PART I

Overview of the U.S. Lodging Industry

CHAPTER 1

Introduction

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 contract with a full understanding of the consequences of including or disallowing a particular provision. If either party is permitted to include provisions that are disproportionately favorable to its position, the working relationship between the parties can be severely damaged.

Chapter 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 satisifed 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 diligence, 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.