

Both the hotel owner and operator should recognize that the fund must be of adequate size to meet the replacements required without being excessively large to tie up capital unnecessarily. In order to put the concept of a reserve for replacement into its proper perspective, the management contract should contain a clause such as the following:

The percentages for the reserve for replacement fund are estimates. If, in good faith, Operator believes that such percentages have become excessive, given the needs of the hotel, such percentages shall be reduced at the option of Owner. On the other hand, as the hotel ages these percentages may not be sufficient to keep the reserve for replacement fund at levels necessary to make the expenditures required to keep the hotel in first-class condition. In such an event, Operator may adjust the percentages upward.

16.16 **AREA RESTRICTIONS FOR OPERATOR**

Competition among different hotel chains within the same market area can adversely affect the operating results of a particular property. Competition from hotels with the same chain affiliation or management can be even more devastating. Hotels with identical names operating in the same market area and going after the same market segments can produce a competitive environment that is not only confusing to the market but counterproductive in capturing room-night demand.

To prevent a situation in which a hotel chain establishes too many hotels within a market area, some hotel management contracts provide for area restrictions. Basically, area restrictions limit a hotel company from owning, leasing, operating, or franchising other lodging facilities within a defined geographic area surrounding the subject property. This owner-oriented provision is most important when the operator is a first-tier management company whose corporate name has a public identity. The act of placing the chain's name and trademarks on other hotels within the same mar-

ket area can dilute potential room-night demand and reduce operating levels for existing properties. Second-tier hotel operators, without a recognizable brand name identity, have much less of an effect on their existing properties when they take over additional hotels in the same market area. However, even if the public is not aware that two hotels of differing chain names are under identical management, the potential for a conflict of interest and favoritism is always present. This is particularly true if the management company has an ownership interest in the competitive hotel. For these reasons, hotel owners generally attempt to negotiate some form of area restriction.

Restrictions on a management company to own, lease, operate, or franchise other lodging facilities within a defined market area should be structured so that they protect an existing property from adverse competition but, at the same time, give the operator the opportunity to expand when demand allows. An area restriction clause must provide two important pieces of information. First, the primary market area must be clearly defined so there is no spill-over into other nearby areas that are not directly competitive. Several formats are available to achieve this objective. Some contracts utilize a specific radius to outline the perimeter of the market area. Other contracts provide street names to outline the protected territory or use the boundaries of a city or other established area. Second, the clause must specify the duration of the restriction. Restricted market areas are sometimes redefined over time. A circle with a radius of ten miles might be used for the first five years, shrinking in size to a five-mile radius for the next five years and then eliminated for the remaining term of the agreement.

Operators who consent to an area restriction generally look for ways either to have the protected territory reduced in size over time or to incorporate a provision that will allow the restriction to be lifted if sufficient local area demand can be proven. The best way to demonstrate that the impact of another hotel carrying the operator's trade name or management will be minimal is to establish a minimum level of occupancy requirement before the operator is allowed to enter the market with another property. For example, a clause might give the operator permission to add another hotel any time after the existing property has achieved an occupancy level of at least 75 percent for two consecutive years. Whatever the occupancy level selected, it should be high enough to demonstrate that there is sufficient area lodging demand to support another property carrying the same trade name.

Some hotel companies use the services of hotel consulting firms to perform impact studies that assess the negative effect on the subject property if the operator adds another lodging facility to the market area. As with any study of this type, the quality of results are directly related to the skills of the consultant performing the work and the ultimate determination is still largely subjective and prone to dispute.

16.17 **INDEMNIFICATION**

Most hotel management contracts contain clauses that indemnify each party from various liabilities and losses. Owners and operators face different risks in their respective capacities, so indemnification provisions are variously structured in order to meet each party's need to reduce their exposure. The major types of indemnification clauses are as follows:

- Indemnification provided by the owner.* Generally, the operator wants indemnity from all liability, loss, damage, cost, or expense relating to or

arising from the operation of the hotel. This coverage usually also includes any act or omission, negligence, tortious or otherwise, of any agent or employee of the operator. It typically requires the owner to assume the cost and expense of the defense of any legal proceeding arising out of the allegation of any such act or omission. In most instances, the indemnification provisions protecting the operator are not totally absolute; they usually contain exceptions for circumstances such as: willful operator misconduct, gross negligence, fraud, theft, malicious conduct, and breach of trust. During the negotiation process hotel operators try to limit these exceptions by using modifying terms such as “gross” negligence, while owners try to broaden the exceptions so that no indemnification would be required if the operator was merely negligent. Most management contracts include some sort of indemnification for the operator.

- Indemnification provided by the operator.* Most management contracts contain provisions that require the operator to indemnify the owner from liability, loss, damage, cost, or expense caused by the operator’s breach of the management agreement. In addition, the hotel company is sometimes required to also indemnify actions outside the scope of the agreement, including gross negligence, willful misconduct, fraud, or breach of trust. Operators attempt to modify the impact of these clauses by adding modifying terms, such as “material” breach of the management contract and “willful” misconduct.

The use of indemnification provisions in hotel management contracts requires extensive local legal knowledge. The parties to the agreement should consult with their attorneys before approving any indemnification clause.

16.18 **PREOPENING MANAGEMENT SERVICES**

Since most hotel management agreements are structured primarily for operating lodging facilities, hotel companies that are taking over a newly-constructed hotel will generally draw up an additional contract to cover preopening management services. The period known as the preopening phase of a hotel’s development generally begins with the employment of a sales staff or the general manager and extends to the actual opening day. Depending on the type of hotel and the need for preopening sales activity, the pre-opening service can start between three months to three years prior to the opening. Convention hotels, which attract groups that book several years in advance, usually require long lead times in their sales efforts. Some of the services the hotel operator typically provides during the preopening period include:

- *Preopening budget*—Preparation of comprehensive, detailed estimates as to what capital is required to fund all the pre-opening services.
- *Personnel services*—Recruiting, training, directing, and employing the initial staff.
- *Advertising and promotion*—Initiating and conducting such advertising and promotion necessary to attract guests to the hotel.
- *Leases and agreements*—Entering into agreement for leases, licenses, and concessions for stores and other rental space in the hotel.

- *Licenses and permits*—Application for and procurement of all licenses and permits required for the operation of the hotel and its related facilities, including liquor and restaurant licenses.
- *Purchasing*—Purchase of all initial inventories and operating supplies.
- *Installation*—Supervision of the delivery, installation, and acceptance of operating equipment, furnishings, equipment, and consumable supplies.
- *Sales and marketing*—Hiring and supervision of the hotel's sales staff and conducting the sales and marketing efforts, including developing a marketing plan.
- *Financial systems and controls*—Setting up all financial accounting systems and controls, including developing initial budgets and operating projections.
- *Coordination*—Assistance in coordinating the efforts and activities of the architect, interior designer, and all other consultants retained by the owner in connection with the planning and development of the hotel. If the operator is required, in addition to coordinating the various consultants, to review and critique their output, a separate contract, known as a technical services agreement, is generally used.³

Compensation for preopening services can be structured in a number of different ways. It is difficult to define a typical preopening fee, because many operators are willing to provide these services at or near their cost in order to obtain a long-term management contract, so provisions for them are generally negotiated concurrently with the management contract. The following is a list of several formats commonly used for establishing the compensation for preopening services.

- *Amount per room*—A schedule of preopening fees based on a certain amount per room that provides increased compensation as the hotel gets larger. It also sets a standard fixed rate for the fee, which need not be negotiated with each transaction thereafter.
- *Flat amount*—A lump sum for all preopening services determined through negotiations, generally paid in several installments. The primary advantage of the amount per room or the flat amount relates to the fact that the compensation is established and fixed at a specific level that provides a firm budgeted amount and forces the operator to absorb any preopening cost overruns.
- *Actual costs*—A provision that the operator will be reimbursed for all expenses incurred during the preopening phase of the hotel development. These costs generally include the payroll of the management company personnel assigned to the specific hotel.
- *Actual cost plus*—Same as actual cost, but with the addition by the operator of a profit factor, such as 2.5 times the payroll expense.
- *Percent of cost*—A percentage of the total project cost.
- *Per month or per diem*—Compensation based on a specific amount per month, per day, or per hour.

³ See 16.19.

16.19 TECHNICAL SERVICE ASSISTANCE

One of the additional services provided by some hotel management companies prior to and during the preopening phase of a hotel development is called technical service assistance. These activities encompass the technical aspects of hotel layout, design, construction and furnishing. Some of the technical assistance offered by hotel management companies who have this specialized in-house capability are as follows:

- Initial design*—Providing the property owner with guidelines and specifications relating to the hotel's concept, layout, design, and decor, and recommendation and sizing of facilities.
- Architecture and facilities design*—Working with the project architect, engineer, designer, and other development consultants to create working plans and specifications. Specific areas to be covered include:
 - Architecture
 - Mechanical work
 - Electrical and plumbing systems
 - Interior design
 - Operational design
 - Communications
 - Fire safety
 - Computer systems
 - Telephone systems
 - Food facilities design
 - Laundry design and equipment
 - Lighting
 - FF&E specifications
- Final design*—Review by the operator of all plans and specifications prepared by the various development consultants. Based on the critique and recommendations made by the operator, the plans and specifications are revised and approved when acceptable.
- Project supervision*—Provision by the management company of some level of project supervision to see that the plans and specifications are followed during the actual construction of the hotel. This supervision also includes the installation of furniture, fixtures, and equipment. The project supervision offered by a hotel management company will only rarely suffice to replace a full-time project manager, general contractor, or developer.
- Other services*—Other technical services sometimes offered by the operator, including:
 - *Project feasibility*—Either preparing or reviewing market studies and appraisals
 - *Franchise affiliation*—Assistance to the owner by second-tier management companies in obtaining a franchise affiliation
 - *Project financing*—Assistance in securing debt and equity financing

Not every hotel management company has the in-house capability and expertise to provide technical assistance. It should also be pointed out that operators offering this type of assistance are not attempting to take over the development responsibili-



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