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# Hotel Investments Handbook

# 2002

Previously published in part as ***Hotel Investments: A Guide For Lenders And Owners*** by:

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*President and Founder*
*HVS International*
*Mineola, New York*

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Previously published, in part, as *Hotel Investments: A Guide for Lenders and Owners*

PRINTED IN THE UNITED STATES OF AMERICA

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HVS International has provided consulting services for thousands of clients in all 50 states and more than 60 foreign countries. Its professional staff of more than 150 industry specialists offers a wide range of services, including market feasibility studies, valuations, strategic analyses, development planning, and litigation support. Through its divisions, HVS supplies unique hotel consulting expertise in the areas of executive search, food and beverage operations, gaming, technology, hotel operations, asset management, marketing, interior design, parking, golf, and investment counseling. HVS International is the industry's primary source of hotel sales information. Its databases contain information on more than 10,000 hotel transactions and thousands of financial statements. HVS is also the most comprehensive source of hotel compensation data.

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February, 2004

# 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 to the potential for gain.

*Hotel Investments Handbook—2002* has been written as a guidebook for those who want to 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. and international hotel industries; 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 along with 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 useful to a first-time hotel investor, while at the same time offering valuable insights to experienced investors.

*Hotel Investments Handbook—2002* brings together in one easy-to-use volume all 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 case studies that illustrate the various procedures used in evaluating hotel investments in a real-world setting.

Since hotel investing is a dynamic process and the hotel industry is constantly changing, *Hotel Investment Handbook* will be updated yearly with a new edition.

STEPHEN RUSHMORE

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CHAPTER 1

# Overview of the U.S. Lodging Industry


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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 a certain amount of research regarding both the industry as a whole and the investment itself. *Hotel Investments Handbook* presents the necessary information and analytical methods in the sequence in which they are used in order to make a prudent investment. Before embarking on a hotel investment, a prudent investor gains a general knowledge of the hotel industry and the ways in which it works. Chapters 1 through 4 provide an overview of the industry and discuss the forces that affect it.

### [1] History

The evolution of the lodging industry in the United States is, of course, closely related to the economic history of the country. Usually, the health of the industry can be gauged by the condition of the economy as a whole. Prosperous times for the nation typically mean increased room and occupancy rates and the construction of more lodging facilities. When the economy falters, leisure and business travelers tend to stay home or spend less on accommodations when travel is necessary. Internal industry cycles also have a strong effect on the lodging industry. The most important of these is the continually changing relationship between room demand and room supply. For example, hotel construction is fueled by several factors other than simple demand. The availability of funds is often a determining factor. Oversupply, often the result of periods of increased construction activity, has meant stagnation for the industry, even when the economy as a whole performs well. This was the case in the late 1980s.

Along with the evolution of lodging products and the identification and pursuit of specific segments of the lodging market, the ownership and management of lodging facilities have undergone many changes. The industry, which began with entrepreneurs who owned and managed individual properties, has come to be dominated by national and international chains. At one time, the chains built and owned the properties on which their names were displayed, but the trend in the

industry is for many of the major hotel chains to develop and manage properties for outside investors. This fundamental change has dramatically increased the number of individuals and corporate entities involved in hotel projects.

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

### [2] National Supply and Demand

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

## » 1.02 PLANNING A HOTEL INVESTMENT

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

**Hotel Acquisition:**

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

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

**Hotel Development:**

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

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

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

## [1] Selecting a Lodging Market

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

or rejected. Some of the important factors that investors should consider are the following:

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

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

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

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

## [2] Property and Site Selection

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

Real estate brokers are the best source of information regarding the availability of property for sale. When looking for an existing hotel, investors often use the services of a broker whose practice is concentrated in the lodging industry. A knowledgeable hotel broker can save considerable time and effort by showing only properties that meet the investor's particular criteria. When looking for potential hotel sites, it is best to use a land broker familiar with the local area—particularly the zoning regulations, building codes, and related laws. One of the most difficult aspects of accomplishing a hotel development is obtaining the necessary zoning changes and

variances. A knowledgeable land broker understands these issues and can direct the developer to suitable sites requiring minimal zoning changes and approvals. Brokers are compensated by the seller with commissions based on a percentage of the sales price—generally 1 percent to 4 percent for existing hotels and 4 percent to 10 percent for vacant land.

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

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

## [3] Preliminary Market Study and Appraisal

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

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

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

An important step in any hotel investment is an examination of the supply of lodging facilities in the subject area. Before the success of the proposed hotel investment can be determined, the appraiser must first determine the degree to which

other hotels in the area would compete with the subject property. Chapter 8 discusses how this analysis should be performed. It explains how operating information for competitive hotels can be obtained or projected and shows how data obtained from competitors can be adjusted to eliminate any bias that they might contain.

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

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

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

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

## » 1.03 DEVELOPMENT, ACQUISITION, AND FINANCING

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

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

In this chapter, the following business entities are discussed:

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

**7.** Trust

**8.** Real estate investment trust (REIT)

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

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

**1.** Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:

—Commercial banks;

—Life insurance companies;

—Private credit companies; and

—Pension funds.

**2.** Investment conduits, which are primarily entities that invest in hotel real estate mortgages and pass through income and gain to investors (both private individuals and institutions), including:

—Real estate limited partnerships (RELPs);

—Real estate investment trusts (REITs); and

—Commercial mortgage-backed securities (CMBS).

**3.** Mortgage financing, which is how most hotels are financed. Topics covered include:

—Types of Mortgage loans; and

—Obtaining a hotel mortgage.

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

## » 1.04 FRANCHISE AFFILIATIONS AND HOTEL MANAGEMENT

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

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

## [1] Property Management

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

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

## [2] Management Contracts

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

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

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

## » 1.05 OTHER ISSUES

Chapters 22 through 24 discuss other timely issues of interest to hotel developers. The focus in Chapter 22 is on international markets. The chapter includes a discussion of the benefits of investing in developed countries versus developing ones. It also

includes country-by-country descriptions of the hotel markets in Europe and the Middle East. For each country, the state of the current hotel market and its potential for growth is discussed.

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

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

## » 1.06 INDUSTRY SOURCES AND CONTACTS

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

HVS

CHAPTER 2

# History of the Lodging Industry


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# » 2.01 COLONIAL TIMES TO WORLD WAR II

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

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

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

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

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

### [a] The First Significant Commercial Hotel

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

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

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

## [3] Overdevelopment in the 1920s

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

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

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

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

## [4] Depression Years

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

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

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

As is generally the case in real estate cycles, a major opportunity arose from the collapse of the hotel industry for investors who had available cash. These investors

were able to acquire distressed hotels with minimal cash outlays and reasonable financing. It was during this period that some of the most well-known hotel chains were born.

### [b] The First Major Hotel Chains

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

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

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

### [c] Early Valuation Theory

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

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

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

Hotel occupancy levels recovered shortly after 1940 as the general economy of the United States improved. Room supply had been diminished by the closing of many hotels during the depression. With the onset of World War II, the industry experienced a tremendous increase in lodging demand that surpassed even the booming 1920s. As a result of the war, the country was on the move; servicemen traveled home on leave, civilians relocated near defense plants, and the commercial market segment increased

dramatically as all industrial activity related to the war effort was heightened. Despite the large increase in demand, supply remained constant because construction materials and labor were focused on the war effort. Additionally, financing was generally unavailable for new construction because lenders and investors still had a fresh memory of the devastation in the real estate industry caused by the last economic downturn.

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

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

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

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

### [1] Motels

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

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

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

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

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

### [a] International Expansion Activities

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

### [b] Marketing Advantages Through Related Activities

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

### [c] Evolution of the Convention Hotel

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

### [d] Start of Franchise Development

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

### [e] Product Diversification and Segmentation

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

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

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

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

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

### [1] The Bubble Burst

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

Many lenders and developers believed, wrongly, that a national franchise

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

### [2] The Involuntary Owners

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

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

### [3] Historical Perspective on Hotel Values

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

## » 2.04 LATE 1970s: RECOVERY AND CALM

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

Decreased building activity, the normal retirement of older hotels from the market, and an improving economy created a favorable supply-and-demand relationship and record-high occupancy levels from 1979 to 1980. Average room rates increased

rapidly as operators took advantage of excess demand to recoup earlier losses and keep up with inflation.

### [1] Maturation of Systems and Procedures

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

### [2] Chain Expansion Through Asset Sales

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

## » 2.05 THE 1980s

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

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

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

## [1] Non-Economic Real Estate Transactions

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

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

## [2] The Savings and Loan Debacle

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

## [3] Development of Product Segmentation

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

have tended to be reduced or eliminated in order to reduce or maintain low room rates, which are of prime importance in this market segment.

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

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

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

### [5] Supply and Demand Imbalance

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

### [6] Lodging Industry Stock Performance

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

## » 2.06 THE 1990s: SIGNIFICANT EVENTS

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

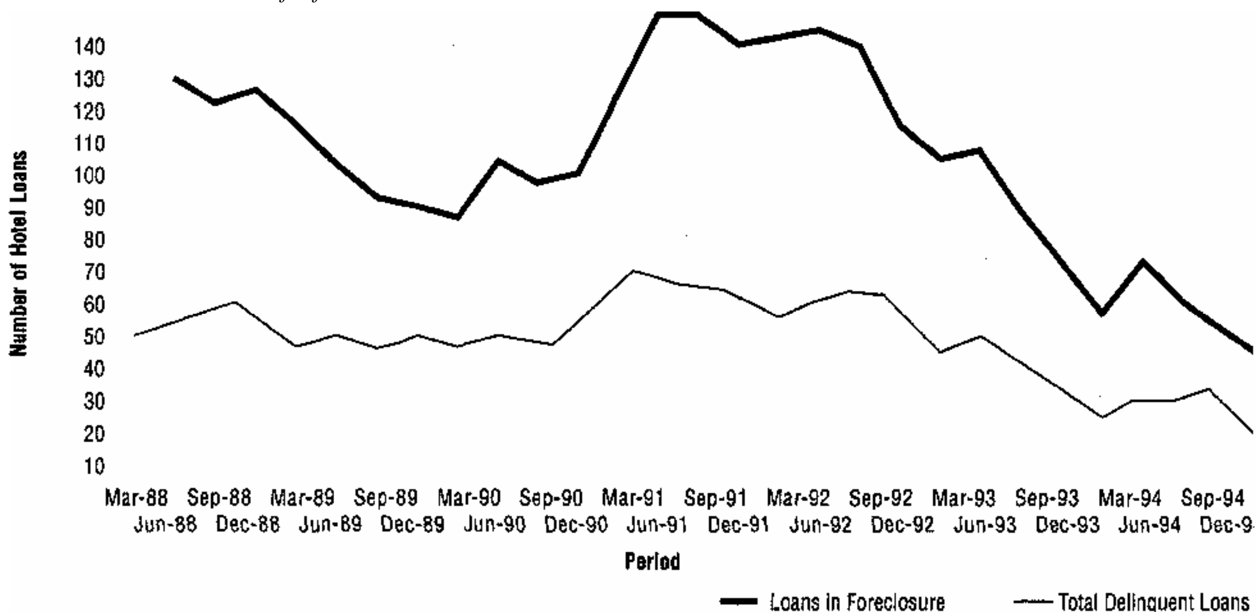
### [1] Nonperforming Loans

The number of nonperforming loans reached record levels, and the majority of lenders moved to a workout mode of operation in order to foreclose and restructure

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

Exhibit 2-1 Hotel Loan Performance

*Source: American Council of Life Insurance*




## [2] Gradual Improvement

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

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

## [3] Rebirth of the REIT

In 1993, Real Estate Investment Trusts (REITs) again emerged as an alternative financing source for hotel acquisition and development. The first successful hotel REIT offering of the 1990s occurred in August, 1993, with the initial public offering of RFS Hotel Investors, Inc. Since the initial offering, numerous additional of-

ferings have been completed. Hotel income does not qualify as income from real estate under REIT operating restrictions, which stipulate that a REIT must derive at least 75 percent of its gross income from rents and mortgage interest. Therefore, hotel operating income must be converted to lease income through a more complete REIT structure whereby the REIT owns the hotel properties and leases them to a third-party operating entity.

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

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

## [4] Alternative Financing Sources

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

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

As occupancy rates continued to improve, resulting in rapidly rising hotel values, acquisition activity continued to increase. There was a feeling in the investment community, however, that the market for acquisitions was becoming overheated, and

investors were becoming cautious in order to avoid the first-loss position that the equity players take. New construction of full-service hotel projects continued to be rare, but several developers indicated they were preparing to develop several projects. The only significant addition to supply was in the limited-service market segment.

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

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

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

## [6] Demand Outpaces Supply

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

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

The top five markets for new construction were the Orlando, 6819 rooms; New York, NY, 5372 rooms; Chicago, 4226 rooms; Dallas, 4384 rooms; and Washington, D.C., 8129 rooms. Additionally, the top five contenders for most rooms added to a hotel market segment in 1999 were Hilton Garden Inn, 13,736; Courtyard Marriott, 12,390;

Marriott, 12,210; Hampton Inns, 10,336; and Holiday Inn Express, 9,850.

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

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

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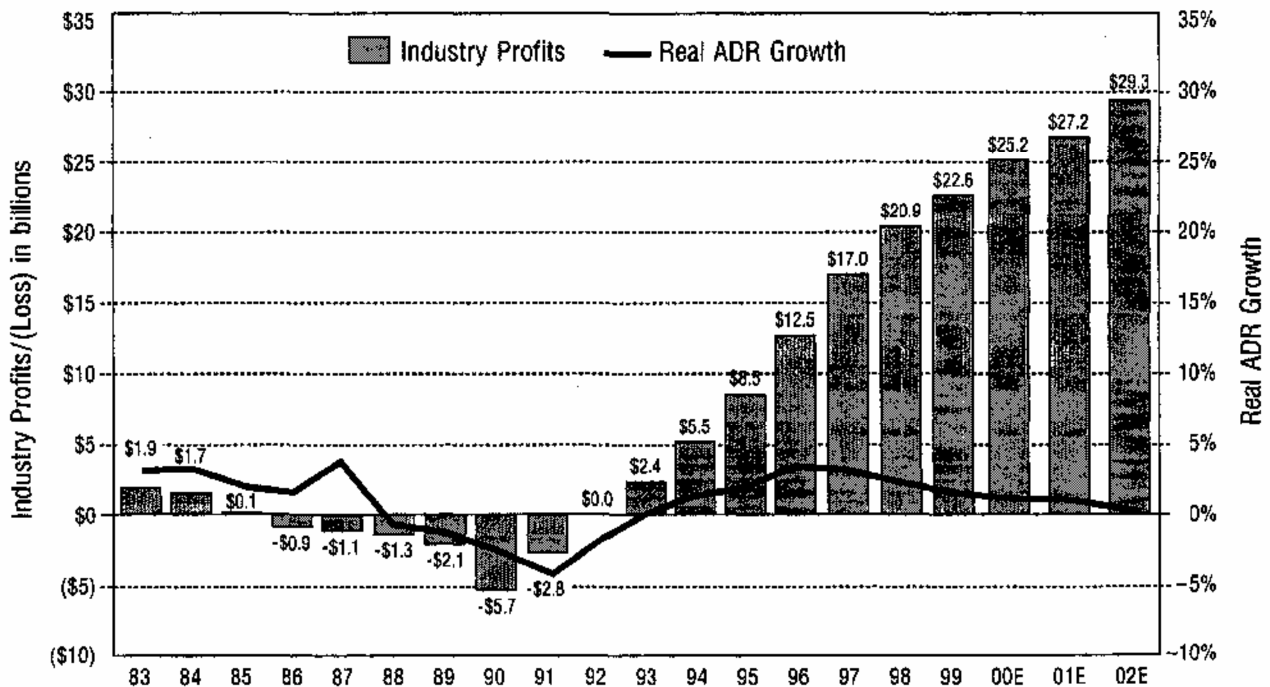
## [8] Future Trends

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

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

**Exhibit 2-2 U.S. Lodging Industry—Real ADR Growth Versus Industry Profitability (1983–2002E)**

*Sources: Smith Travel Research; PricewaterhouseCoopers L.L.P.; Bureau of Labor Statistics.*




Although many analyses had seen a slight decline in the hotel industry during the second half of the year 2001, it appears that the World Trade Center bombing will cause a major decline in industry profits. The country should return to normal in the year 2002, but the impact of the terrorist attack on the United States may delay that recovery till the second half of 2002. Fortunately, hotel chains are not in debt to the extent of the last major recession in the early 1990's. So bankruptcies should be minimal and the hotel industry should remain financially viable.

**Exhibit 2-3 Actual and Projected Industry Fundamentals (1998-2002)**

*Sources: PricewaterhouseCoopers L.LP.*

| Indicator | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|
| Occupancy (Percent) | 63.2 | 63.5 | 63.0 | 63.3 | 63.1 |
| Percentage Change from Prior Year | -1.0 | 0.6 | -0.8 | 0.4 | -0.2 |
| Pet. Point Difference from Prior Year | -0.6 | 0.4 | -0.5 | 0.2 | -0.1 |
| Average Daily Rate ($) | $81.37 | $85.36 | $88.76 | $92.20 | $96.02 |
| Percentage Change from Prior Year | 4.1 | 4.9 | 4.0 | 3.9 | 4.1 |
| Annual RevPAR ($, Seas. adj.) | $18,758 | $19,799 | $20,420 | $21,290 | $22,131 |
| Percentage Change from Prior Year | 3.1 | 5.5 | 3.1 | 4.3 | 3.9 |
| Inflation as Measured by CPI | 2.2 | 3.4 | 2.7 | 2.3 | 2.8 |
| Real GDP, Percent Change from Prior Year | 4.2 | 5.0 | 2.4 | 3.7 | 2.6 |
| Average Daily Rooms Sold (OOOs) | 2,446 | 2,537 | 2,590 | 2,661 | 2,714 |
| Percent Change from Prior Year | 3.1 | 3.7 | 2.1 | 2.7 | 2.0 |
| Annual Room Starts (OOOs) | 145.9 | 122.3 | 108.1 | 107,8 | 106.6 |
| Percentage Change from Prior Year | -9.7 | -16.2 | -11.6 | -0.3 | -1.1 |
| Prior End-of-Year Supply (OOOs) | 3,792 | 3,928 | 4,043 | 4,147 | 4,241 |
| Plus: Annual Room Completions (OOOs) | 156.1 | 127.7 | 120.7 | 110.3 | 108.5 |
| Less: Average Annual Removals (OOOs) | 20.1 | 13.0 | 16.3 | 16.7 | 17.1 |
| Equals: End-of-Year Supply (OOOs) | 3,928 | 4,043 | 4,147 | 4,241 | 4,332 |
| Net Annual Change in Supply (OOOs) | 136.0 | 114.7 | 104.4 | 93.5 | 91.4 |
| Percentage Change from Prior Year | 3.6 | 2.9 | 2.6 | 2.3 | 2.2 |
| Industry Revenues (Mil. $) | $103,118 | $112,310 | $119,163 | $127,167 | $135.066 |
| Percentage Change from Prior Year | 7.3 | 8.9 | 6.1 | 6.7 | 6.2 |

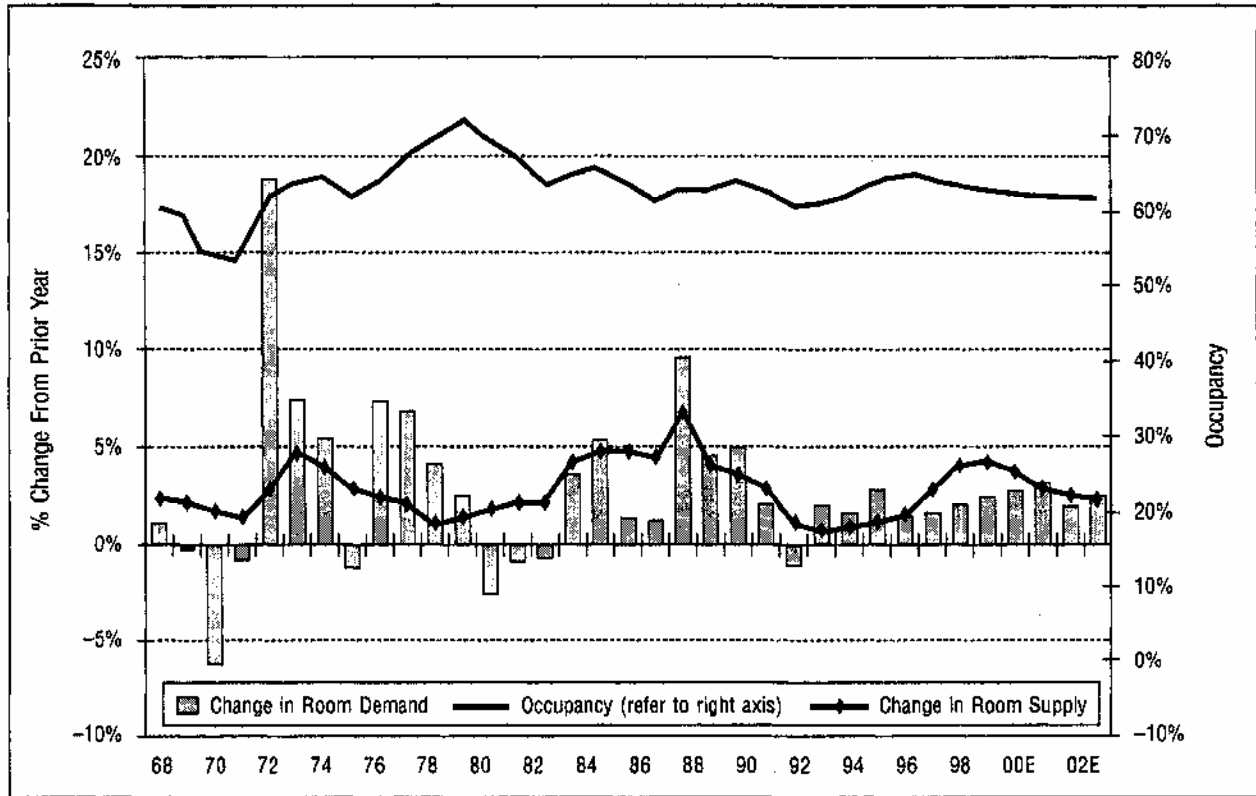
Occupancy is calculated by dividing the room night demand by the supply. During the historical period, supply increased at rates ranging from 0.7% in 1982 to 6.0% in 1974. Demand declined each year from 1980 until 1983 and also in 1974, but increased in all other years. In 1979, demand growth peaked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

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

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

**Exhibit 2-4 U.S. Lodging Industry—Occupancy, Demand, and Supply Growth from Prior Year**

*Sources: PricewaterhouseCoopers L.L.P.; Smith Travel Research.*



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CHAPTER 3

# National Supply


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## » 3.01 QUANTIFICATION OF SUPPLY

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

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

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

**Exhibit 3-1 Year-over-Year Change in Supply Demand—All Bear Stearns Brand Segments (1Q95-4Q99)**

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

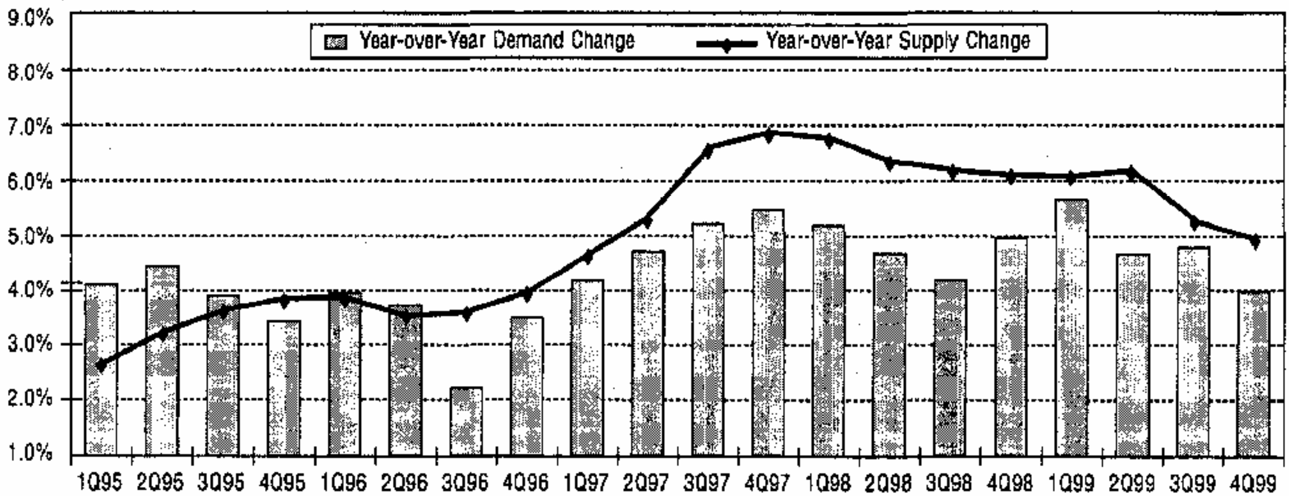



Exhibit 3-2 Five-Year Operating Statistics—All Bear Steams Brand Segments (1995-99)

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research; PricewaterhouseCoopers L.L.P.*

| | 1995 | 1996 | 1997 | 1998 | 1999 |
|---|---|---|---|---|---|
| Y-O-Y Demand Growth | 4.0% | 3.4% | 5.0% | 4.8% | 4.8% |
| Y-O-Y Supply Growth | 3.3% | 3.7% | 5.9% | 6.4% | 5.6% |
| *Equilibrium Index* | *70bps* | *-30 bps* | *-90 bps* | *-160bps* | *-80 bps* |
| Occupancy | 66.2% | 66.0% | 65.5% | 64.5% | 64.0% |
| *Change from Prior Year* | *40bps* | *-20 bps* | *-50 bps* | *-100bps* | *-50 bps* |
| Average Daily Rate | $67.11 | $71.91 | $75.87 | $79.35 | $81.76 |
| *% Change from Prior Year* | *4.9%* | 7.2% | 5.5% | *4.6%* | 3.0% |
| Revenue per Available | $44.46 | $47.47 | $49.67 | $51.17 | $52.29 |
| *% Change from Prior Year* | *5.6%* | *6.8%* | *4.6%* | 3.0% | *2.2%* |

## Exhibit 3-3 1999 Operating Statistics of Individual Brands Ranked by RevPAR Growth

*Sources: PricewaterhouseCoopers L.L.P.; Bear, Steams & Co. Inc.; Smith Travel Research.*

| **Occupancy** | | | | | | **ADR** | | | **RevPA R** | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Segment** | **Brand** | **1999** | **1998** | ***Chg.*** | **1999** | **1998** | **% *Chg.*** | **1999** | **1998** | **% *Chg.*** |
| Deluxe | Ritz-Carlton | 77.8% | 74.4 | *340 bps* | *$219.37* | *$207.93* | 5.5% | $170.67 | $154,70 | *10.3%* |
| | Four Seasons (US) | 74.9% | 74,6 | *30bps* | $317.00 | $300.00 | 5,7% | $237.43 | $223.80 | *6,1%* |
| | **Segment Average** | **71.7%** | **72.5** | ***-80bps*** | **$204.62** | **$194.07** | **5.4%** | **(146.55** | **$140.74** | ***4.2%*** |
| | St. Regis/Luxury Collection | 71,2% | 73.2 | *-200 bps* | $338,22 | $320.82 | 5.4% | $240.81 | $234.84 | *2.5%* |
| | Wyndam Luxury Resorts (1) | 72,0% | 68,6 | *340bps* | $300.97 | $312,52 | -3.7% | $216.70 | $214.39 | *1.1%* |
| Luxury | Sheraton | 73.1% | 70.9 | *220bps* | $141,78 | $138,01 | 2.7% | $103.64 | $97,85 | *5.9%* |
| | Westin | 72.7% | 71,3 | *140bps* | $137.10 | $133,12 | 3.0% | $99.67 | $94,91 | *5.0%* |
| | Wyndham | 69.7% | 68.6 | *110bps* | $127.83 | $124.08 | 3.0% | $89,10 | $85.12 | *4.7%* |
| | Marriott | 77.5% | 77.6 | *-10bps* | $140.86 | $135.52 | 3.9% | $109.17 | $105.16 | *3.8%* |
| | Renaissance | 70.8% | 70,3 | *50bps* | $132.09 | $129,32 | *2.1%* | $93.52 | $90.86 | *2.9%* |
| | **Segment Average** | **71.8%** | **72.0** | ***-20 lips*** | **$140.90** | **$136.78** | ***3.0%*** | **$101.11** | **$98.50** | **2,7%** |
| | Hilton | 70.7% | 71.2 | *-50 bps* | $130.60 | $127.19 | *2,7%* | $92.33 | $90,56 | 2.0% |
| Upscale | Crowne Plaza | 69.1% | 68.9 | *20bps* | $108.07 | $103.71 | *4.2%* | $74.68 | $71.46 | 4,5% |
| | Hilton Garden Inn | 65.9% | 64,0 | *190bps* | $92.05 | $91,00 | *1.2%* | $60.66 | $58,24 | *4.2%* |
| | Courtyard by Marriott | 79.3% | 79.4 | *-10bps* | $91.48 | $88.99 | *2.8%* | $72.54 | $70,66 | *2.7%* |
| | Embassy Suites | 73.1% | 72.5 | *60bps* | $121,49 | $120.77 | *0.6%* | $88.81 | $87.56 | *1.4%* |
| | **Segment Average** | **68.3%** | **69,2** | ***-90bps*** | **$97.67** | **$95.62** | ***2.1%*** | **$66.69** | **$66.20** | ***0.7%*** |
| | Doubletree | 70.1% | 70.8 | *-70 bps* | $108.01 | $106,34 | *1.6%* | $75.72 | $75.29 | *0.6%* |
| | Wyndham Garden | 69.7% | 71.4 | *-170bps* | $93,41 | $92.94 | *0.5%* | $65.11 | $66.36 | *-1.9%* |
| Midscale | Holiday Inn | 65.5% | 65.5 | *Obps* | $76.77 | $73.32 | *4.7%* | $50.28 | $48.03 | *4.7%* |
| with F&B | **Segment Average** | **60.3%** | **60.9** | ***-60 lips*** | **$69.95** | **$67.30** | ***3.9%*** | **$42.16** | **$40.99** | ***2.9%*** |
| | Quality Inn | 58,0% | 58.9 | *-90 bps* | $61.89 | $60.02 | *3.1%* | $35.90 | $35.35 | *1.5%* |
| | Clarion | 59,0% | 60.5 | *-150bps* | $74.17 | $72.25 | *2.7%* | $43,76 | $43.71 | *0.1%* |
| Midscale | Holiday Inn Express | 64,7% | 63.8 | *90bps* | $66.35 | $62.83 | *5.6%* | $42.93 | $40.11 | 7.0% |
| w/o F&B | Comfort Inn | 64.4% | 65.0 | *-60 bps* | $58,98 | $56.58 | *4.2%* | $37.98 | $36,78 | 3.3% |
| | **Segment Average** | **64.9%** | **66.0** | ***-110 bps*** | **$66.66** | **$63.54** | ***4.9%*** | **$43.24** | **$41.96** | **3.7%** |
| | Comfort Suites | 67,2% | 68.1 | *-90 bps* | $69.44 | $67.56 | *2.8%* | $46.66 | $46.01 | *1.4%* |
| | Hampton Inn | 68,1% | 70,0 | *-190bps* | $71.29 | $68.57 | *4.0%* | $48,55 | $48.00 | *1,1%* |
| | Signature Inns | 57.9% | 61,5 | *-360 bps* | $63.41 | $61.48 | *3.1%* | $36.71 | $37.81 | *-2.9%* |
| Economy | Rodeway Inn | 50.7% | 50.1 | *60bps* | $45.57 | $44.03 | *3.5%* | $23.10 | $22.06 | *4.7%* |
| | Jameson Inns | 62,3% | 63.6 | *-130bps* | $52.87 | $50.48 | *4.7%* | $32.94 | $32.11 | *2.6%* |
| | **Segment Average** | **56.6%** | **57.7** | ***-110bps*** | **$51.85** | **$50.70** | ***2.3%*** | **$29.36** | **$29.27** | ***0.3%*** |
| | Fairfield Inn | 71,0% | 73.2 | *-220bps* | $58,87 | $56.97 | *3.3%* | $41.80 | $41,70 | *0.2%* |
| Budget | Segment Average | 60.3% | 60.4 | *-10bps* | $43.42 | $41.73 | *4.0%* | $26.19 | $25.19 | *4.0%* |
| | Econo Lodge | 54,0% | 54.3 | *-30 bps* | $45.01 | $43.55 | *3.4%* | $24.31 | $23.65 | *2.8%* |
| | Sleep Inn | 60.6% | 62.0 | *-140bps* | $53.91 | $51.32 | *5.0%* | $32.67 | $31.82 | *2.7%* |
| Upper-Tier | Residence Inn | 83.0% | 83,1 | *-10bps* | $99.03 | $98.15 | *0.9%* | $82.19 | $81.56 | *0.8%* |
| Ext.-Stay | Summerfield by Wyndham | 80.9% | 81.6 | *-70 bps* | $121.39 | $119.65 | *1.5%* | $98.20 | $97.63 | *0.6%* |
| | Homewood Suites by Hilton | 73.7% | 73.9 | *-20bps* | $95.01 | $96.01 | *-1.0%* | $70.02 | $70,95 | *-1.3%* |
| | **Segment Average** | **76.2%** | **78.0** | ***-180 lips*** | **$98.34** | **$97.48** | ***0.9%*** | **$74.97** | **$75.99** | ***-1.3%*** |
| Lower-Tier | MainStay Suites | 66.9% | 57.5 | *940bps* | $58.84 | $56.40 | *4.3%* | $39.36 | $32.43 | *21.4%* |
| Ext.-Stay | Crossland Economy Studios | 69,0% | 61,0 | *800 bps* | $30,00 | $28.29 | *6.1%* | $20,70 | $17,25 | *20.0%* |
| | Homestead Village | 70,2% | 70.4 | *-20 bps* | $49.86 | $43,00 | *15,9%* | $35.00 | $30.27 | *15.6%* |
| | Candlewood | 67,7% | 65.7 | *200bps* | $58,24 | $53,14 | *9.6%* | $39.43 | $34.91 | *12.9%* |
| | **Segment Average** | **68.6%** | **67.5** | ***110 tips*** | **$46.62** | **$42.83** | ***8.8%*** | **$31.96** | **$28.92** | ***10.5%*** |
| | StudioPlus | 73,0% | 68.0 | *500 bps* | $47.71 | $47,86 | *-0.3%* | $34.83 | $32,54 | *7.0%* |
| | Extended Stay America | 75.0% | 75.0 | *Obps* | $42.29 | $40.14 | *5.3%* | $31,71 | $30.11 | *5.3%* |
| | Suburban Lodges | 79,0% | 82,0 | *-300 bps* | $27,29 | $25.03 | *9.0%* | $21,56 | $20.53 | *5.0%* |

(1) Formerly Grand Bay.

Other valuable sources are the Bear Steams *Global Lodging Almanac,* Price-waterhouse Coopers, LLP, Arthur Anderson consulting, KPMG Peat Marwick, LLP and EYKL Hospitality Services.

Exhibit 3-1 shows how overall supply has been exceeding demand nationwide since 2Q of 1996. As mentioned earlier, the increased supply has put pressure on the overall occupancy rates and has held down the increases in RevPAR as shown in Exhibit 3-2.

Exhibit 3-3 shows the classification of lodging segments by segments. The segments start with Deluxe hotels and end with Lower-Tier Extended Stay hotels. As noted in the chart, all segments, with the exception of Upper-Tier Extended Stay properties, show some increase in RevPAR for the year. However, only the Lower-Tier Extended Stay segment managed to report a double digit (10.5%) increase in RevPAR for the year.

## [1] Facility Types

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

### [a] Deluxe Hotels

This segment consists of the very top of the hotel industry in regard to service, physical facilities, and amenities. The most commonly associated brands in this segment include the Four Seasons and Ritz Carlton. This segment is also likely to contain independently-owned hotels who have established their reputation over many decades. Some notable examples include the Lenox in Boston and the Mark in New York. Exhibit 3.4 shows that 114 properties qualify as deluxe.

**Exhibit 3-4 Bear Steams Brand Segments—Deluxe Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research, PricewaterhouseCoopers LLP.*

| Brand | Property Count | Room Count |
|---|---|---|
| Preferred | 64 | 14,512 |
| Four Seasons | 22 | 6,984 |
| Ritz-Carlton | 18 | 6,520 |
| Fairmont Hotel | 10 | 5,576 |
| Segment Totals: | 114 | 33,592 |

### [b] Luxury Hotels

Commercial facilities cater primarily to the individual business traveler and are generally situated in downtown or commercial districts. Amenities typically include a restaurant, a lounge, meeting facilities, a fitness room, and a gift shop. The services offered by many commercial hotels include room service, a business center, concierge and valet services, shoe shine service, daily newspapers, airport shuttle, and local transportation. Modern commercial facilities also provide work desks, multiple telephones with dual lines and data ports, in-room coffee makers, irons and ironing boards, and copy and facsimile services. Convention hotels are large facilities that characteristically have meeting spaces with the capacity to handle large groups of people. Generally, hotels with more than 30 square feet of meeting space per guest-

room located near convention centers are considered convention hotels. Convention hotels generally contain a large inventory of guestrooms with a high percentage of double/double bedding configurations. Most convention hotels provide large ballrooms and small breakout rooms for meetings and conferences. In addition, some hotels feature exhibit space and auditoriums. Convention properties also typically offer extensive food and beverage facilities and other services and facilities found in commercial hotels, although the level of service tends to be less personal.

**Exhibit 3-5 Bear Steams Brand Segments—Luxury Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research; PricewaterhouseCoopers L.L.P.*

| Brand | #of Hotels | #of Rooms | #0f Brand | Hotels | #of Rooms |
|---|---|---|---|---|---|
| Marriott | 262 | 106,587 | W Hotels | 12 | 3,538 |
| Sheraton Hotel | 172 | 62,663 | Swissotel | 5 | 2,221 |
| Hyatt | 109 | 54,596 | Raphael Hotel | 2 | 295 |
| Hilton | 55 | 38,734 | Park Plaza | 5 | 1,284 |
| Westin | 57 | 29,104 | Meridien | 5 | 2,217 |
| Wyndham | 62 | 21,063 | Inter-Continental | 11 | 4,946 |
| Renaissance | 41 | 17,814 | Hotel Sofitel | 7 | 2,073 |
| Omni | 34 | 13,014 | Helmsley Hotel | 6 | 2,221 |
| Loews | 12 | 5,288 | Doral | 6 | 1,778 |
| | | | **Segment Totals:** | **863** | **369,436** |

Luxury hotel segment includes both commercial hotels and convention hotels. Exhibit 3-5 indicates that there are 863 facilities that are categorized as Luxury, with Marriott dominating the segment with 262 properties and 106,587 rooms.

## [c] Upscale Hotel Segment

This segment consists of hotels and all-suite brands that cater primarily to business travelers who do not need the amenities of a full service luxury hotel. Also, this segment appeals to leisure travelers who want more amenities than can be found in a Midscale Hotel.

**Exhibit 3-6 Bear Steams Brand Segments—Upscale Segment**

*Sources; Bear, Steams & Co. Inc.; Smith Travel Research; PricewaterhouseCoopers L.L.P.*

| Brand | #0f Hotels | #0f Rooms | Brand | #of Hotels | #0f Rooms |
|---|---|---|---|---|---|
| Courtyard | 439 | 61,071 | Doubletree Guest Suites | 38 | 8,038 |
| Radisson | 233 | 55,971 | Regal | 13 | 4,891 |
| Hilton Inn | 158 | 41,349 | Red Lion | 25 | 4,108 |
| Embassy Suites | 150 | 36,556 | Westcoast | 10 | 2,088 |
| Doubletree | 94 | 29,439 | Westmark | 10 | 1,461 |
| Crowne Plaza | 67 | 21,207 | Embassy Vacation | 6 | 1,232 |
| Clarion | 123 | 20,511 | Woodfield | 7 | 888 |
| Holiday Inn Select | 70 | 17,826 | Hotel Novotel | 3 | 873 |
| Adam's Mark | 21 | 11,542 | Delta Hotels | 1 | 760 |
| Wyndham | 59 | 10,577 | | | |
| | | | Segment Totals: | 1,527 | 261,279 |

Exhibit 3-6 indicates that there are 1,527 properties in this segment with Courtyard by Marriott and Radisson hotels dominating the segment with 439 and 233 properties respectively.

## [d] Midscale with F&B Hotel Segment

Midscale with food and beverage is the largest single segment in the nation. This segment is represented by some old line brand names such as Holiday Inn and Best Western. Over the years, except for a brief period in the 4th quarter of 1997, supply has declined in this segment. The future does not look any brighter, as changes in consumer behavior does not appear to favor this segment. Exhibit 3-7 shows that there are 4,725 properties with 608,288 rooms.

**Exhibit 3-7 Bear Steams Brand Segments—Midscale with F&B Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research: PricewaterhouseCoooers L.L.P.*

| Brand | #of Hotels | #0f Rooms | #of Brand | Hotels | #of Rooms |
|---|---|---|---|---|---|
| Holiday Inn | 1,015 | 191,094 | Park Inn | 39 | 3,644 |
| Best Western | 2,121 | 189,897 | Outrigger | 7 | 3,550 |
| Ramada | 664 | 101,219 | Cavanaugh's | 14 | 3,162 |
| Quality Inn | 422 | 48,133 | Sheraton Inn | 14 | 2,958 |
| Howard Johnson | 263 | 32,528 | Little America | 6 | 2,276 |
| Four Points | 92 | 18,098 | Harvey Hotel | 5 | 1,513 |
| Doubletree Club | 25 | 5,076 | Garden Plaza | 4 | 691 |
| Quality Suites | 31 | 3,898 | Harley Hotel | 3 | 551 |
| | | | Segment Totals: | 4,725 | 608,288 |

## [e] Limited Service Segments

Perhaps no segment has more sub-groups than the limited service segment. As consumers seek more value for their dollar, the limited service sector has responded by increasing the supply of hotels. Unfortunately, this rush to build has created an abundance of supply that demand cannot meet and as a result, occupancy which peaked at 64.3% in 1995 has now fallen to 60.7% in 1999. The limited service segment is divided into three sub-groups: Midscale without F&B, Economy, and Budget.

**Exhibit 3-8 Bear Steams Brand Segments—Midscale without F&B Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research: PricewaterhouseCoopers L.L.P.*

| Brand | #Of Hotels | #0f Rooms | Brand | #Of Hotels | #Of Rooms |
|---|---|---|---|---|---|
| Comfort Inn | 1,264 | 100,089 | Amerihost | 77 | 4,885 |
| Hampton Inn | 914 | 94,067 | SpringHill Suites | 41 | 4,157 |
| Holiday Inn | 919 | 71,541 | Sumner Suites | 27 | 3,298 |
| La Quinta | 300 | 38,933 | Signature Inn | 26 | 3,071 |
| Comfort Suites | 232 | 18,667 | Wellesley Inn | 29 | 2,887 |
| Country Inn & | 199 | 15,169 | Lee's Inn of America | 21 | 1,684 |
| AmeriSuites | 99 | 12,721 | Heartland | 19 | 1,649 |
| Garden Inn | 62 | 8,849 | Clubhouse Inns of | 11 | 1,645 |
| Drury Inn | 69 | 8,837 | Cabot Lodge | 6 | 1,076 |
| Hampton Inn Suites | 68 | 7,952 | Master Hosts Inn | 4 | 945 |
| Shilo Inn | 47 | 5,332 | Conley Inn | 5 | 291 |
| | | | Segment Totals: | 4,434 | 407,454 |

The midscale without F&B supply is the largest sub segment of limited service and in 1999 its supply grew by 12.2%. In fact, this segment has seen supply grow at a rate exceeding 10% every year beginning in 1995. Exhibit 3-8 shows 4,434 properties in this group with a total of 407,454 rooms. Comfort Inn and Hampton Inn dominate this segment with 100,089 and 94,067 rooms respectively.

**Exhibit 3-9 Bear Steams Brand Segments - Economy Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research; PricewaterhouseCoopers L.L.P.*

| Brand | #Of Hotels | #0f Rooms | Brand | #Of Hotels | #0f Rooms |
|---|---|---|---|---|---|
| Days Inn | 1,822 | 157,722 | Jameson Inn | 83 | 3,868 |
| Travelodge | 507 | 40,610 | Susse Chalet | 32 | 3,680 |
| Fairfield Inn | 416 | 39,453 | Guest House Inns | 47 | 3,353 |
| Red Roof Inn | 330 | 37,464 | Vagabond Inn | 43 | 3,230 |
| Ramada Limited | 364 | 27,273 | Country Hearth Inn | 49 | 3,022 |
| Baymont Inns & | 172 | 16,979 | Innkeeper | 21 | 1,810 |
| Rodeway Inn | 168 | 10,571 | Mcintosh Motor Inn | 13 | 1,499 |
| Best Inns Of | 120 | 9,459 | Nendels | 12 | 765 |
| Shoney's Inn | 74 | 7,191 | Key West Inn | 12 | 765 |
| Americinn | 138 | 6,873 | L-K Motel | 3 | 80 |
| | | | Segment Totals: | 4,426 | 375,667 |

The economy segment are hotels that offer larger rooms than the typical budget hotel. This segment has seen supply growth of only 7.1% in 1999. In fact, this segment has not seen demand or supply grow at more than 8% since 1995. Exhibit 3,9 shows 4,426 hotels with a total of 375,667 rooms.

**Exhibit 3-10 Bear Steams Brand Segments—Budget Segment**

*Sources: Bear, Steams & Co. Inc.: Smith Travel Research; PricewaterhouseCoopers L.L.P.*

| Brand | #Of Hotels | #Of Rooms | #0f Brand | Hotels | #0f Rooms |
|---|---|---|---|---|---|
| Super 8 | 1,843 | 112,659 | Budget Inn | 22 | 1,507 |
| Motel 6 | 789 | 84,908 | Select Inn | 15 | 1,402 |
| Econo Lodge | 729 | 46,276 | Travelers Inn | 14 | 1,247 |
| Knights Inn | 281 | 22,241 | Admiral Benbow | 9 | 1,051 |
| Sleep Inn | 236 | 18,065 | Thriftlodge | 19 | 977 |
| Microtel | 189 | 13,954 | Interstate Inn | 13 | 795 |
| Howard Johnson Express | 195 | 13,278 | Wynfield Inn | 3 | 578 |
| Budget Host Inn | 173 | 6,778 | Roadstar Inn | 7 | 576 |
| Scottish Inn | 130 | 6,417 | Motel Orleans | 7 | 480 |
| Red Carpet Inn | 104 | 6,245 | Ha' Penny | 5 | 454 |
| Masters Inn | 34 | 4,139 | Sixpence Inn | 5 | 439 |
| Cross Country Inn | 25 | 3,009 | Friendship Inn | 9 | 346 |
| ExelInn | 26 | 2,917 | Passport Inn | 7 | 297 |
| E-Z8 | 26 | 2,673 | Great Western | 6 | 267 |
| Family Inns of America | 26 | 2,291 | Hometown Inn | 4 | 262 |
| National 9 | 56 | 2,115 | Thrifty Inn | 3 | 227 |
| Economy Inns of America | 21 | 2,001 | Cricket Inn | 1 | 126 |
| Wilson | 12 | 1,717 | Imperial Inns | 4 | 124 |
| Good Nile Inn | 14 | 1,692 | | | |

The budget hotel segment is distinguished from economy properties by their smaller hotel room sizes and lack of most amenities that are common in economy type properties. This segment is very popular among senior citizens and people traveling on a very limited budget. This is more mature then the economy segment and thus the supply of hotel rooms has increased only a modest 2.7% in 1999. As shown in Exhibit 3-10, Super 8 and Motel 6 dominate this segment with 1,843 and 789 properties respectively.

### [f] Extended-Stay Hotels

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

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

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

**Exhibit 3-11 Bear Steams Brand Segments—Upper-Tier Extended-Slay Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research; PricewaterhouseCoopers L.L.P.*

| Brand | #of Hotels | #0f Rooms |
|---|---|---|
| Residence Inn | 324 | 38,366 |
| Hawthorn Suites | 102 | 10,236 |
| Homewood Suite | 89 | 9,866 |
| Summerfield | 37 | 5,005 |
| Woodfin Suites | 7 | 894 |
| Segment Totals: | 559 | 64,367 |

Exhibit 3-11 illustrates the upper-tier Extended-Stay segment. The total market consists of 559 properties with 64,367 rooms. Residence Inn dominates this market with 324 hotels and 38,366 rooms. The supply of upper-tier Extended Stay hotels grew by 19.95 in 1999.

A relatively new segment to the hotel industry has been the lower-tier Extended-Stay hotel. This has been the fastest growing segment with new supply increasing 44.5% over the previous year. As this market matures, the growth rate should return to a more modest figure. Exhibit 13-12 shows 976 hotels with 108,392 rooms. Extended Stay America is currently the largest company in this segment with 230 hotels and 26,006 rooms in 1999.

**Exhibit 3-12 Bear Steams Brand Segments—Lower-Tier Extended-Stay Segment**

*Sources: Bear, Steams & Co. Inc.; Smith Travel Research, PricewaterhouseCoopers L.L.P.*

| Brand Hotels | #Of Rooms | Brand | #Of Hotels | #Of Rooms |
|---|---|---|---|---|
| Extended Stay America 230 | 26,006 | Grassland Suites | 39 | 5,068 |
| Homestead Village 136 | 18,056 | Inn Town Suites | 15 | 2,053 |
| Suburban Lodge 110 | 14,877 | Mainstay Suites | 30 | 2,813 |
| Villager Lodge 135 | 10,790 | Inn Suites | 9 | 1,516 |
| StudioPlus 99 | 7,839 | Sierra Suites | 17 | 1,864 |
| Candlewood Hotel 77 | 9,103 | Lexington Hotel Suites | 8 | 1,184 |
| Towneplace Suites 66 | 6,609 | Homegate | 5 | 614 |
| | | Segment Totals: | 976 | 108,392 |

### [g] Casino Hotels

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

### [h] Bed and Breakfast Inns

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

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

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

### [j] Boutique Hotels

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

### [k] Health Spas

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

### [l] Boatels

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

## [2] Class

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

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

**Exhibit 3-13 AOR Performance by Location Type (1996-1997)**

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

| Location | 1997 | 1996 | % Chg. |
|---|---|---|---|
| Resort | $114.85 | $108.69 | 5,7% |
| Urban | 114.80 | 106.56 | 7.7 |
| Airport | 77.98 | 72.11 | 8.1 |
| Suburban | 72.23 | 68.31 | 5.7 |
| Highway | 55.16 | 52.46 | 5.1 |
| Total U.S. | $75.16 | $70.81 | 6.1% |

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

The lodging industry does not seem to have a uniform definition of the various hotel classes. Terms such as "economy," "first-class" (or "upscale"), and "luxury" have different meanings for different people. However, Smith Travel Research publishes average rate and occupancy information for each class category defined previously. Exhibits 3-13 and 3-14 illustrate the various class categories and the corresponding average occupancy and average room rates for lodging facilities in the United States.

**Exhibit 3-14 Occupancy Performance by Location Type (1996-1997)**

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

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

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

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

## [3] Location

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

### [a] Airports

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

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

### [b] Highways

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

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

### [c] Downtowns

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

### [d] Suburbs

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

### [e] Convention Centers

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

### [f] Resorts

Resort hotels are located in areas with considerable scenic beauty or recreational opportunities. Resort properties attract primarily the leisure demand segment of the lodging market and sometimes leisure-oriented meetings and conventions such as corporate-incentive groups. Resorts typically feature extensive food and beverage facil-

ities, recreational amenities, and retail facilities. Activity desks are also usually provided for off-property activities and tours. Resorts also provide 24-hour room service, currency exchange, in-room movies, ample parking space, and manicured landscaping. Artwork and design motifs reflect the property's location.

### [g] Mixed-Use Facilities

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

## » 3.02 GUESTROOM DESIGN

Hotel guestroom design is more influenced by facility orientation and class than by locational attributes. The floor plans in Exhibit 3-15 illustrate typical sizes and guestroom layouts for various types and classes of hotels.

Exhibit 3-15(a) shows the floor plan of a microbudget motel guestroom. The total area is 190 square feet and provides enough space for one bed. Although the guestroom is relatively small, it has all of the normal amenities found in conventional budget motel guestrooms.

Exhibit 3-15(b) shows the floor plan for a typical budget motel. The total area of the room is 236 square feet and provides sufficient space for two double beds. In this example, the window is situated adjacent to the entry door, which means that the property probably has exterior corridors.

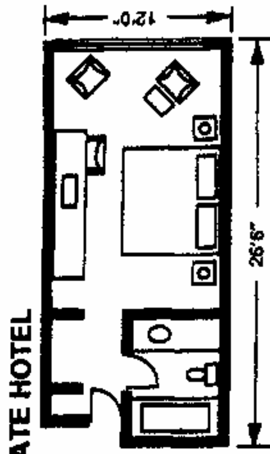
Exhibit 3-15(c) shows a floor plan typical of a mid-rate facility. The 300-square-foot room includes a larger bathroom, a separate closet, and a sleeping area containing a king-sized bed and two chairs. The guestroom also contains a combination desk/dresser with a television. The corridor to which the room has access is interior.

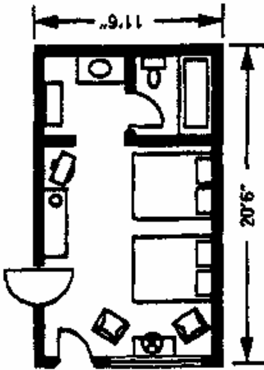
Exhibit 3-15(d) provides an example of a luxury hotel room that totals 450 square feet. Although the length of the room is 25 feet, which is comparable to properties of lower class, its width is 18 feet, creating a feeling of greater open space. The bathroom is above average in size and the sleeping area has capacity for a desk, two small couches, and a coffee table.

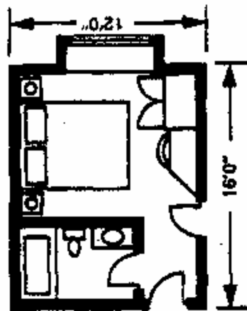
The accommodations offered by suite hotels come in many sizes and shapes, but by definition a suite contains separate sleeping and living areas. Exhibits 3-15(e) and 3-15(f) illustrate the layout of two typical suite configurations. Exhibit 3-15(e) shows a rectangular guestroom module in which the living area is in the front -and the sleeping area is to the rear. The suite in Exhibit 3-15(f) is square, which results in a side-by-side placement of the living and sleeping areas. Both of these suite layouts contain approximately 400 to 500 square feet of space, which is only slightly larger than a typical luxury guestroom module.

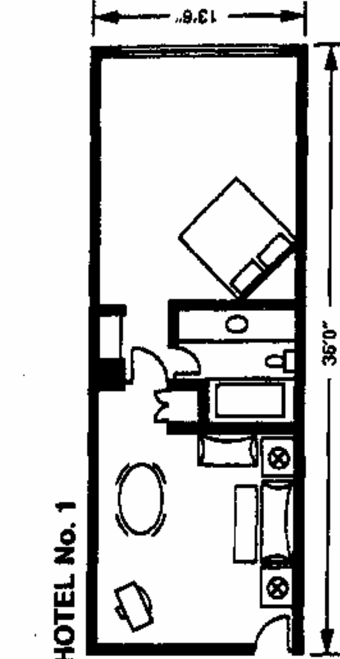
Exhibit 3-15(g) shows a residence hotel room layout. A residence-type hotel, or extended-stay hotel, typically provides the greatest amount of space of any type of lodging facility. Guestroom modules typically consist of full-size living rooms, kitchens, and bedrooms. The layout in Exhibit 3-15(g) is of a duplex-loft arrangement, On the first floor there is a living room and full kitchen toward the front, and a bedroom area and full bath to the rear. On the second floor there is a second bedroom and second full bath. The first floor is 580 square feet in area and the loft second floor 244 square feet, for a total of 824 square feet.

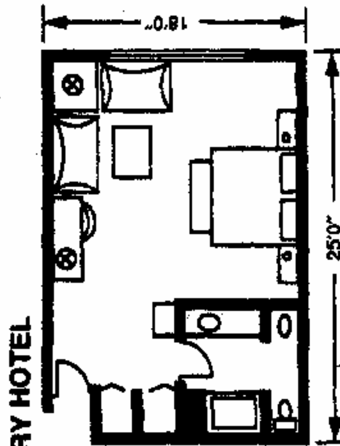
**Exhibit 3-15 Typical Guestroom Sizes and Layouts for Various Hotel Types**

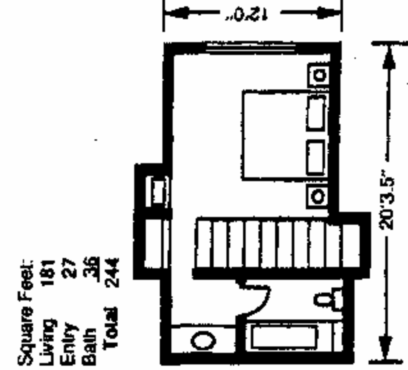


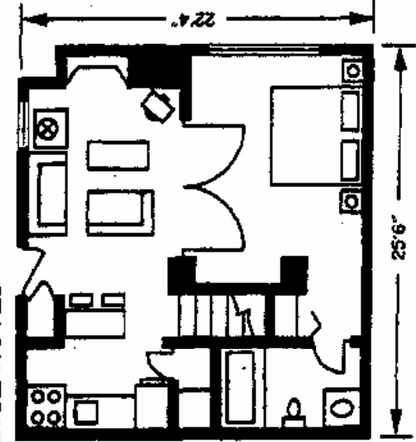



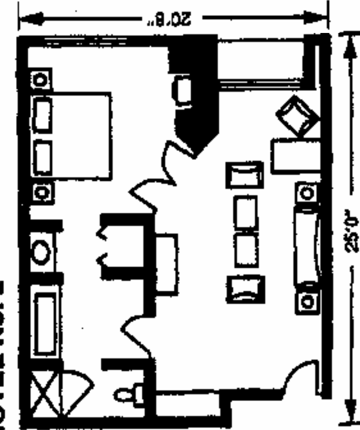



**Exhibit 3-15 (cont'd)**

| **(a) Microtel** | **(b) Budget Motel** | **(c) Mid-Rate Hotel** |
|---|---|---|
| *Square Feet:* | *Square Feet:* | *Square Feet:* |
| Living 132 | Living 204 | Living 221 |
| Entry 15 | Entry 0 | Entry 35 |
| Bath 45 | Bath 32 | Bath 48 |
| Total 192 | Total 236 | Total 304 |
| **(d) Luxury** | **(e) Suite Hotel No. 1** | |
| *Square Feet:* | *Square Feet:* | |
| Living 379 | Living 235 | |
| Entry 0 | Entry 0 | |
| Bath 71 | Bath 62 | |
| | Bedroom 189 | |
| Total 450 | Total 486 | |
| **(f) Suite Hotel No. 2** | **(g) Residence Hotel** | |
| *Square Feet:* | *Square Feet:* | *Square Feet:* |
| Living 239 | Living 320 | Living 181 |
| Entry 0 | Entry 0 | Entry 27 |
| Bath 81 | Bath 50 | Bath 36 |
| Bedroom 180 | Bedroom 210 | |
| Total 500 | Total 580 | Total 244 |

## »3.03 AMENITIES

Amenities such as swimming pools, room service, and personal care items play a large role in the marketing of hotel rooms. Exhibit 3-16 shows the results of a survey conducted for the Dial Corporation by Michigan State University's School of Hospitality Business to determine frequent travelers' expectations of amenities and services. The American Hotel and Motel Association conducted a survey to quantify the usage of the amenities and services provided. The results of that survey are presented in Exhibit 3-17.

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

**Exhibit 3-16 Amenities and Services Expected by Frequent Travelers**

*Sources; Dial Corporation, Michigan State University*

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

**Exhibit 3-17 Usage of Amenities and Services**

*Source: American Hotel and Motel Association*

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

## » 3.04 FINANCIAL OPERATING CHARACTERISTICS

Income and expense statements for several types of hotels are contained in Exhibit 3-18, illustrating the common differences between the classes of hotels.

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

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

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

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

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

While the operating data shown in Exhibit 3-18 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.

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## Exhibit 3-18 Hotel Operating Statistics by Type

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

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

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CHAPTER 4

# National Demand


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## »4.01 INTRODUCTION

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

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

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

## » 4.02 NATIONAL DEMAND DATA

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

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

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

## » 4.03 USE OF TRANSIENT ACCOMMODATIONS

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

regarding the use of transient accommodations in the course of preparing nationwide industrial statistics.

## [1] Trends in Hotel Travel Volume

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

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

*Sources: Travel Industry Association's National Survey*

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 86-96 Change |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Trips | | | | | | | | | | | | |
| Volume (millions) | 247.9 | 282. | 273.3 | 290.5 | 291.1 | 291.1 | 325.8 | 329.5 | 318.5 | 316.4 | 334.0 | 35% |
| Share of total 47% | | 50% | 47% | 49% | 49% | 49% | 50% | 51% | 48% | 47% | 49% | |

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

**Exhibit 4-2 Travel Growth Rates**

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

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

## [2] Trends in Total Room Sales

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

**Exhibit 4-3 Room Sales—U.S. Total**

*Source: Smith Travel Research*

| Year | Percent Change |
|---|---|
| 1987 | 8.3% |
| 1988 | 8.9 |
| 1989 | 9.1 |
| 1990 | 6.7 |
| 1991 | 1.2 |
| 1992 | 5,3 |
| 1993 | 6.3 |
| 1994 | 8.6 |

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

## »4.04 TRAVEL INDUSTRY STATISTICS

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

## [1] Food and Beverage Sales

Food and beverage sales are quantified each year by the National Restaurant Association for several categories, including lodging places and hotel and motel restaurants. According to data found in the *Statistical Abstract of the United States* 115th Edition, food and drink sales at lodging facilities had a compounded annual growth of 2.3 percent between 1980 and 1992, slowing to a rate of 1.3 percent annually from 1985 to 1992. Reflecting the economic recession, food and drink sales at lodging facilities declined by 0,9 percent from 1990 to 1992. Hotel restaurants showed growth rates of 4.1 percent, 2.3 percent, and negative 0.4 percent in 1990, 1991, and 1992, respectively. Motel restaurants experienced significantly lower volumes each year, with a 7.3 percent decline from 1980 to 1992, a 6.6 percent decline from 1985 to 1992, and a 5.4 percent decline from 1990 to 1992.

## [2] Domestic Passenger Traffic

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

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

## [3] International Travel Demand

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

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

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

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

## » 4.05 ECONOMIC AND DEMOGRAPHIC TRENDS

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

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

## » 4.06 CHARACTERISTICS OF TRAVEL DEMAND

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

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

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

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

*Source: U.S. Travel Data Center*

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

As the exhibit shows, the number of persons per trip has remained relatively flat during the past ten years—approximating 1.6 persons per trip—although during the late 1980s, the figure dipped slightly. As the late 1980s was a period of rapid economic expansion, the slightly lower statistics during that time might indicate an increase in individual business travel. The number of nights per trip has generally decreased from

a 1985 peak of 5.4 nights per trip to 4.2 in 1993. Business travel budgets have been reduced, particularly during the recessive early 1990s, having a direct impact on the length of business trips, and increasing number of flight options and lower airfares have led to more short "commuter" flights.
With the increase in dual-income households, vacations have changed over the past decade. Mostly gone is the single, multi-week family vacation each summer;
today, an increasing number of couples and families prefer shorter but more frequent vacations.

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

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

## [1] Commercial Demand Segment

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

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

*Source: Travel Industry Association's National Survey*

| | **1986** | **1987** | **1988** | **1989** | **1990** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **86-96 Change** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Trips | | | | | | | | | | | | |
| Volume (millions) | 164.4 | 185.0 | 182.8 | 199.3 | 182.8 | 176,9 | 210.8 | 210.4 | 193.2 | 207.8 | 192.8 | 17% |
| Share of total | 31% | 33% | 31% | 34% | 31% | 30% | 32% | 32% | 29% | 31% | 29% | |
| PERSON-TRIPS | | | | | | | | | | | | |
| Volume (millions) | 200,1 | 218.3 | 224.1 | 245.6 | 221.8 | 224.0 | 278.0 | 275.4 | 246.7 | 275.2 | 251.2 | 26% |
| Share of total | 24% | 24% | 24% | 26% | 23% | 23% | 26% | 26% | 22% | 23% | 22% | |
| Travel Party Size | | | | | | | | | | | | |
| (People) | 1.22 | 1.18 | 1.23 | 1.23 | 1.21 | 1.27 | 1.32 | 1.31 | 1.28 | 1.32 | 1.31 | |

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

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

*Source: U.S. Travel Data Center*

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

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

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

*Source: U.S. Travel Data Center*

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

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

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

*Source: U.S. Travel Data Center*

| Primary Type Used | |
|---|---|
| Car travel | 62% |
| Airline | 35% |
| Bus/motorcoach | 1% |
| Company plane | 0.5% |
| Train | 0,5% |
| Other | 1% |

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

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

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

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

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

## [2] Meeting and Convention Demand Segment

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

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

*Source: U.S. Travel Data Center*

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

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

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

| Type of meeting | Average attendance | Average number of days' duration | Number in past year | Percentage of total | Average number of months' planning lead time |
|---|---|---|---|---|---|
| Management Meetings | 43 | 2.7 | 159,900 | 20% | 4.9 |
| Sales Meetings | 64 | 2.98 | 133,900 | 17 | 8.2 |
| Training Seminars | 67 | 2.6 | 261,000 | 33 | 2 |
| Incentive Trips | 81 | 6.5 | 60,200 | 8 | 4.6 |
| Stockholder Meetings | 82 | 1.6 | 10,300 | 1 | 4.7 |
| Professional/Technical Meetings | 86 | 4.6 | 101,000 | 13 | 3.3 |
| New Product Introductions | 98 | 2.3 | 30,500 | 4 | 1.5 |
| Other Meetings | 107 | 2.1 | 44,500 | 6 | 9.4 |
| Average/Total | 69 | 3.2 | 801,300 | 100% | 5.1 |

Corporate meetings typically have a fairly small attendance (the average is approximately 69 people) and range in duration from 1.6 days for stockholder meetings to 6.5 days for incentive trips. The average length of a corporate meeting is 3.2 days. Training seminars make up the largest number of corporate meetings, roughly one-third

of all, followed by management meetings and regional sales meetings. The planning lead time for corporate meetings ranges from a low of 2 months to a high of 9.4 months. The length of lead time is an important consideration for new hotels that must pre-sell meeting space early enough to capture this element of the lodging market.

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

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

Source: *Meeting Planners Survey*

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

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

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

Source: *1994 Meetings Market Report*

| Type of Meeting | Average Attendance | Average Duration (Days) | Number In Past Year | Number of Month's Lead Time |
|---|---|---|---|---|
| Board Meeting | 35 | 1.8 | 62,500 | 6.3 |
| Educational Seminars | 102 | 2.1 | 57,000 | 9.2 |
| Professional/Technician | 111 | 2.3 | 35,700 | 7.2 |
| Regional/Local Chapter | 98 | 1.9 | 33,500 | 11.7 |
| Other | 178 | *2A* | 17.800 | *-S2* |
| Average/Total | 91 | 2.1 | 206,500 | 10 |

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

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

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

*Source: 1994 Meetings Market Report*

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

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

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

of suites

Meetings and conventions are unquestionably an important market for the lodging industry. Most of these events make use of all of the facilities within a hotel, including meeting rooms, banquet rooms, lounges, restaurants, and recreational facilities. In addition, some groups are willing to meet on weekends and holidays,

thus complementing commercial demand, which falls off during these periods. Another advantage is that meeting plans are typically made by a small committee that can consolidate and facilitate a hotel's marketing and selling activities. In addition, group arrangements such as banquets, centralized booking, check-in, and billing increase the efficiency of convention hotel operations.

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

## [3] Leisure Demand Segment

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

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

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

*Source: U.S. Travel Data Center*

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

## [4] Comparison of Demand Characteristics

Exhibit 4-15 contains listings of customer preference items, which have been ranked according to the importance with which they are regarded by the three main demand segments (1 being most important and 6 least important). The six preference items surveyed are price, travel time, quality, management, amenities, and image. Price simply represents what is charged by lodging facilities for their guestrooms. Travel time is the time it takes to travel to the facility if it is not the primary destination of the traveller, and is primarily a measure of convenience. Quality is a measure of the grade of the accommodations offered by a facility; a high-quality hotel generally has larger

guestrooms, better furnishings, and more personalized service. Management is largely responsible for a lodging facility's atmosphere, which can affect guest comfort and the perceived status of the facility. Amenities are items provided above and beyond the normal necessities found in a lodging facility; they usually become more elaborate as the level of quality rises. Image is an intangible that describes the feeling that is created by a facility and its management and that is augmented through marketing and guest experience.

**Exhibit 4-15 Customer Preference**

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

HVS

CHAPTER 5

# Market, Product, and Site Selection


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## » 5.01 LONG-TERM TRENDS

Hotel development or acquisition begins with three basic steps:

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

When looking at market areas in which to develop or acquire a lodging facility, the investor should first focus on long-term economic trends and on future supply-and-demand characteristics rather than historical factors. A knowledge of the economic history of a market area is useful, but the ability of a new hotel (whether recently constructed or acquired and renovated) to survive and succeed depends on the long-term supply and demand conditions in the market area. The economic life of

a lodging facility typically ranges from twenty to sixty years, with a median of thirty-five to forty years. A long-term evaluation is necessary to determine whether the current economic characteristics of the market are likely to continue or whether some development could take place that would alter the economic climate.

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

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

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

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

## » 5.02 TRENDS IN THE BUDGET AND ECONOMY SEGMENTS

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

**Exhibit 5-1 Hotel Industry Segments**

*Source: Smith Travel Research*

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

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

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

*Source: Smith Travel Research*

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

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

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

| Brand | #0f Hotels | #0f Rooms | #0f Brand | Hotels | #0f Rooms |
|---|---|---|---|---|---|
| Super 8 | 1,580 | 96,873 | National 9 | 52 | 1,935 |
| Motel 6 | 746 | 83,183 | Thriftlodge | 37 | 1,884 |
| Econo Lodge | 735 | 47,849 | Good Nite Inn | 14 | 1,692 |
| Knights Inn | 229 | 19,552 | Select Inn | 14 | 1,364 |
| Howard Johnson Express Inn | 173 | 13,174 | Budget Inn | 16 | 1,264 |
| Sleep Inn | 154 | 11,426 | Admiral Benbow | 10 | 1,163 |
| Red Carpet Inn | 129 | 7,774 | Motel Orleans | 13 | 844 |
| Budget Host Inn | 186 | 7,500 | Friendship Inn | 18 | 685 |
| Scottish Inn | 140 | 7,010 | Ha' Penny | 6 | 631 |
| Microtel | 66 | 5,502 | Passport Inn | 13 | 607 |
| Travelers Inn | 35 | 4,256 | Cricket Inn | 4 | 598 |
| Masters Inn | 32 | 3,828 | Wynfield Inn | 3 | 578 |
| Excel Inn | 27 | 3,013 | Sixpence Inn | 6 | 577 |
| Cross Country Inn | 25 | 3,009 | Roadstar Inn | 7 | 576 |
| E-Z8 | 27 | 2,728 | Hometown Inn | 5 | 332 |
| Economy Inns Of America | 22 | 2,474 | Great Western | 7 | 323 |
| Wilson | 15 | 2,405 | Thrifty Inn | 4 | 315 |
| Family Inns Of America | 26 | 2,291 | Travel Inn | 4 | 204 |
| Little America | 6 | 2,276 | | | |
| | | | Segment Totals: | 4,586 | 341,695 |

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

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

| Brand | #of Hotels | #0f Rooms | #0f Brand | Hotels | #0f Rooms |
|---|---|---|---|---|---|
| Days Inn | 1,738 | 155,795 | Vagabond Inn | 49 | 3,419 |
| Travelodge | 443 | 35,089 | Best Inns Of America | 33 | 3,129 |
| Fairfield Inn | 345 | 33,231 | Innkeeper | 23 | 1,903 |
| Red Roof Inn | 259 | 29,725 | Country Hearth Inn | 30 | 1,755 |
| Ramada Limited | 218 | 16,065 | Jameson Inn | 37 | 1,659 |
| Budgetel | 153 | 15,930 | Mcintosh Motor Inn | 12 | 1,410 |
| Rodeway Inn | 210 | 13,331 | Nendels | 16 | 1,072 |
| Shoney's Inn | 87 | 8,836 | Key West Inn | 13 | 590 |
| Americinn | 90 | 4,177 | L-K Motel | 5 | 190 |
| Susse Chalet | 33 | 3,714 | | | |
| | | | Segment Totals: | 3,794 | 331,020 |

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

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

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

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

## [1] Regional Performance

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

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

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

Overall, as compared to the previous years, the budget and economy segments achieved a 1.70 percent increase in supply for the year ended October 1997, but they experienced no demand growth. This trend of supply surpassing demand is expected to continue for the foreseeable future, until such time when the construction of new properties in the budget and economy segments is no longer feasible. This occurs when the per-room construction costs exceed the values per room of these products. Simply put, new construction occurs when the value of a new hotel is higher than the cost to build it. This positive feasibility draws capital into lodging development; as

more and more hotels are built, occupancies fall and values begin to decline. Feasibility becomes negative when it costs more to build a new hotel than to purchase an existing property with the same utility. At that point, the supply of capital evaporates and new construction ceases.

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

*Sources: HVS International and Smith Travel Research*

| | Occupancy | | Average Daily Rate | | Percent Change | | |
|---|---|---|---|---|---|---|---|
| **Year Ended Region** | **Oct. 1997** | **Year Ended Oct. 1996** | **Year Ended Oct. 1997** | **Year Ended Oct. 1996** | **Demand** | **Supply** | **Revenue** |
| New England | 61.6% | 59.4% | $54.68 | $50.88 | 3.7% | -0.04% | 11.49% |
| Middle Atlantic | 64.4 | 64.3 | 66.66 | 61.09 | 1.1 | 1.01 | 10.30 |
| Pacific | 64.1 | 64.0 | 50.66 | 46.84 | 0.6 | 0.32 | 8.80 |
| East North Central | 56.8 | 58.6 | 45.52 | 42.62 | -0.0 | 3.13 | 6.80 |
| West South Central | 57.8 | 59.1 | 39.50 | 37.41 | 0.1 | 2.42 | 5.67 |
| West North Central | 56.5 | 57.7 | 41.38 | 39.49 | -0.1 | 2.04 | 4.66 |
| South Atlantic | 60.5 | 61.9 | 43.56 | 41.28 | -1.1 | 1.20 | 4.33 |
| Mountain | 62.4 | 64.4 | 41.74 | 40.59 | 0.3 | 3.54 | 3.16 |
| East South Central | 56.2 | 58.1 | 38.79 | 37.56 | -2,1 | 1.17 | 1.07 |
| **U.S. Total** | 60.3% | 61.35% | $46.53 | $43.76 | -0.0% | 1.70% | 6.34% |

## [2] Hotel Valuation Index

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

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

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

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

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

Sources: *HVS International and Smith Travel Service*

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Economy** | $31,00 | $33,2 | $29,5 | $26,24 | $27,7 | $28,08 | $29,49 | $35,3 | $36,121 | $36,4 | $37,72 | $37,48 | $36,2 |
| Percent Change | - | 7% | -11% | -11% | 6% | 1% | 5% | 20% | 2% | 1% | 4% | -1% | -3% |
| **Budget** | $26,94 | $26,9 | $25,4 | $21,81 | $22,6 | $24,99 | $27,49 | $33,0 | $34,797 | $37,1 | $33,98 | $33,47 | $31,4 |
| Percent Change | - | 0% | -6% | -14% | 4% | 10% | 10% | 20% | 5% | 7% | -9% | -2% | -6% |

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

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

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

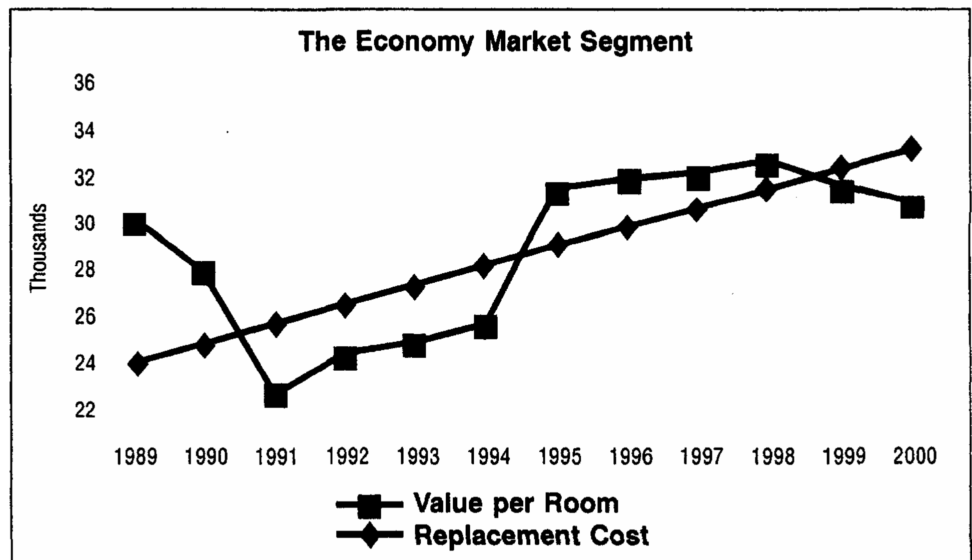
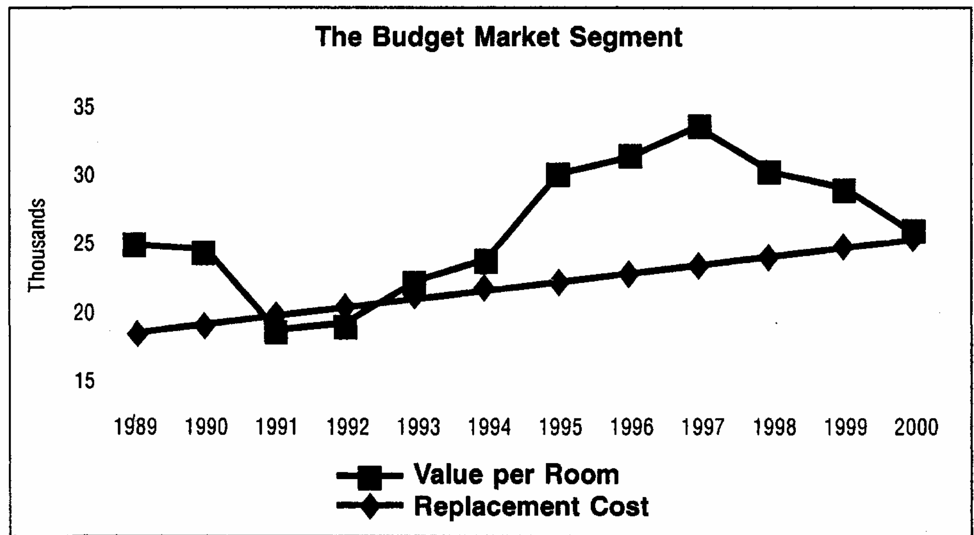


**Exhibit 5-6 Budget Hotels: Replacement Cost vs. Value per Room**




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

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

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

It appears that there are two additional challenges facing the budget and economy segments of the lodging industry. The first challenge is the introduction of budget and economy-oriented extended-stay products. According to F.W. Dodge (a firm that tracks new construction in markets throughout the country), as of the third quarter 1997, there were approximately 229 budget and economy extended-stay products that were in the "start" stage of development. This is the stage of development after plan-

ning and typically is at the point of, or close to ground breaking. These 229 projects amounted to an estimated 28,572 new rooms. Additionally, there were approximately 60 budget and economy extended-stay products in the planning stage. These new additions to supply in the extended-stay arena are expected to magnify the threat of oversupply and erode demand in the budget and economy transient segments.

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

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

## » 5.03 MARKET POTENTIAL

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

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

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

   or the improved attractiveness of a city as a destination (e.g., Atlantic City af-

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

2. *A cyclical market experiencing an upward trend in occupancy.* Care must be taken not to overestimate the length of the upward trend; such an error could lead the investor to enter the market just as occupancies are peaking before they decline. The best time to develop or acquire a lodging facility is when the cycle is nearing its lowest point. In these situations, prices tend to be depressed and a property can be acquired under the most favorable terms. For example, by the end of the 1980s depressed hotel markets in Houston, Tulsa, and Denver seemed to have hit the low point in their occupancy cycle; consequently, this period was a good time either to acquire an existing hotel or to start developing a new one in these markets. Although this strategy is theoretically sound, it takes both personal determination and strong financial staying power to actually follow such a course.
3. *Markets in which newly-constructed additions to lodging supply have been restricted or inhibited (i.e., where there are barriers to entry).* Barriers to entry tend to favor existing hotels, which benefit directly from a stable supply of competitive rooms. The most common barriers are zoning restrictions, which can sometimes actually bar new hotel development or make it so time-consuming and expensive that developers choose a different use of the property. Zoning can also reduce the feasibility of a hotel project by limiting the number of rooms or by requiring unnecessary facilities such as excessive parking. Other governmental regulations that can restrict development include building moratoriums brought about by a lack of sewage capacity or available water, adverse environmental impact (e.g., traffic congestion), and zero-growth policies. Lack of developable land on a site and proposals of a higher and better use of the land are also forms of barriers to entry. In New York City, the high cost of construction brought about by escalating land values and development costs makes it difficult to economically justify new hotel projects. Investors should be aware of market areas in which barriers to entry are likely to arise in the near future and should look into developing a new lodging facility or acquiring an existing one before the barrier takes effect.
4. *Markets that offer diversity of demand.* Over the long term, hotel markets that cater to a wide spectrum of lodging demand generally suffer fewer significant downturns than areas that are dependent on a small number of demand generators. Cities that depend on one type of industry run the risk that eventually the industry may decline or even go out of business. Markets in the midwest, for example, have suffered considerably when steel and automotive plants have closed. Houston and Tulsa were severely affected by the decline in domestic oil production. In addition to looking for locations with a number of different industries and businesses, hotel investors should also seek areas that attract a variety of market segments. An ideal hotel location caters heavily to all three of the major market segments: commercial, meeting and convention, and leisure. These segments tend to have complementary usage patterns. For example, when commercial demand is weak (weekends and summer months), leisure travel demand is strong, and vice versa. Meeting and convention demand tends to fill the gaps between the strong commercial travel and leisure travel periods, San Francisco, Boston, New York, and New Orleans are examples of cities that have been able to attract strong patronage from all three major market segments.

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## » 5.04 MARKET OVERVIEW STUDY

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

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

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

## » 5.05 PRODUCT SELECTION

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

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

The addition of each new amenity or service required economic justification, such as improved occupancy or average room rate. The general trend became a slight upward adjustment in room rate whenever a new amenity was added. Over time, an economy-oriented lodging chain became a mid-rate chain with some individual facil-

ities achieving first-class status. Other chains, such as TraveLodge, Ramada Inns, and Days Inns also began in the economy segment of the lodging industry, but through amenity creep have become established as mid-rate chains.

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

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

## [1] New Hotel Products

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

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

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

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

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

## [2] Success Factors for Unique Hotel Products

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

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

## » 5.06 MATCHING THE PRODUCT TO THE MARKET

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

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

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

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

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

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

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

If the success factors cited can be duplicated, then two issues remain to be dealt with: (1) whether or not there is sufficient demand to justify another product of this

type; and (2) the likelihood that other, similar products will enter the market over the short and the long term, given expected barriers to entry. **If** there are any market segments that are not being adequately served by area lodging facilities, the following considerations should be explored: the depths of these market segments, their expected growth, and the probability of competition for these segments.

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

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

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

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

## » 5.07 HOTEL SITE SELECTION

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

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

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

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

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

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

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

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

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CHAPTER 6

# Site Analysis


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## » 6.01 PHYSICAL SUITABILITY

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

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

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

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

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

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

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

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

## » 6.02 ACCESS AND VISIBILITY

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

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

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

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

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

**Exhibit 6-1 Access and Visibility**

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

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

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

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

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

In a market study and appraisal, the access and visibility of the proposed property should be thoroughly analyzed, and a determination should be made regarding how well the property compares with competing lodging facilities. Specific reference

should be made to access and visibility for all normal modes of transportation as well as the local generators of transient visitation. The conclusions regarding the proposed site's access and visibility should then be reflected in the selection of competitive indexes for the room-night analysis. (See H 11.03.)

## » 6.03 UTILITIES AND OTHER SERVICES

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

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

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

## » 6.04 APPLICABLE REGULATIONS

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

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

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

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

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

## » 6.05 EXCESS LAND

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

Whether or not an apparently unused parcel is actually used is often a subjective decision. Vacant land often provides aesthetic qualities—such as increased visibility, reduced noise, and greater privacy—that are difficult to quantify but that generally improve the property's overall value. If the value enhancement of not using the excess land is less than the land's independent market value if sold separately,

then the land can be considered excess and should be used in some manner. Favorable uses 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.

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

# CASE STUDY Site Analysis

## DESCRIPTION OF LAND

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

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

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

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

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

## ACCESS AND VISIBILITY

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

At the point at which I-86/I-286 passes adja-cent to the subject property, it is part of the New York State Thruway system, a limited-access toll route originating in New York City, extending north to Albany, continuing west through Utica, Syracuse, and Rochester, and terminating in Buffalo. At Albany, 1-86 departs from the Thruway system and continues northward to the U.S.-Canadian border, where it becomes Quebec Highway 15 leading to Montreal. Several miles east of the subject property, 1-286 crosses the Hudson River at the Tappan

Zee Bridge and also leaves the Thruway system to become the Cross Westchester Expressway, which ties in directly with the New England Turnpike (I-95) in Rye, New York. Continuing south from the Tappan Zee Bridge, 1-86 becomes the Major Deegan Expressway when it enters New York City

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

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

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

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

State Route 16 originates in Kearny, New Jersey, near the Lincoln Tunnel (which provides access to Manhattan) and extends northwestward through the western end of Rockland County, par

alleling the New York State Thruway. At Harriman, Route 16 heads westward along the southern tier of New York State, where it terminates at the Pennsylvania border near Erie, Pennsylvania.

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

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

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

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

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

one mile in either direction.

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

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

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

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

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

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

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

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

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

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

As Exhibit 6-2 indicates, the subject property is centrally located in relation to many of the area's

businesses. With the excellent highway system throughout the immediate market area and the proximity of the subject property to the New York State Thruway, access to most of the nearby generators of visitation is equal to, if not better than, that of competitive lodging facilities.

## UTILITIES AND OTHER SERVICES

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

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

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

## APPLICABLE REGULATIONS

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

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

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

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

## SITE SUITABILITY

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

*Advantages;*

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

*Disadvantages:*

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

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

HVS

# CHAPTER 7

# Neighborhood and Market Area Analysis


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## » 7.01 INTRODUCTION

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

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

## » 7.02 NEIGHBORHOOD ANALYSIS

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

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

### [1] Observation

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

- A list of different land uses in the neighborhood, categorized in broad terms (e.g., retail, office, industrial, rural, suburban, or urban).
- An inventory of specific land uses within one-quarter to one-half of a mile (depending on density) of the subject property (e.g., strip shopping center) with the following tenants:

—Single-use office building

—Free-standing mid-price chain restaurant

—Driving range (among others)

- Characteristics of properties situated near the subject property, including:

—Age

— Condition

—Style

—Class

— Image

- A review of neighborhood development, including:

—Density of existing development in the area

—Description of any development in progress

— Identification of vacant land that could be developed

- An evaluation of the competitive environment, including the identification of other lodging facilities and food, beverage, and entertainment establishments.

## [2] Economic Trends

After identifying and analyzing the salient characteristics of the subject property's neighborhood, the appraiser should obtain information on local economic trends from the municipality's planning and building departments, zoning officials, economic development agencies, real 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, including the following:

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

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

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

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

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

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

## » 7.03 MARKET AREA ANALYSIS

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

### [1] Boundary Definition

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

Overnight travelers generally seek lodging accommodations that are convenient with respect to the demand generator that they are visiting. In most instances, transient visitors will travel up to twenty minutes from a generator of visitation, or demand generator, to their lodging accommodations. Therefore, the market area

perimeter surrounding the subject property generally has a radius of approximately twenty travel minutes. In most instances, where the primary mode of transportation is the automobile, twenty travel minutes is the same as twenty driving minutes. Depending on the highway patterns, the market area perimeter may take on a variety of shapes showing the various distances that can be traveled over a twenty-minute period. It will, for example, be elongated along the path of an interstate highway, and shortened where travel is restricted to local streets.

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

## [2] Economic and Demographic Data

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

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

### [a] Population Age Distribution

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

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

### [b] Retail Sales

Trends in retail sales reflect overall changes in population and changes in the ability and desire of area inhabitants and visitors to spend money for retail goods. As with

population trends, retail sales have no direct correlation with hotel room-night demand; rather, they gauge the economic health and vitality of a market area.

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

### [c] Work Force Characteristics

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

### [d] Major Businesses and Industries

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

### [e] Office Space

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

### [f] Highway Traffic

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

### [g] Airport Statistics

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

## [3] Data Collection

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

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

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

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

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

## [4] Data Analysis

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

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

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

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

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

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

1992 - 1991 = 12,943,767 - 12,566,764 = 1.03 - 1.00 = +3% The change

between 1992 and 1993 was

1993 - 1992 = 12,614,736 - 12,943,767 = 0.975 - 1.00 = -2.5%

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

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

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

-1 + (A - B)^-[1])) = C

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

Thus, the annual compounded percent change for the years 1991 through 1995 is -1 +

(14,377,202 - *12,566,764)W*$^{5}$-^) = 3.4%

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

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

| Year | Retail Sales (current $) | Retail Sales (1995 $) | % Change From Previous Year |
|---|---|---|---|
| 1991 | $1,118,539 | $1,251,581 | — |
| 1992 | 1,223,391 | 1,328,901 | 6.2% |
| 1993 | 1,310,534 | 1,382,183 | 4.0 |
| 1994 | 1,407,998 | 1,447,901 | 4,8 |
| 1995 | 1,451,832 | 1,451,832 | 0.3 |
| Annual | compounded percent change | (1991-1995) | 3.8% |

Exhibit 7-4 shows retail sales in Rockland County from 1991 to 1995. According to this information, sales increased a total of 30 percent, using current (inflated)

dollars. Performing the same calculation using 1995 (constant) dollars shows a 16 percent increase, which is the amount of real growth in retail sales during the same period. The difference between the inflated dollar calculation (30 percent) and the constant dollar calculation (16 percent) is attributed to inflation rather than real growth in retail demand. The annual compounded percent change in real terms over this period is 3.7 percent.

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

**Exhibit 7-5 Consumer Price Index**

*Sources: Bureau of Labor Statistics*

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

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

1995 CPI - 1994 CPI = (152.4 - 147.2) X ($1,407,997 - 1) = $1,447,901

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

1995 CPI - 1993 CPI = (152.4 - 144.5) X ($1,310,534 - 1) = $1,372,173

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

## [5] Estimate of Future Transient Demand

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

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

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

### [a] Commercial Market Segment

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

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

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

## [b] Meeting and Convention Market Segment

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

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

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

## [c] Leisure Market Segment

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

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

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

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

## [d] Conclusion

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

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

# CASE STUDY
# Neighborhood and Market Area Analysis

## NEIGHBORHOOD ANALYSIS

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

### Character of Surrounding Area

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

### Development of Neighborhood

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

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

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

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

### Commercial Properties in Neighborhood

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

A one-story strip shopping center containing approximately fifteen retail outlets is located immediately north of the subject property, on the western side of Central Avenue. The tenants include a men's wear shop, a women's lingerie boutique, a travel agent, a real estate broker, a jeweler, an ice cream shop, a liquor store, and an antique dealer. The quality and variety of these shops would complement a nearby lodging facility, though they would also compete with similar facilities contained in a nearby hotel. Facilities located immediately north of the strip mall include a Mer-

cedes-Benz dealer, a three-story medical building, and an office building housing the regional headquarters of IBM Office Equipment Marketing. This branch of the national computer firm is responsible for developing marketing programs in the northeastern United States and training all sales representatives. Numerous conferences are held in this building as a result of these training programs; a majority of the attendees are housed in nearby commercial lodging facilities.

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

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

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

### Conclusion

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

## MARKET AREA ANALYSIS

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

### Definition and Geographic Character

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

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

The natural north-south contours of the land have had a significant impact on the development of a transportation system of highways and railways that generally conforms to this geographic model. The significant exception to the north-south

highway pattern is the New York State Thruway (I-77/1-277), which traverses the southern part of Rockland County in a mostly east-west direction, cutting through the rugged hills and intersecting with each of the north-south highways. The fact that virtually all east- and westbound traffic occurs on a single roadway benefits the adjacent subject property in terms of both access and visibility.

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

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

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

## Population

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

Between 1970 and 1994, Rockland County, the New York MSA, and the State of New York all registered average annual population growth factors of 0.3 percent, a level considerably lower than the 1,0 percent annual average gain registered by the nation during the same period. The subject county's population actually decreased in 1977 and 1978, before beginning to record stronger positive gains in 1991 and 1992. At the same time, the New York MSA's population growth has remained flat in recent years, below state and national levels. The region's limited population gains are partially attributable to the high cost of living and doing business in the northeastern United States and the taxes paid by New York State residents, which have discouraged large-scale migration to the area in recent years. Forecasts indicate that the population of Rockland County will continue to increase at a slow rate through 2020, with growth rates generally above those of the MSA and in line with those of the state,

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

## Age Distribution

The age distribution of an area's population provides an indication of probable spending patterns, food, beverage and banquet patronage, and the propensity to travel. A growing local population under the age of 20 is likely to yield greater banquet business in the form of weddings, proms, award dinners, and similar functions. Growth in the 20- to 39-year age group is likely to create increased lounge patronage and demand for entertainment facilities. Individuals aged 40 to 64 generally have the largest amount of disposable income, and thus represent potential restaurant and lounge patrons. Exhibit 7-6 shows the expected trends in the population age distribution for Rockland County as compared with those of the United States.

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

*Source: Woods & Poole Economics, Inc.*

| Rockland County | | | | New York, NY MSA | | | State of New York | | | United States | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Year | Population | Percent Change[1] | Percent Change[2] | Population | Percent Change[1] | Percent Change[2] | Population | Percent Change[1] | Percent Change[2] | Population | Percent Change[1] | Percent Change[2] |
| 1970 | 231.1 | — | — | 9,078.7 | — | — | 18,264.5 | — | — | 203,982.3 | — | — |
| 1975 | 247.6 | 1.4% | — | 8,694.9 | (0.9)% | — | 18,044.0 | (0.2)% | — | 215,465.2 | 1.1% | — |
| 1980 | 259.6 | 1.0 | — | 8,277.1 | (1.0) | — | 17,566.4 | (0.5) | — | 227,225.6 | 1.1 | — |
| 1985 | 264.4 | 0.4 | 0.4% | 8,491.4 | 0.5 | 0.5% | 17,791.8 | 0.3 | 0.3% | 237,924.8 | 0.9 | 0.9% |
| 1986 | 265.5 | 0.4 | 0.4 | 8,536.8 | 0.5 | 0.5 | 17,833.5 | 0.2 | 0.3 | 240,133.9 | 0.9 | 0.9 |
| 1987 | 264.6 | (0.3) | 0.3 | 8,560.9 | 0.3 | 0.5 | 17868.9 | 0.2 | 0.2 | 242,289.9 | 0.9 | 0.9 |
| 1988 | 264.6 | (0.0) | 0.2 | 8,575.9 | 0.2 | 0.4 | 17,941.4 | 0.4 | 0.3 | 244,499.8 | 0.9 | 0.9 |
| 1989 | 264.8 | 0.1 | 0.2 | 8,567.4 | (0.1) | 0.4 | 17,983.1 | 0.2 | 0.3 | 246,819.8 | 0.9 | 0.9 |
| 1990 | 265.9 | 0.4 | 0.2 | 8,547.5 | (0.2) | 0.3 | 18,001.6 | 0.1 | 0.2 | 249,399.4 | 1.0 | 0.9 |
| 1991 | 268.4 | 0.9 | 0.3 | 8,540.6 | (0.1) | 0.3 | 18,046.9 | 0.3 | 0.2 | 252,137.0 | 1.1 | 1.0 |
| 1992 | 270.9 | 0.9 | 0.4 | 8,551.8 | 0.1 | 0.3 | 18,109.5 | 0.3 | 0.3 | 255,077.4 | 1.2 | 1.0 |
| 1993 | 271.6 | 0.3 | 0.3 | 8,564.5 | 0.1 | 0.3 | 18,163.5 | 0.3 | 0.3 | 257,919.5 | 1.1 | 1.0 |
| 1994 | 272.4 | 0.3 | 0.3 | 8,574.5 | 0.1 | 0.3 | 18,211.8 | 0.3 | 0.3 | 260,663.9 | 1.1 | 1.0 |
| 1995 | 272.9 | 0.2 | 0.3 | 8,577.7 | 0.0 | 0.2 | 18,245.9 | 0.2 | 0.3 | 263,211.0 | 1.0 | 1.0 |
| 2000 | 274.7 | 0.1 | 0.3 | 8,571.1 | (0.0) | 0.2 | 18,3681 | 0.1 | 0.2 | 275,260.0 | 0.9 | 1.0 |
| 2005 | 276.0 | 0.1 | 0.2 | 8,548.8 | (0.1) | 0.1 | 18,455.8 | 0.1 | 0.2 | 286,757.8 | 0.8 | 0.9 |
| 2010 | 277.6 | 0.1 | 0.2 | 8,536.1 | (0.0) | 0.1 | 18,564.1 | 0.1 | 0.2 | 298,528.7 | 0.8 | 0.9 |
| 2015 | 279.7 | 0.1 | 0.2 | 8,537.8 | 0.0 | 0.1 | 18,703.6 | 0.1 | 0.2 | 310,788.2 | 0.8 | 0.9 |
| 2020 | 281.7 | 0.1 | 0.2 | 8,538.9 | 0.0 | 0.1 | 18,841.9 | 0.1 | 0.2 | 323.023.5 | 0.8 | 0.9 |

[1] annual average compounded percentage change from previous year shown

[2] annual average compounded percentage change from 1980

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

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

Between 1970 and 1994, the median age of the Rockland County population increased from 31,1 to 35.2 years, a median age slightly higher than the 1994 national median age of 34.1 years. The shift in the county's age distribution during this period was associated with a decline in the percentage of residents under 20 and an increase in the percentage of the county population in the age groups of 40 to 64 and 65 and over. Projections suggest continued aging of the county population through the year 2000 with the median age expected to reach 36.7. The percentage of county residents in age groups of under 20, 20 to 39, and 65 and over are expected to decline between 1993 and 2000, while the 40-to-64 age group increases substantially

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

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

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

**Retail Sales**

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

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

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

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

*Source: Woods & Poole Economics, Inc.*

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

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

**Personal Income**

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

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

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

**Workforce Characteristics**

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

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

**Farm, Agricultural Services, Mining**

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

**Construction**

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

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

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

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

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

*Source: Woods & Poole Economics, Inc.*

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

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

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

*Source: Woods & Poole Economics, Inc.*

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

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

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

*Source; Woods & Poole Economics, Inc.*

| | | | | | | | | | Average Annual Compounded Percent Change | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Industry | 1980 | Percent of Total | 1990 | Percent of Total | 1994 | Percent of Total | 2000 | Percent of Total | 1980-1994 | 1990-1994 | 1994-2000 |
| Farm | 0.1 | 0.1% | 0.1 | 0.0% | 0.1 | 0.0% | 0.1 | 0.0% | (3.3)% | 0.0% | 0.0% |
| Agriculture Services, Other | 0.6 | 0.6 | 0.8 | 0.6 | 0.8 | 0.6 | 0.8 | 0.6 | 1.6 | (0.7) | 0.4 |
| Mining | 0.4 | 0.4 | 0.3 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | (4.2) | (5.9) | 0.7 |
| Construction | 3.7 | 3.6 | 5.6 | 4.5 | 4.7 | 3.7 | 4.6 | 3.6 | 1.7 | (4J) | (0.1) |
| Manufacturing | 16.4 | 15.9 | 15.3 | 12.1 | 14.6 | 11.5 | 14.4 | 11.2 | (0.8) | (1.2) | (0.2) |
| Trans., Comm. & Public Utils. | 4.1 | 4.0 | 5.9 | 4.7 | 6.6 | 5.2 | 6.6 | 5.1 | 3.5 | 2.7 | 0.0 |
| Total Trade | 22.2 | 21.6 | 25.7 | 20.3 | 24.5 | 19.3 | 24.4 | 19.0 | 0.7 | (1.1) | (0.1) |
| Wholesale Trade | 4.9 | 4.8 | 7.1 | 5.6 | 6.6 | 5.2 | 7.4 | 5.8 | 2.2 | (1.8) | 1.9 |
| Retail Trade | 17.3 | 16.8 | 18.6 | 14.7 | 17.9 | 14.1 | 17.0 | 13.3 | 0.3 | (0.9) | (0.9) |
| Finance, Insurance & Real Estate | 7.2 | 7.0 | 11.0 | 8.7 | 11.1 | 8.7 | 11.6 | 9.0 | 3.2 | 0.1 | 0.8 |
| Services | 26.8 | 26.1 | 39.5 | 31.3 | 43.9 | 34.4 | 44.6 | 34.7 | 3.6 | 2.7 | 0.3 |
| Total Government | 21.4 | 20.9 | 22.1 | 17.5 | 21.1 | 16.6 | 21.2 | 16.5 | (0.1) | (1.t) | 0.0 |
| Federal Civilian Govt. | 0.8 | 0.8 | 1.0 | 0.8 | 0.9 | 0.7 | 0.9 | 0.7 | 0.8 | (3-6) | (0.2) |
| Federal Military Govt. | 0.8 | 0.7 | 0.8 | 0.7 | 0.8 | 0.6 | 0.8 | 0.6 | 0.3 | (1.5) | 0.0 |
| State & Local Govt. | 19.9 | 19.3 | 20.2 | 16.0 | 19.5 | 15.3 | 19.5 | 15.2 | (0.1) | (1.0) | 0.0 |
| TOTAL | 102.7 | 100.0% | 126.3 | 100.0% | 127.5 | 100.0% | 128.4 | 100.0% | 1.6% | 0.2% | 0.1% |

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

Source: *Rockland County Economic Development Authority*

| **Single Family** | | | **Multi-Family Total** | | | |
|---|---|---|---|---|---|---|
| Number Year of | Units | Percent Change | Number of Units | Percent Change | Number of Units | Percent Change |
| 1985 | 529 | — | 1,144 | — | 1,673 | — |
| 1986 | 508 | (4.0)% | 972 | (15.0)% | 1,480 | (11.5)% |
| 1987 | 467 | (8.1) | 875 | (10.0) | 1,342 | (9.3) |
| 1988 | 475 | 1.7 | 770 | (12.0) | 1,245 | (7.2) |
| 1989 | 502 | 5.7 | 768 | (0.3) | 1,270 | 2.0 |
| 1990 | 460 | (8.4) | 624 | (18.8) | 1,084 | (14.6) |
| 1991 | 367 | (20.2) | 525 | (15.9) | 892 | (17.7) |
| 1992 . | 287 | (21.8) | 492 | (6.3) | 779 | (12.7) |
| 1993 | 285 | (0.7) | 497 | 1,0 | 782 | 0.4 |
| 1994 | 302 | 6.0 | 510 | 2.6 | 812 | 3.8 |
| 1995 | 325 | 7.6 | 535 | 4.9 | 860 | 5.9 |
| Average Annual percent Change 1985-1995 | | (4.8)% | | (7.3)% | | (6.4)% |
| Proj. 1996-2000 annual increases | 330 | —— | 545 | —— | 875 | —— |

**Total County Nonresidential Property Assessment**

*Source; Rockland County Assessment Department*

| **Year** | **Assessed Value in 1995 Dollars** | **Percent** |
|---|---|---|
| 1985 | $1,105,000 | — |
| 1986 | 1,116,000 | 1.0% |
| 1987 | 1,149,000 | 3.0 |
| 1988 | 1,195,000 | 4.0 |
| 1989 | 1,208,000 | 1.1 |
| 1990 | 1,198,000 | (0.8) |
| 1991 | 1,164,000 | (2,8) |
| 1992 | 1,102,000 | (5.3) |
| 1993 | 1,057,000 | (4.1) |
| 1994 | 1,105,000 | 4.5 |
| 1995 | 1,207,000 | 9.2 |
| Avg. Annual | % Change 1985-1995 | 0.9% |

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

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

Manufacturing

Employment in Rockland County's manufacturing firms declined at an average annual compounded

rate of 4.2 percent between 1970 and 1994, and a more severe drop of 5.9 percent annually occurred from 1990 to 1994. According to information provided by the Chamber of Commerce, there were more than 100 manufacturing plants in Rockland County in 1994 and these plants shipped products worth more than $1.2 billion out of the area, representing an approximate 9 percent increase from 1977. Rockland represents slightly more than 4 percent of total manufacturing production in the New York metropolitan area. Between 1972 and 1994, two manufacturing plants terminated operations in Rockland County. A total of 407 major manufacturing plants closed in the New York metropolitan area during this ten-year period. Projections indicate a further decline of 0,1 percent per year in manufacturing employment in Rockland County between 1994 and 2000.

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

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

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

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

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

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

**Transportation, Communications, and Public Utilities**

In 1994, the transportation, communications, and public utilities sector represented a minor portion of the Rockland County employment base; most of these employees work for either postal services or telephone companies. Between 1970 and 1994, employment in this sector increased at an average annual compounded rate of 3,5 percent. Firms in this sector have a mixed propensity to generate hotel demand. Communications firms and utilities are not highly labor intensive and are unlikely to produce significant lodging demand. Projections indicate that TCPU employment will remain flat between 1994 and 2000,

**Wholesale and Retail Trade**

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

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

and distribution centers further enhance the dominance of the trade sector.

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

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

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

**Services**

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

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

**Government**

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

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

**Major Businesses and Industries**

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

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

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

**Office Space**

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

**Exhibit 7-16**
**Major Employers In Rockland County**

Source; *Rockland County Chamber of Commerce*

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

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

*Nyack Office Center:*

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

Size: 500 acres Number

of Firms: 250

Occupied Office Space: 2,145,400 square feet Total

Office Space; 2,524,500 square feet Vacancy Rate:

15 percent Major Tenants; Avon Products, Inc., Ciba-

Geigy, Lederle Laboratories, U.S. Polychemical

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

*Eastwood Office Park:*

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

Size: 300 acres

Number of Firms: 125

Occupied Office Space: 752,300 square feet

Total Office Space: 947,000 square feet

Vacancy Rate: 10 percent

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

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

*Suffern Corporate Center:*

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

Size: 600 acres

Number of Firms: 73

Occupied Office Space: 367,700 square feet

Total Office Space: 461,000 square feet

Vacancy Rate: 20 percent

Major Tenants: Chrysler Motors, World-Wide Volkswagen

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

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

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

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

*Source: Rockland County Real Estate Board*

| Year | Available Space | Percent Change | Occupied Space | Percent Change | Vacancy Rate |
|---|---|---|---|---|---|
| 1985 | 6,545,000 | — | 5,845,000 | — | 10.7% |
| 1986 | 6,617,000 | 1.1% | 6,200,000 | 6.1% | 6.3 |
| 1987 | 6,637,000 | 0.3 | 6,278,000 | 1.3 | 5.4 |
| 1988 | 6,697,000 | 0.9 | 6,362,000 | 1.3 | 5.0 |
| 1989 | 7,234,000 | 8.0 | 6,398,000 | 0,6 | 11.6 |
| 1990 | 7,459,000 | 3.1 | 6,278,000 | (1.9) | 15.8 |
| 1991 | 7,601,000 | 1.9 | 6,123,000 | (2.5) | 19.4 |
| 1992 | 7,639,000 | 0.5 | 6,145,000 | 0.4 | 19.6 |
| 1993 | 7,635,000 | (0.1) | 6,232,000 | 1.4 | 18.4 |
| 1994 | 7,669,000 | 0.4 | 6,452,000 | 3.5 | 15.9 |
| 1995 | 7,735,000 | 0.9 | 6,637,000 | 2.9 | 14.2 |
| Avg. Annual percent | | | | | |
| Change 1985-1995 | | 1.7% | | 1.3% | |

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

### Highway Traffic

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

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

### Airport Traffic

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

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

**Exhibit 7-18 Highway Traffic Counts**

*Source: New York State Department of Highways*

| Year | New York State Thruway[1] | Percent Change | Garden State Parkway[2] | Percent Change | Palisades Parkway[3] | Percent Change |
|---|---|---|---|---|---|---|
| 1984 | 12,566,764 | — | 6,153,928 | — | 5,431,492 | — |
| 1985 | 12,943,767 | 3.0% | 6,369,315 | 3.5% | 5,632,457 | 3,7% |
| 1986 | 13,614,836 | 5.2 | 6,604,980 | 3.7 | 5,846,490 | 3.8 |
| 1987 | 13,522,145 | (0.7) | 6,803,129 | 3.0 | 6,056,964 | 3.6 |
| 1988 | 14,377,202 | 6.3 | 7,068,451 | 3.9 | 6,299,243 | 4.0 |
| 1989 | 14,528,352 | 1.1 | 7,153,254 | 1.2 | 6,342,102 | 0.7 |
| 1990 | 14,423,351 | (0.7) | 7,159,265 | 0.1 | 6,423,012 | 1.3 |
| 1991 | 14,395,230 | (0.2) | 7,002,341 | (2.2) | 6,397,123 | (0.4) |
| 1992 | 14,412,023 | 0.1 | 7,100,256 | 1.4 | 6,445,251 | 0,8 |
| 1993 | 14,385,178 | (0.2) | 7,209,356 | 1.4 | 6,445,251 | 0.8 |
| 1994 | 14,525,108 | 1.0 | 7,211,369 | 0.0 | 6,428,798 | 0.5 |
| 1995 | 14,528,397 | 0.0 | 7,205,446 | (0.1) | 6,439,555 | 0.2 |
| Avg. Annual percent Change 1984-1995 | | 1.3% | | 1.4% | | 1.6% |

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

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

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

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

### Rockland County Convention and Exhibition Center

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

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

**Exhibit 7-19 Stewart Airport Statistics**

*Source: Stewart Airport Authority*

| Year | Passenger Enplanement | Percent Change[1] | Percent Change[2] | Cargo Tons | Percent Change[1] | Percent Change[2] |
|---|---|---|---|---|---|---|
| 1978 | 197,105 | — | — | 53,120 | — | — |
| 1983 | 245,628 | 4.5% | 4,5% | 67,796 | 5,0% | 5.0% |
| 1988 | 297,423 | 3.9 | 4.2 | 88,189 | 5.4 | 5.2 |
| 1992 | 372,420 | 5.8 | 4.6 | 117,171 | 7.4 | 5.8 |
| 1995 | 388,876 | 1.5 | 4.1 | 133,288 | 4.4 | 5.6 |
| 1998 | 475,321 | 4.1 | 4.5 | 149,217 | 4.1 | 5.3 |
| 2003 | 609,546 | 5.1 | 4.6 | 194,099 | 5.4 | 5.3 |

[1] Annual average compounded percentage change from previous year

² Annual average compounded percentage change from 1978

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

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

Source; *Rockland County Convention Bureau*

| Year | Number of Convention | Percent Change | Number Delegates | Percent Change |
|---|---|---|---|---|
| 1984 | 14 | — | 7.000 | — |
| 1985 | 22 | 57.1% | 12,100 | 72.9% |
| 1986 | 36 | 63.6 | 20,700 | 71.1 |
| 1987 | 30 | (16.7) | 18,000 | (13.0) |
| 1988 | 41 | 36.7 | 25,825 | 43.5 |
| 1989 | 45 | 9.8 | 29,250 | 13.3 |
| 1990 | 46 | 2.2 | 29,623 | 1.3 |
| 1991 | 49 | 6.5 | 31,875 | 7.6 |
| 1992 | 51 | 4.1 | 33,071 | 3.8 |
| 1993 | 49 | (3.9) | 32,456 | (1.9) |
| 1994 | 47 | (4.1) | 32,799 | 1.1 |
| 1995 | 58 | 23.4 | 43,799 | 33.5 |
| Avg. Annual percent Change 1984-1995 | | 13.8% | | 18.1% |

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

## Leisure Travel

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

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

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

Source: *New York State Department of Tourism*

| Year | Rockland County | Percent Change | Metro New York | Percent Change | New York State | Percent Change |
|---|---|---|---|---|---|---|
| 1984 | 1.5 | — | 15.2 | — | 25.8 | — |
| 1985 | 1.5 | 0.0% | 17.5 | 15.1% | 28.2 | 9.3% |
| 1986 | 1.6 | 6.7 | 17.1 | (2.3) | 28.8 | 2.1 |
| 1987 | 1.7 | 6.3 | 17.0 | (0,6) | 29.1 | 1.0 |
| 1988 | 1.7 | 0.0 | 16.9 | (0.6) | 29.6 | 1,7 |
| 1989 | 1.8 | 5.9 | 17.1 | 1.2 | 31.2 | 5.4 |
| 1990 | 1.8 | 0.0 | 17,1 | 0.0 | 31.1 | (0.3) |
| 1991 | 1.7 | (5.6) | 17.0 | (0.6) | 30.6 | (1.6) |
| 1992 | 1.7 | 0.0 | 16.9 | (0.6) | 30.5 | (0.3) |
| 1993 | 1.6 | (5.9) | 16.8 | (0,6) | 30.1 | (1.3) |
| 1994 | 1.8 | 12.5 | 17.0 | 1.2 | 30.7 | 2.0 |
| 1995 | 1.9 | 5.6 | 17.5 | 2.9 | 30.9 | 0,7 |
| Avg. Annual percent Change 1984-1995 | | 2.2% | | 1.3% | | 1.7% |

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

*Source: New York State Board of Tourism*

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

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

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

Tourist Attractions

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

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

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

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

| Year | Number of Visitors | Percent Change |
|---|---|---|
| 1985 | 232,793 | -% |
| 1986 | 242,338 | 4.1 |
| 1987 | 237,249 | (2.1) |
| 1988 | 244,366 | 3.0 |
| 1989 | 246,890 | 1.0 |
| 1990 | 253,852 | 2.B |
| 1991 | 248,325 | (2.2) |
| 1992 | 241,230 | (2,9) |
| 1993 | 240,339 | (0,4) |
| 1994 | 249,782 | 3.9 |
| 1995 | 250,856 | 0.4 |
| Avg. Annual percent change 1985-1995 | | 0.8% |

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

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

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

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

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

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

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

### Summary of Market Conditions

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

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

reflect real change.

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

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

### Commercial Market Demand

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

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

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

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

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

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

### Meeting and Convention Market Demand

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

Future meeting and convention demand is

| Exhibit 7-25 Commercial Visitation Data for Rockland County | | | | |
|---|---|---|---|---|
| **Data Type** | **Period** | **Data Point** | **Data Point** | **Avg. Annual Comp. Change** |
| Population | | | | |
| Historical | 1980-1994 | 259.6 | 272.4 | 0.3% |
| | 1990-1994 | 265.9 | 272.4 | 0.6 |
| Projected | 1994-2000 | 272.4 | 274.7 | 0.1 |
| Retail Sales | | | | |
| Historical | 1980-1994 | 1,394,7 | 1,534.8 | 0.7 |
| | 1990-1994 | 1,569.5 | 1,534.8 | (0.6) |
| Projected | 1994-2000 | 1,534.8 | 1,774.1 | 2.4 |
| Personal Income | | | | |
| Historical | 1980-1994 | 4,461.8 | 5,907,2 | 2.0 |
| | 1990-1994 | 5,823.2 | 5,907.2 | 0.4 |
| Projected | 1994-2000 | 5,907.2 | 6,489.5 | 1.6 |
| Personal Income Per Capita | | | | |
| Historical | 1980-1994 | 17,188.0 | 21,687.0 | 1.7 |
| | 1990-1994 | 21,898.0 | 21,687.0 | 0.4 |
| Projected | 1994-2000 | 21,687.0 | 23,625.0 | |
| Historical Employment | | | | |
| Construction | 1980-1994 | 3.7 | 4.7 | 1.7 |
| Manufacturing | 1980-1994 | 16.4 | 14.6 | (0.8) |
| Transportation, Communications & Public Utilities | 1980-1994 | 4.1 | 6.6 | 3.5 |
| Total Trade | 1980-1994 | 22.2 | 24.5 | 0.7 |
| Wholesale Trade | 1980-1994 | 4.9 | 6.6 | 2.2 |
| Retail Trade | 1980-1994 | 17.3 | 17.9 | 0.3 |
| Finance, Insurance & Real Estate | 1980-1994 | 7.2 | 11.1 | 3.2 |
| Services | 1980-1994 | 26.8 | 43.9 | 3.6 |
| Total Government | 1980-1994 | 21.4 | 21.1 | (0.1) |
| Total Employment | 1980-1994 | 102.7 | 127.5 | 1.6 |
| Projected Employment | | | | |
| Construction | 1994-2000 | 4.7 | 4.6 | (0.1) |
| Manufacturing | 1994-2000 | 14.6 | 14,4 | (0.2) |
| Transportation, Communications & Public Utilities | 1994-2000 | 6.6 | 6.6 | 0.0 |
| Total Trade | 1994-2000 | 24.5 | 24.4 | (0.1) |
| Wholesale Trade | 1994-2000 | 6.6 | 7.4 | 1.9 |
| Retail Trade | 1994-2000 | 17.9 | 17.0 | (0.9) |
| Finance, Insurance & Real Estate | 1994-2000 | 11.1 | 11.6 | 0.8 |
| Services | 1994-2000 | 43.9 | 44.6 | 0.3 |
| Total Government | 1994-2000 | 21.1 | 21.2 | 0.0 |
| Total Employment | 1994-2000 | 102.7 | 127.5 | 1.6 |
| Office Space | | | | |
| Available | 1985-1995 | 6,545.0 | 7,735.0 | 1.7 |
| Occupied | 1985-1995 | 5,845.0 | 6,637.0 | 1.3 |
| Non-Residential Building Activity | 1985-1995 | 1,105.0 | 1,207.0 | 0.9 |
| Traffic Counts | | | | |
| New York State Thruway | 1984-1995 | 12,566.8 | 14,528.4 | 1.3 |
| Garden State Parkway | 1984-1995 | 6,153.9 | 7,205.4 | 1.4 |
| Palisades Parkway | 1984-1995 | 5,431.5 | 6,439.6 | 1.6 |

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

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

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

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

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

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

Given this economic and demographic data, along with consideration of the demand potential of the renovated and enlarged convention and exhibition center, it is fair to estimate that meeting and convention demand in the Spring Valley market area will increase by 4,0 percent in 1996, with the rate of growth decelerating to 3.0 percent in 1997 and 2,0 percent in 1997 and each year thereafter.

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

| Data Type | Period | Data Point | Data Point | Avg. Annual Comp. Change |
|---|---|---|---|---|
| Convention Activity—Rockland County Convention & Exhibition Center | | | | |
| Convention Attendance | 1984-1995 | 7,0 | 43.8 | 18.1% |
| Number of Conventions | 1984-1995 | 14.0 | 58.0 | 13.8 |
| Tourist Visitation | | | | |
| Rockland County | 1984-1995 | 1,500.0 | 1,900.0 | 2.2 |
| West Point Visitation | 1985-1995 | 232,8 | 250.9 | 0.8 |

### Leisure Market Demand

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

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

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

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

### Airline Market Demand

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

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

While these figures indicate a favorable trend for future airline activity at Stewart Airport, it must be noted that this facility is situated ten miles north of the Spring Valley hotel market area. As a result of this distance, airlines generally use the Spring Valley hotels as overflow for their crews favoring lodging facilities more conveniently located near Stewart Airport. For that reason, the Spring Valley overflow airport room-night demand can be expected to grow at 1,0 percent per year.

### Conclusion

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

**Exhibit 7.27**

**Projected Market Segment Growth Rates**

| Segment | 1996 | 1997 | 1998 | 1999 | 2000 |
|---|---|---|---|---|---|
| Commercial | 2,5% | 2.5% | 2.5% | 2.5% | 2.5 |
| Meeting and | 4.0 | 3.0 | 2,0 | 2.0 | 2.0 |
| Leisure | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 |

HVS

CHAPTER 8

# Lodging Supply Analysis

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## » 8.01 INTRODUCTION

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

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

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

## » 8.02 EVALUATION OF COMPETITION

Primary competition includes any lodging facility that attempts to attract the same transient visitors as does the subject property. Secondary competition generally con-

sists of lodging facilities that attract the same transient visitors as the subject property, but under special circumstances.

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

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

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

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

Properties in the secondary category are considered competitive because they sometimes attract the same customers as the subject property and the subject property's primary competition. However, this tends to happen only as a result of special circumstances, such as when all of the primary competitors are at capacity, so that

travelers who would prefer that type of accommodation must settle for one of the secondary competitors. A lodging facility that is not of the same class or image as the subject property might also be a secondary competitor if it has a particularly good location—for example, one adjacent to a demand generator. Because travelers are inclined to stay at the first hotel they encounter, especially during inclement weather, *a,* secondary competitor with a convenient location will attract a certain percentage of the market for which the subject property competes.

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

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

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

## » 8.03 FIELDWORK

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

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

## » 8.04 BENCHMARK INFORMATION

Before an appraiser conducts competitor interviews (see the following section) he should first collect some pertinent data that is verifiably accurate. The appraiser can

use this information as a benchmark to determine whether data that is gathered during the interviews, such as occupancy or room rates, is biased in any way. The most useful piece of information is an actual occupancy percentage for a competitive hotel in the market area under consideration. The following is a list of possible sources of actual occupancy information;

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

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

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

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

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

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

January rooms revenue = $10,416 - 0.04 = $260,400 Rooms revenue per day = $260,400 - 31 = $8,400 Rooms revenue per room per day = $8,400 - 200 = $42.00

Percentage of occupancy = $42.00/$60.00 = 70%

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

can be calculated from this information by dividing total guestroom sales by the product of room count and occupancy rate and multiplied by 365.

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

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

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

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

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

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| **Subject Property** | | | | | | |
| Occupancy | 67.0% | 68.0% | 68.4% | 69.3% | 70.1% | 72.1% |
| Percent Change | — | 1.5 | 0.6 | 1.3 | 1.2 | 2.9 |
| Occupancy Penetration | 102.0% | 102.4% | 104.0% | 103.9% | 98.9% | 94.4% |
| Average Rate | $54.67 | $56.78 | $57.50 | $62.23 | $63.46 | $66.44 |
| Percent Change | — | 3.9 | 1.3 | 8.2 | 2.0 | 4.7 |
| Average Rate Penetration | 106.6% | 104.2% | 99.3% | 98.8% | 95.9% | 94.8% |
| RevPAR | $36.53 | $38.61 | $39.33 | $43.13 | $44.49 | $47.90 |
| Percent Change | — | 5.4 | 1.9 | 9.7 | 3.2 | 7.7 |
| RevPAR Penetration | 108.7% | 106.7% | 103.2% | 102.6% | 94.8% | 89.5% |
| **Areawide (STR)** | | | | | | |
| Occupancy | 65.7% | 66.4% | 65.8% | 66.7% | 70.9% | 76.4% |
| Percent Change | — | 1,1 | (0.9) | 1.4 | 6.3 | 7.8 |
| Room Rate | $51.29 | $54.48 | $57,92 | $63.00 | $66.16 | $70.05 |
| Percent Change | — | 6.2 | 6.3 | 8.8 | 5.0 | 5.9 |
| RevPAR | $33.70 | $36.17 | $38.11 | $42.02 | $46.91 | $53.52 |
| Percent Change | — | 7.4 | 5.4 | 10.3 | 11.6 | 14.1 |

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

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

## » 8.05 COMPETITOR INTERVIEWS

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

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

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

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

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

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

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

HVS

CHAPTER 9

# Lodging Demand Analysis


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## » 9.01 INTRODUCTION

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

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

| Exhibit 9-1 Lodging Demand Generators | | |
|---|---|---|
| Airports | County seats and state capitals | National or state parks |
| Amusement parks | Court houses | Racetracks |
| Association headquarters | Festival sites | Regional shopping malls |
| Casinos | Historical attractions | Resort areas |
| Colleges and universities | Hospitals | Sports stadiums |
| Companies and businesses | Military installations | Theaters |
| Convenient highway stopping points | Museums | Tourist attractions |
| Convention Centers | Offices and industrial parks | World and state fairs |

## » 9.02 DEMAND GENERATOR BUILD-UP APPROACH

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

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

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

## [2] Potential Demand Generators

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

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

## [3] Demand Interviews and Surveys

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

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

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

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

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

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

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

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

**1.** Company Name:

**2.** Phone Number:

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

**4.** Distance from site of proposed hotel:

**5.** Name of contact/position:

**6.** Present number of employees:

**7.** Projected growth in employees:

**8.** What hotels/motels does interviewee currently use?

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

**10.** Room-nights booked:

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

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

## » 9.03 LODGING ACTIVITY BUILD-UP APPROACH

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

The steps involved in this approach are as follows;

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

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

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

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

Room count X Occupancy percentage X Market segmentation X 365 = Total number of occupied rooms per year

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

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

## [a] Unaccommodated Demand

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

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

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

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

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

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

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

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

Unaccommodated demand is generally estimated as a percentage of the accommodated demand for each market segment. Unaccommodated demand typically ranges from zero percent to 30 percent of the accommodated demand, with the upper

end of the range representing exceptionally strong markets. In good hotel markets, a reasonable level of unaccommodated demand is usually 5 percent to 10 percent. Unaccommodated demand is always difficult to quantify accurately, so a conservative estimate by the appraiser is usually warranted.

### [b] Induced Demand

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

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

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

### [c] Final Determination of Latent Demand

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

## [3] Accommodatable Latent Demand

Accommodatable latent demand is the portion of latent demand that can be absorbed by a market area in the future; it is based on the number of additional new rooms that are expected to become part of the market supply. In order to calculate accommodat-

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

Appraisers use the following criteria to make their determination:

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

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

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

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

- Local building department
- Assessor

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

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

200 rooms X 365 X 75% = 54,750 room-nights

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

## [4] Accommodated Room-Night Demand

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

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

## [5] Total Usable Latent Demand

Total usable latent demand represents the amount of latent demand in a market area that could be accommodated if the supply of rooms were adequate. It differs from accommodatable latent demand only in that it may be a smaller amount. In other words, although the market may have the capacity to accommodate a certain amount of latent demand, the actual "usable" latent demand may be smaller, so some capacity still remains that could absorb more latent demand if it existed.

## [6] Total Available Room-Nights

The total number of room-nights available in the market area is calculated by multiplying the number of competitive rooms for each projected year by 365. If additional

rooms become operational during a projected year (either in the form of a new hotel or as an addition to an existing property), the total number of rooms must be adjusted to reflect the actual number of rooms available during the year.

## [7] Overall Occupancy

The overall area occupancy for each year during the projected period is calculated by dividing the projected usable room-night demand (i.e., accommodated room-night demand) by the annual number of available rooms.

Overall area occupancy is an important statistic for providing a preliminary indication of project feasibility. A general rule of thumb applicable to new hotels is that the occupancy level of a hotel should be somewhat below the areawide occupancy during its first year of operation. In its second year, a hotel should operate at the same level as the overall area occupancy. A hotel should exceed the area occupancy by its third year of operation. If the overall area occupancy is expected to be below profitable levels when the new hotel is scheduled to open, the potential for financial difficulties could decrease the feasibility of the project. Extreme caution should be exercised when developing a hotel in a market that shows a potential overall area occupancy of less than 55 percent to 60 percent. If the overall area occupancy is projected to fall below 50 percent, a hotel project is rarely justified.

**Exhibit 9-3 Sample Demand Generator Survey**

**Spring Valley Hotel Survey**

A new hotel is planned for the Spring Valley area. It will be conveniently located for many area businesses at the northwestern corner of the intersection formed by Central Avenue (State Route 59) and Exit 14 of the New York State Thruway.

Your responses to the following questions will assist us in assessing what type of lodging facility will best serve the needs of your firm and other firms in the area. While we realize that you may not be able to precisely answer a number of the following questions, we would appreciate your best estimates. If you have any questions or comments, feel free to call John Smith at (212) 123-4567.

Your Name/Title ______________________________

Company Name ______________________________

Department ______________________________

Street Address ______________________________

City, State, Zip Code ______________________________

Telephone Number ______________________________

What is the current number of employees at this location? ____________
Entire Firm ____________ Your department ____________

What are the primary business activities at this location? ____________

In answering the following questions, please indicate whether your response is for your FIRM as a whole or for your DEPARTMENT individually by circling the proper word in the question.

1. Within the next year, is the number of employees in your FIRM/DEPARTMENT projected to (circle one) Increase? Decrease? By how much? ________
   Remain the same ________
2. During an average month, how many people visiting your FIRM/DEPARTMENT require overnight hotel accommodations? ____________
3. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations arrive during the following seasons?
   Winter ____ Spring ____ Summer ____ Fall ____ Total 100%
4. What percentage of the visitors described above currently:
   Book their own accommodations? ____________
   Have their own accommodations booked by someone in your company? ________
   Please indicate the name, department, and telephone number of the person in your firm responsible for booking accommodations:

   Name: ______________________________

   Department: ______________________________

   Telephone Number: ______________________________
5. Please complete the following chart.
   a. What percentage of the people visiting your FIRM/DEPARTMENT who require overnight accommodations do so for the reasons indicated? ____________
   b. What is the average number of nights per visit? ____________
   c. On average, how many people stay in one hotel room per visit?

| Reason for overnight stay | (a) Percent of total visitors | (b) Average length of stay | (c) Number of people per room |
|---|---|---|---|
| Relocation | | | |
| Training | | | |
| Temporary Assignment | | | |
| Consulting | | | |
| Meeting/Conference | | | |
| Other (please specify) ________________ | | | |

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

| Name of Facility | Room Rate Charged |
|---|---|
| (1) | |
| (2) | |
| (3) | |
| (4) | |
| (5) | |

7. What characteristics determine how a lodging facility is chosen?
   a. Please rank the following six factors in order of importance in choosing a lodging facility (1 = most important; 6 = least important).

| Factor | Rating | Factor | Rating |
|---|---|---|---|
| Price | ____ | Convenience of location | ____ |
| Quality of amenities | ____ | Chain affiliation | ____ |
| Facilities offered | ____ | Other (please specify)__________ | ____ |

   b. Would the availability of a health club/fitness center be an important consideration in choosing a lodging facility? ______________________________

8. Do you currently use meeting and/or banquet facilities in area hotels? (Please circle whichever applies) Meeting facilities Banquet facilities Neither

   (If meeting and/or banquet facilities are used, please complete the following chart.)

| | For meetings | For banquets |
|---|---|---|
| How frequently do you use these facilities? | ______ | ______ |
| What is the average size of your group? | ______ | ______ |
| What is the smallest size? | ______ | ______ |
| What is the largest size? | ______ | ______ |
| What percentage of attendees require overnight accommodation? | ______ | ______ |
| What percentage occurs on weekends? | ______ | ______ |

**9.** a. Are you familiar with the location of the Spring Valley project? ________________

b. How would you rank the location of the Spring Valley project as compared with the locations of the hotels you currently use? (Please circle one)

About the same Inferior Superior

**10.** Given a choice between a full-service hotel (e.g., Marriott, Hyatt, Westin, Hilton) and a limited-service hotel (e.g., Hampton Inn, Super 8, Red Roof Inn), which would you be more likely to choose when booking overnight accommodations for visitors?

________________________________________

Why? ________________________________________

________________________________________

________________________________________

**11.** All-suite hotels (e.g., Residence Inn by Marriott, Embassy Suites) provide separate living and sleeping rooms within the same guest area. Typically, these accommodations are priced $10 to $15 more per room than comparable full-service hotels. Given the choice between a full-service hotel and an all-suite hotel, which would you be more likely to choose when booking overnight accommodations for visitors? ________________________________________

Why? ________________________________________

________________________________________

**12.** Please rank the following hotel chains (eighteen are listed) in the order in which you would choose them when booking overnight hotel accommodations for visitors. Thank you for your cooperation.

| *Hotel Chain* | *Rank* | *Hotel Chain* | *Rank* |
|---|---|---|---|
| Marriott | _____ | Holiday Inn | _____ |
| Sheraton | _____ | Comfort Inn | _____ |
| Westin | _____ | Hampton Inn | _____ |
| Hyatt | _____ | La Quinta | _____ |
| Hilton | _____ | Days Inn | _____ |
| Four Seasons | _____ | Residence Inn | _____ |
| Doubletree | _____ | Hawthorn Suites | _____ |
| Loews | _____ | Embassy Suites | _____ |
| Radisson | _____ | | |

HVS

# CHAPTER 10

# Analysis of Market Share, Occupancy, and Average Room Rates


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## » 10.01 INTRODUCTION

After the total current lodging demand in the subject market area is calculated and future projections for demand are made, the appraiser must identify the competitive positions of all of the area lodging facilities. This entails determining first the current market share, occupancy rates, and average room rates of the existing competitor facilities and then how these quantities would be affected by the addition of the proposed hotel. Once this information is generated, the appraiser can set about forecasting the average room rates for the market area facilities and for the subject property, so that a determination can be made about the economic feasibility of the proposed project.

Appraisers use one of two methods to analyze competitive positions: the market penetration method and the competitive index method. Both methods determine the market share captured by a lodging facility (market share is the percentage of the area's room-night demand actually supplied by the particular facility). By knowing the market share, a calculation can be made to determine the expected level of occupancy for the facility.

## » 10.02 MARKET PENETRATION METHOD

The term penetration as it applies to the lodging industry refers to the percentage relationship between the actual market share and the fair market share of a lodging facility. The actual market share of a hotel is the number of rooms that are occupied per day in the hotel divided by the total number of occupied rooms in the market per day. The fair market share (also known as the average market share) of a hotel consists of its total number of rooms divided by the total of all the rooms in the market. The market penetration of a hotel is calculated by dividing its actual market share by its fair market share. It shows in percentages how well the hotel is attracting or capturing hotel room-night demand relative to a hypothetical "average" hotel in the market. Exhibits 10-1 and 10-2 illustrate the calculations that are used to determine the actual market share, the fair market share, and finally the market penetration of four hypothetical hotels.

The results of the penetration calculation show that Hotel A is achieving 12 percent more than its fair market share or 12 percent more than the average capture for the area; Hotel *B is* achieving 91 percent of its fair market share, so it is performing about 9 percent below the market; Hotel C is performing slightly above its fair market share; and Hotel *D* is achieving 2 percent less than its fair market share.

Exhibit 10-1 Determining the Actual Market Share

| Hotel | Number of Rooms | | Percentage of Occupancy | | Number of Occupied Rooms Per Day | Actual Market Share |
|---|---|---|---|---|---|---|
| A | 100 | X | 80% | = | 80 | 13.2% |
| B | 200 | X | 65 | = | 130,0 | 21.4 |
| C | 250 | X | 75 | = | 187.5 | 30.9 |
| D | 300 | X | 70 | = | 210.0 | 34.5 |
| | 850 | | | | 607.5 | 100.0 |

| Exhibit 10-2 Determining Fair Market Share and Penetration | | | | | | | |
|---|---|---|---|---|---|---|---|
| Hotel | Number of Rooms | Fair Market Share | Actual Market Share | | Fair Market Share | | Penetration |
| *A* | 100 | 11.8% | 13.2% | ÷ | 11.8% | = | 1.12 |
| *B* | 200 | 23.5 | 21.4 | ÷ | 23.5 | = | 0.91 |
| *C* | 250 | 29.4 | 30.9 | ÷ | 29.4 | = | 1.05 |
| *D* | 300 | 35.3 | 34.5 | ÷ | 35.3 | = | 0.98 |
| | 850 | 100.0% | 100.0% | | 100.0% | | |

## » 10.03 COMPETITIVE INDEX METHOD

The competitive index of a hotel simply reflects the number of days per year for which one room in a hotel is occupied. In contrast to the penetration method, only one calculation is necessary; the competitive index is calculated by multiplying the percentage of occupancy by 365 days, as Exhibit 10-3 shows.

| Exhibit 10-3 Calculating Competitive Index | | | | | |
|---|---|---|---|---|---|
| Hotel | Percentage of Occupancy | | Days per Year | | Competitive Index |
| *A* | 80% | x | 365 | = | 292.0 |
| B | 65 | x | 365 | = | 237.0 |
| C | 75 | x | 365 | = | 273.0 |
| D | 70 | x | 365 | = | 255.0 |

The competitive index and market penetration show the relative competitiveness (i.e., the relative occupancy ranking) of each hotel. For example, Hotel A is 23 percent more competitive than Hotel *B,* as demonstrated by the calculations in Exhibit 10-4.

| Exhibit 10-4 Calculating Relative Competitiveness | | | | | |
|---|---|---|---|---|---|
| | Hotel *A* | | Hotel *B* | | Relative Competitiveness |
| Competitive Index | 292 | ÷ | 237 | = | 1,23 |
| Penetration | 1.12 | ÷ | 0.91 | = | 1.23 |

### [1] Advantages of Competitive Index Method

One advantage of the competitive index method over the penetration method is that the one calculation it requires is based on a single room and thus is easy to carry out. The penetration method, on the other hand, makes use of the entire room count of a property in two of the three calculations that it requires, which becomes complicated

in dynamic market areas that have fluctuating room supplies. For example, assume an additional Hotel *E* were to enter our hypothetical market, and an appraiser wanted to determine the effect of the addition on the competitive relationship between Hotel A and Hotel *B*. Exhibit 10-5 shows the different calculations that would have to be done for each method.

As the exhibit shows, the competitive index method provides the same result as the penetration method, but requires less work.

Another advantage of the competitive index is that, as an analytical tool, it is generally easier for parties not familiar with hostelry terminology to grasp, particularly when market segmentation is being considered. For example, consider the competitive indexes for Hotels *A* and *B* for each individual market segment, as shown in Exhibit 10-6.

**Exhibit 10-5 Two Methods Compared**

| Hotel | Number of Rooms | | Percentage of Occupancy | | Number of Occupied Rooms Per Day | Actual Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | X | 80.0% | = | 80.0 | 10.4% |
| *B* | 200 | X | 65 | = | 130.0 | 16.9 |
| *C* | 250 | *X* | 75 | = | 187.5 | 24,4 |
| *D* | 300 | *X* | 70 | = | 210.0 | 27.3 |
| *E* | 225 | X | 72 | = | 162.0 | 21.1 |
| | 1,075 | | | | 769.5 | 100.0% |

**PENETRATION**

| Hotel | Number of Rooms | Fair Market Share | Actual Market Share | | Fair Market Share | | Penetration |
|---|---|---|---|---|---|---|---|
| *A* | 100 | 9.3% | 10.4% | ÷ | 9.3% | = | 1.12 |
| *B* | 200 | 18.6 | 16.9 | ÷ | 18.6 | = | 0.91 |
| *C* | 250 | 23.3 | 24.4 | ÷ | 23,3 | = | 1.05 |
| *D* | 300 | 27.9 | 27.3 | ÷ | 27.9 | = | 0,98 |
| *E* | 225 | 20.9 | 21.0 | ÷ | 20.9 | = | 1.01 |
| | 1,075 | 100.0% | 100.0% | | 100.0% | | |

**COMPETITIVE INDEX METHODS**

| Hotel | Percentage of Occupancy | | Days Per Year | | Competitive Index |
|---|---|---|---|---|---|
| *A* | 80% | × | 365 | = | 292 |
| *B* | 65 | × | 365 | = | 237 |
| *C* | 75 | × | 365 | = | 273 |
| *D* | 70 | × | 365 | = | 255 |
| *E* | 72 | × | 365 | = | 263 |

**COMPARISON OF METHODS**

| | Hotel *A* | | Hotel *B* | | Relative Competitiveness |
|---|---|---|---|---|---|
| Competitive Index | 292 | ÷ | 237 | = | 1.23 |
| Penetration | 1.12 | ÷ | 0.91 | = | 1.23 |

Using competitive indexes, the appraiser can state in simple terms that in Hotel A, one hotel room is occupied 175 nights per year by a commercial traveler, 29 nights per year by a meeting traveler, and 88 nights per year by a leisure traveler. Compared with Hotel *B,* Hotel A is almost 50% more competitive in the commercial market and 83% more competitive in the leisure market. Hotel *B* is, however, almost 150 percent more competitive than Hotel A in the group and meeting market.

**Exhibit 10-6 Market Segment Percentage and Market Segment Competitive Index**

| | Market Segment Percentage | | | Market Segment Competitive Index | | |
|---|---|---|---|---|---|---|
| Hotel | Commercial | Group & Meeting | Leisure | Commerical | Group & Meeting | Leisure |
| *A* | 60% | 10% | 30% | 175 | 29 | 88 |
| *B* | 50 | 30 | 20 | 118 | 71 | 48 |

## [2] Evaluation of Proposed Properties

The competitive index method is most often used to evaluate the relative competitiveness of proposed facilities and to forecast their stabilized occupancy.

This is accomplished by assigning competitive indexes to the subject's market segments based on how it is expected to compete with the other properties in the market. Once the relative competitiveness of each hotel is determined, an estimate of market share can be made. To accomplish this, the subject's projected market share is multiplied by the area's room-night demand, which yields an estimate of the room-nights captured; this figure is in turn converted into an occupancy percentage.

For example, assume that a market area comprises the five hotels (A, *B, C, D,* and *E)* discussed earlier. Another hotel, *F,* is a 150-room, commercially oriented facility that is planned for the area. It will have a minimal amount of meeting space and will be an average competitor in the leisure market. To estimate its stabilized occupancy, an appraiser would compile the data listed in Exhibit 10-7.

**Exhibit 10-7 Estimating Stabilized Occupancy**

| | | Estimated Market Segment | | | Market Segment Competitive Index | | |
|---|---|---|---|---|---|---|---|
| Hotel | Occupancy | Commerical | Group & Meeting | Leisure | Commerical | Group & Meeting | Leisure |
| *A* | 80% | 60% | 10% | 30% | 175 | 29 | 88 |
| *B* | 65 | 50 | 30 | 20 | 118 | 71 | 48 |
| *C* | 75 | 70 | 20 | 10 | 192 | 55 | 27 |
| *D* | 70 | 45 | 40 | 15 | 115 | 102 | 38 |
| *E* | 72 | 45 | 35 | 20 | 118 | 92 | 53 |

The proposed subject property might be expected to have the following competitive indexes;

| | Market Segment Competitive Index | | |
|---|---|---|---|
| | **Commercial** | **Group and Meeting** | **Leisure** |
| Hotel F | 190 | 30 | 50 |

The rationale for assigning these competitive indexes is as follows: Hotel *F* is planned to be oriented towards the commercial segment, so it is similar to Hotel C, which has a commercial competitive index of 192. In terms of meeting space, the proposed hotel is similar to Hotel A, which has a group and meeting competitive index of 29. The average leisure competitive index for the five existing hotels is 50, so it can be assumed that the proposed hotel will be similar in that regard.

The competitive indexes serve as a basis for calculating market share and percentage of occupancy estimates for the proposed hotel. However, the appraiser must first use the lodging activity build-up approach to determine room-night demand, market share, and occupancy for each hotel that is currently operating in the market (see K 9.03 for a discussion of the lodging activity build-up approach).

## [a] Current Room-Night Demand

Using the lodging activity build-up approach, the current room-night demand (including both accommodated and latent demand) is shown in Exhibit 10-8.

**Exhibit 10-8 Estimating Stabilized Occupancy**

| Hotel | Commercial | Group and Meeting | Leisure |
|---|---|---|---|
| *A* | 17,520 | 2,920 | 8,760 |
| *B* | 23,725 | 14,235 | 9,490 |
| *C* | 47,907 | 13,688 | 6,844 |
| *D* | 34,492 | 30,660 | 11,498 |
| *E* | 26,609 | 20,695 | 11,826 |
| *Total Accommodated* | 150,253 | 82,198 | 48,418 |
| *Latent Demand* | 7,513 | 2,466 | 484 |
| *Total Demand* | 157,766 | 84,664 | 48,902 |

## [b] Projected Market Share

The projected market share for each property is determined by market segment by first multiplying the room count for each property by its appropriate competitive index, which results in a factor called the market share adjuster. The competitive index quantifies the competitiveness of only one room, so multiplying the competitive index by the property's room count adjusts the competitive index so that it reflects the entire property's competitiveness. The market share adjuster for one property is then divided by the total market share adjuster for all of the area's competitive hotels, which results in the market share for each property. Exhibit 10-9 shows the calculations for projected market share.

**Exhibit 10-9 Calculations for Projected Market Share**

**COMMERCIAL SEGMENT**

| Hotel | Number of Rooms | | Commercial Competitive Index | | Market Share Adjuster | Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 175 | = | 17,500 | 9.8% |
| *B* | 200 | × | 118 | = | 23,600 | 13.2 |
| *C* | 250 | × | 192 | = | 48,000 | 26.9 |
| *D* | 300 | × | 115 | = | 34,500 | 19.3 |
| *E* | 225 | × | 118 | = | 26,550 | 14.9 |
| *F* | 150 | × | 190 | = | 28,500 | 15.9 |
| Total | | | | | 178,650 | 100.0% |

**MEETING SEGMENT**

| Hotel | Number of Rooms | | Meeting Competitive Index | | Market Share Adjuster | Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 29 | = | 2,900 | 3.3% |
| *B* | 200 | × | 71 | = | 14,200 | 16.4 |
| *C* | 250 | × | 55 | = | 13,750 | 15.9 |
| *D* | 300 | × | 102 | = | 30,600 | 35.3 |
| *E* | 225 | × | 92 | = | 20,700 | 23.9 |
| *F* | 150 | × | 30 | = | 4,500 | 5.2 |
| Total | | | | | 86,650 | 100.0% |

**LEISURE SEGMENT**

| Hotel | Number of Rooms | | Leisure Competitive Index | | Market Share Adjuster | Market Share |
|---|---|---|---|---|---|---|
| *A* | 100 | × | 88 | = | 8,800 | 15.7% |
| *B* | 200 | × | 48 | = | 9,600 | 17.2 |
| *C* | 250 | × | 27 | = | 6,750 | 12.1 |
| *D* | 300 | × | 38 | = | 11,400 | 20.3 |
| *E* | 225 | × | 53 | = | 11,925 | 21.3 |
| *F* | 150 | × | 50 | = | 7,500 | 13.4 |
| Total | | | | | 55,975 | 100.0% |

The percentage of occupancy for each hotel is calculated by first multiplying the market share percentage by the total room-night demand for the corresponding segment to arrive at the room-nights captured for the corresponding segment. Then the subject property's combined total room-nights captured is divided by the number of available rooms per year at the subject property (i.e., the subject property's room count multiplied by 365).

### [c] Projected Occupancy

Exhibit 10-9 shows the projected occupancy of Hotel *F,* as well as the effect it would have on the occupancies of the existing hotels in the market area. Note the difference in the number of room-nights captured as compared to the data for the market before the introduction of Hotel F (see H 10.03[2][a]).

**Exhibit 10-10 Room-Nights Captured**

| Hotel | Commercial | Group & Meeting | Leisure | Total | Occupancy [1] |
|---|---|---|---|---|---|
| *A* | 15,461 | 2,794 | 7,678 | 25,933 | 71% |
| *B* | 20,825 | 13,885 | 8,411 | 43,121 | 59 |
| *C* | 42,439 | 13,462 | 5,917 | 61,818 | 68 |
| *D* | 30,449 | 29,886 | 9,927 | 70,262 | 64 |
| *E* | 23,507 | 20,235 | 10,416 | 54,158 | 66 |
| *F* | 25,084 | 4,403 | 6,553 | 36,040 | 66 |

[1] 0ccupancy = Total room-nights captured - (Room Count x 365)

In addition to the introduction of a new hotel, other factors that can change the competitive indexes of hotels include:

- A major renovation or an addition to an existing hotel.
- A change in management of a hotel franchise.
- A change in market orientation for a particular property.
- The physical or functional obsolescence of a facility.

Any of these factors can make the evaluation of the relative competitiveness of a new lodging facility more difficult. However, competitive indexes are useful tools in that they help to portray the competitive dynamics of a market area.

## » 10.04 STABILIZED OCCUPANCY

Stabilized occupancy figures represent the anticipated levels of occupancy for lodging facilities over their economic life, including any stages of build-up, plateau, or decline in their life cycles. Stabilized occupancy calculations exclude any abnormal relations of supply and demand, as well as any transitory or nonrecurring conditions (favorable or unfavorable) that may result in unusually high or low levels of occupancy. While it is likely that a hotel will operate at occupancies above its stabilized level for a period of time, it is equally possible for new competition and temporary downturns in the economy to force the actual occupancy below this standard. Essentially, stabilized occupancy is the typical occupancy experienced by a hotel over its economic life.

For new hotels, an assumed two- to five-year build-up in occupancy is generally included in the projection; a stabilized occupancy level starting with the first year is not expected. The initial years often see operating losses, so the inclusion of the build-up period in the projection is necessary to properly account for the actual startup cash requirements.

Many factors influence the projection of a stabilized level of occupancy. The following are some of the key *market-specific* considerations:

- Historical occupancy cycles
- Composition of demand
- Supply and demand trends
- Trends in competitive properties
- Significant area development

These are some of the important *property-specific* considerations:

- Age
- Degree of obsolescence
- Location
- Market share
- Management and image

The nature of the local hotel demand is probably the best indicator for establishing a stabilized level of occupancy. Different types of travelers have different travel patterns (i.e., days of travel, length of stay and seasonality), and the particular mixture of these visitors within a given market will influence the area's overall level of occupancy.

For example, assume that the demand in a market has a very strong business base that generates a significant room-night demand Monday through Thursday nights. However, the local area has no leisure attractions, so very few people use the market area's lodging facilities on Friday and Saturday nights. There is, however, some commercial demand on Sunday nights from business travelers planning an early start on the work week. This occupancy pattern adds up to an average areawide level of occupancy of approximately 72 percent, assuming the daily occupancies listed in Exhibit 10-11.

**Exhibit 10-11 Occupancy Statistics**

| Weekday | Percent of Occupancy |
|---|---|
| Monday | 100% |
| Tuesday | 100 |
| Wednesday | 100 |
| Thursday | 100 |
| Friday | 30 |
| Saturday | 35 |
| Sunday | 40 |
| Weekly Average | 72% |

Under the market conditions given in the exhibit, and given the nature of the existing lodging demand, there would be little justification for using a stabilized occupancy factor of more than 72 percent for a proposed facility in this market unless the

property had significant competitive attributes that would enable it to capture a larger than average share of the limited weekend demand. Furthermore, because it is highly unusual for a hotel to consistently achieve 100 percent occupancy levels 52 weeks a year with the normal commercial drop off on three-day weekend holidays, Christmas week, and the summer months, it would be difficult to maintain a 72 percent level on a year-round basis in any event, so a good case can be made for establishing the stabilized level in this example at a more reasonable 68 percent level.

Historical occupancy cycles for a market area provide an indication of the level at which stabilized occupancy should be set. Exhibit 10-12 provides the twenty-year occupancy cycle, with related statistical data, for three different cities:

**Exhibit 10-12 Twenty-Year Occupancy Cycle for Three Cities**

| Year | City A | City B | City C |
|---|---|---|---|
| 1 | 71,0% | 72.0% | 57.0% |
| 2 | 66.0 | 74.0 | 68.0 |
| 3 | 63.0 | 76.0 | 62.0 |
| 4 | 69.0 | 75.0 | 56.0 |
| 5 | 60.0 | 69.0 | 50.0 |
| 6 | 61.0 | 68.0 | 47.0 |
| 7 | 63.0 | 69.0 | 49.0 |
| 8 | 66.0 | 70.0 | 51.0 |
| 9 | 64.0 | 69.0 | 46.0 |
| 10 | 66,0 | 64.0 | 57.0 |
| 11 | 68.0 | 71.0 | 59.0 |
| 12 | 69,0 | 71,0 | 61.0 |
| 13 | 72,0 f | 77.0 | 63.0 |
| 14 | 72.0 | 78.0 | 60.0 |
| 15 | 69.0 | 76.0 | 63.0 |
| 16 | 66.0 | 72.0 | 62.0 |
| 17 | 59.0 | 68.0 | 61.0 |
| 18 | 65.0 | 68.0 | 61.0 |
| 19 | 69.0 | 70.0 | 57.0 |
| 20 | 70.0 | 69.0 | 60.0 |
| | **City A** | **City B** | **City C** |
| Average Occupancy | 66.4% | 71.3% | 57.5% |
| Highest Occupancy | 72 | 78 | 68 |
| Lowest Occupancy | 59 | 64 | 46 |
| Difference | | | |

The stabilized occupancy for each of these three cities should approximate their average occupancy, which is generally close to the midpoint between the highest and lowest recorded occupancy level during the twenty-year period.

## » 10.05 AVERAGE RATE PER OCCUPIED ROOM

The average rate per occupied room is among the most important variables in a forecast of the income and expense of a hotel because it directly affects both financial feasibility and market value. Professionals who conduct market studies should understand how average rates are calculated and be familiar with the various factors that affect their future movement.

To be fully documented, an economic market study and appraisal for a lodging facility should include a detailed analysis that explains the derivation of its forecasted average rates as well as a comparison of the subject property's rates with those of competitive hotels. An estimate of average rate depends on the evaluation of many factors, including:

- Supply and demand conditions in the local hostelry market
- Management's marketing expertise and ability to create a positive price/value relationship in the eyes of the consumer
- Current room rates of competitive hotels
- The quality, class, and other attributes of the subject property
- The market orientation of the subject property, including the rate-sensitivity characteristics and double occupancy percentages of each individual market segment

A hotel's average rate per occupied room is calculated by dividing the net rooms revenue derived from guestrooms by the number of paid rooms occupied. The result is the weighted average of the various rate categories used by the hotel during the period.

The equation used to calculate the average rate per occupied room is as follows:

Overall Average Rate Per Occupied Room = Net Rooms Revenue/Number of Paid Rooms Occupied

The *Uniform System of Accounts for Hotels* (8th ed., Hotel Association of New York City, Inc., (1986)) defines the components of this formula as follows:

- *Net rooms revenue:* Total rooms revenue less allowances.
- *Allowances:* Rebates and overcharges or revenue not known at the time of sale but adjusted at a subsequent date. Allowances may also include revenue forgone as a result of hotel promotions or complimentary services.
- *Paid rooms occupied:* Rooms occupied by hotel guests on a paid basis. The overall average rate per occupied room does not include any occupancy derived from complimentary rooms.

## » 10.06 FORECASTING AVERAGE RATE PER OCCUPIED ROOM

The procedure used to forecast average rates per occupied room for lodging facilities varies depending on whether the property is an existing or proposed hotel. An existing hotel's established room rate level and competitive position may change slightly, but they provide the appraiser with a benchmark from which to forecast future trends in average rates. Because proposed hotels have no operating history, an average rate must be derived from an analysis of the competitive rates of local lodging facilities, both current and forecasted, based on anticipated changes in supply, demand, and competitive factors.

## [1] Procedure for Existing Hotels

The first step for the appraiser in this procedure is to compile the property's overall average rates by month for the previous three to five years. The appraiser must verify that the average rates do not contain complimentary rooms. The next step is an analysis of the historical trends in average room rates for the subject property—to determine what the compounded growth rate has been over the past several years. If the data is available, the average room rate should be examined by individual market segments. Lastly, average room rates should be examined to determine if there are any seasonal effects on demand. If so, the average rate by season and month should be elevated to determine the compounded growth trends by season.

After the data regarding historical average room rates has been compiled and analyzed, the historical relationships between occupancy and average rate fluctuations should be investigated. Average room rates are often affected by changes in occupancies. For example, average rates usually soften or even decline as occupancies trend downward, and the reverse takes place as occupancies increase. The reason for this relationship lies both in the local market and in the individual property. On a marketwide basis, hotel occupancies decrease when there is either an increase in the supply of hotel rooms or a decrease in the demand for transient accommodations. Both situations typically increase the competition among area hotels, which often leads to rate sensitivity. While not all hotels feeling the impact of greater competition will immediately institute a price-cutting program, they will be more conscious of the negative effect of raising room rates or of holding a hard rate policy when negotiating new business with groups and contracts. As area occupancies decrease, hotels feel pressured to cut rates in order to hold on to their market share. In a declining market, therefore, appraisers should look for the real possibility that average rates may remain flat or even decline.

Notwithstanding local market conditions, average room rates usually increase as a property's occupancy rises. This can be attributed to the fact that when a hotel approaches 100-percent occupancy, it is able to sell more of its high-priced rooms. In addition, management's bargaining position is enhanced, so it does not have to offer discounts or other inducements to attract patronage. For example, a customer making a reservation at a hotel with one room remaining will probably pay rack or full rate. By selling out the higher-priced rooms, a hotel's average room rate will generally increase faster than either inflation or local market conditions would dictate.

### [a] Average Rates of Competitors

The next step for the appraiser is to compile a list of average room rates for the subject property's primary and secondary competitors. One year's worth of historical data is adequate, but a trend analysis can be made if data from additional years can be gathered. The appraiser must be certain that the information represents average room rates and not other types of hotel room rate statistics, of which there are many. The following is a list of some of the terms used in the industry to describe different types of hotel room rates:

- *Rack rate:* An undiscounted room rate. The term is taken from the front desk's room rack which contains information about each room's rate including the highest rate that can be charged for that accommodation. When a hotel is operating full or when someone comes in without a reservation, the rack rate is generally the only rate available. The average rate is always less than the rack rate.

- *Published rate:* The rate found in directories and other publications. This rate is usually quoted in ranges (i.e., single; $70-$100) and represents the range of rack rates for specific types of accommodations. Published room rates typically set the upper limits of average rates. Average room rates tend to be closer to the published rates for single rooms than for doubles.
- *Commercial rate:* A special discounted rate available to certain commercial accounts. Some hotels allow almost any commercial traveler to use a commercial rate, while others apply this rate only for specific accounts.
- *Contract rate:* A discounted rate available to specific users, such as an airline, convention group, or bus tour. Arrangements for this rate are negotiated individually by the user, and payment is often billed directly to the firm or organization using the room. Depending on the amount and timing of the usage, a contract rate can be heavily discounted and significantly lower than either the average rate or the commercial rate.

### [b] Comparison of Subject Property With Competitive Properties

The next step for the appraiser is to compare the subject property's average rate with that of the competition to determine the reasons for any differences in average rates. Generally, rate variances can be attributed to several factors, including location, physical facilities, management, image, quality, and market segments served. In addition, if there have been any trends in average rate movement over time, these factors should be quantified and evaluated.

### [c] Future Changes in Market Area Economy and Competitive Supply

Once the historical competitive data has been analyzed, the appraiser must forecast any changes in the local economy or competitive supply that may affect average rates in the future. The appraiser must also forecast a yearly percentage change in average room rates over a projection period. The key factors that influence future trends in room rates are:

- *Supply and demand relationship.* As discussed in Chapters 9 and 10, the balance between the market area's supply of transient lodging facilities and the local demand generally has a significant impact on future trends in average room rates, because hotel room rates tend to mirror changes in area occupancies.
- *Inflationary trends.* When an appraiser forecasts the income and expense of a hotel over a projection period, the occupancy usually levels off at a point in time known as the stabilized year. Until this hypothetical point of equilibrium, room rates are usually affected more by local conditions and the increased (or decreased) occupancy of the subject property than by inflationary pressures. After the level of occupancy has reached this stabilized point, and all external market conditions are assumed to be in equilibrium, the average room rate is typically projected to increase at the rate of inflation.
- *New construction.* Newly constructed lodging facilities must typically achieve room rates that are higher than the going market rate in order to cover development costs.

In addition to improving the neighborhood in which it is built, a new hotel often allows existing hotels to push average room rates up so that they are competi-

tively below the new property's rates but significantly above the current levels. However, this type of rate movement takes place only in markets that are not overbuilt. If too many new rooms open at once, the rates of every hotel in the market area will suffer.

#### [d] Average Rate Projection for Subject Property

Once all the previously described data has been accumulated and evaluated, the appraiser forecasts the subject's average rate over the projection period.

### [2] Procedure for Proposed Hotels

The procedure for forecasting average rates for a proposed hotel is similar to that used for an existing facility except that the appraiser does not have the benefit of operating history to provide a starting point for the projection. The appraiser must therefore rely upon room-rate data for competitive properties, particularly average rates by market segment. The relative competitiveness of each property must also be carefully evaluated in order to determine the room-rate differentials necessary to maximize the subject's competitive position.

Appraisers use four basic methods to project average room rates for proposed hotels: competitive positioning, the bottom-up method, the rule of thumb approach, and the market segmentation approach. Each method has advantages and disadvantages that the appraiser must consider in light of the particular circumstances surrounding a proposed hotel. In some instances a combination of methods is used when the strengths of one can counterbalance the weaknesses of another. Each method is analyzed in the following sections.

#### [a] Competitive Positioning Method

The competitive positioning method forecasts the room rates of a proposed hotel by using the rates currently achieved by competitive lodging facilities. The range of average room rates established by competitive hotels is considered to set the general limits for the rates that can be achieved by the proposed hotel. The rate for the proposed hotel is then determined by the actual average room rate of the competitive property that it most closely resembles in quality, size, facilities, market orientation, and location.

Exhibit 10-13 provides the average room rates of the primary competition in a hypothetical market area,

An analysis of the attributes of these hotels reveals Hotel *F to* be the most similar of the group to the proposed property. On the basis of this conclusion, the appraiser should give the room rate achieved by Hotel *F* the most weight when setting the average rate for the proposed property. Further analysis reveals that Hotel *F's* rate of $88.00 should be scaled slightly upward for the following reasons;

- The subject property will be new when it opens. Hotel *F* will be six years old.
- Hotel *F* derives a larger percentage of its business from the meeting and convention market segment, which tends to receive greater discounts than the commercial segment.
- The subject property will have a more visible location with better access than Hotel *F*.

| Exhibit 10-13 Hypothetical Market Area's Average Room Rates | |
|---|---|
| **Property** | **Estimated Average Room Rate** |
| *A* | $68.00 |
| *B* | 82.00 |
| *C* | 77.00 |
| *D* | 80.00 |
| *E* | 87.00 |
| *F* | 88.00 |
| *G* | 78.00 |
| Average | $81.00 |

It appears that an average room rate of between $89.00 and $90.00 would be justified and reasonable for the subject property.

Advantages of the competitive positioning method are as follows:

- The dynamics of the surrounding market area are taken into account by the consideration of actual average room rates achieved by competitive properties.
- The price sensitivities of local demand are reflected in the data used in the process.
- The method is based on other local hotels, so it inherently considers area operating costs.

The disadvantages of the competitive positioning method are as follows:

- It depends on accurate average room rate information from competitive hotels, which is sometimes difficult to obtain.
- It relies on the assumption that a property, similar in almost all respects to the subject, exists in the marketplace. If such a property does not exist, subjective adjustments must be made to compensate for the differences in the subject property. The appropriateness of the ultimate result depends on the skill and experience of the appraiser. The competitive positioning method is a good way to verify that the average room rate achieved by an existing lodging facility actually reflects its competitive position in the local market.

## [b] Bottom-Up Method

The bottom-up method (also known as the Hubbart Formula) assumes that a proposed hotel should charge room rates that will cover all the costs of its operation, including a predetermined net income level, debt service, and development costs. To use this method, an appraiser first determines the development and financing costs of the project. The process continues by working upward from the bottom of an income and expense statement which is tailored to the anticipated operating characteristics of the subject property, until the required room rate is derived. The required room rate, as determined by this method, directly reflects all of the predetermined development and operational considerations specific to the subject property.

Exhibit 10-14 is an abridged version of an income and expense statement for a hypothetical proposed property.

| Exhibit 10-14 Abridged Income and Expense Statement | |
|---|---|
| Required Net Income* | 2,883,000.00 |
| Total Fixed Charges | 878,000.00 |
| Undistributed Operating Expenses | 3,207,000.00 |
| Required House Profit | 6,968,000.00 |
| Estimated Departmental Profits (non-rooms) | 1,519,000.00 |
| Required Rooms Profit | 5,449,000.00 |
| Estimated Rooms Expense (22.6%) | 1,591,000.00 |
| Required Rooms Revenue | 7,040,000.00 |
| Total Occupied Rooms (300 x 72% x 365) | 78,840.00 |
| Estimated Average Room Rate | $89.29 |

*Net income to cover debt service and rate of return on invested equity

Using the bottom-up method, it was determined, on the basis of the total project cost, the amount of the mortgage, and the resulting debt service and equity return requirements, that a net income before debt service of $2,883,000 would be required. Taking into consideration local market conditions and expense factors, estimates were made for expenses such as fixed charges, undistributed operating expenses, and rooms expense as well as several miscellaneous profits such as departmental profit. Assuming an occupancy of 72 percent, the resulting calculation indicates that an average rate of $89.29 would be necessary to generate the required net income.

While the bottom-up method can be used to estimate an average room rate, it does not take into account any local market conditions or competitive factors, which means that many marketplace factors are ignored. Thus, the bottom-up method is more appropriate for justifying project feasibility than for setting actual average room rates. For example, the foregoing computation might be better used to conclude that if the market cannot support an average room rate for the subject property of at least $89.29, then the net income before debt service of $2,883,000 would probably not be achieved, resulting in a lower than contemplated return to the invested capital components (debt and equity).

The bottom-up method of establishing an average room rate has the following advantages:

- Several property-specific factors are accounted for, including return requirements of invested capital, the property's fixed costs and operating expenses, and the contemplated level of occupancy,
- This method does not require information pertaining to the average room rates of competitive lodging facilities.

The bottom-up method has the following disadvantages:

- It does not use a market basis to evaluate the reasonableness of the average room rate estimate. This method may, therefore, result in an average room rate that is unobtainable in the local marketplace.
- This method is relatively complicated to use and is overly dependent on assumptions, such as cost and expense levels.
- It requires an estimate of occupancy for the subject property, which would probably necessitate some fieldwork to compile data on occupancy percentages of competitive lodging facilities.

## [c] Rule of Thumb Method

The rule of thumb method relies on the time-honored theory that every dollar of average room rate should support approximately $1,000 of total hotel value (i.e., land, Improvements, and FF&E) on a per room basis. Exhibit 10-15 illustrates this theory.

| Exhibit 10-15 Rule of Thumb Calculations | |
|---|---|
| Total Hotel Property Value | $26,780,000.00 |
| Number of Available Rooms | - 300 |
| Value Per Room | $89,267.00 |
| Required Average Room Rate | $89.27 |
| | or |
| Estimated Average Room Rate (market) | $89.27 |
| Value Per Room | $89,267.00 |
| Number of Available Rooms | X 300 |
| Total Property Value | $26,780,000.00 |

These calculations show that the rule of thumb method can be used in two directions. The first calculation starts with the local property value and determines the average room rate necessary to justify this amount of investment. This procedure and its conclusion are similar to the bottom-up method in that the average room rate is not market-justified but rather illustrates economic feasibility. The second calculation starts with the average room rate, which is derived from the market, and calculates the maximum amount of total property value this room rate would be able to support.

The rule of thumb method relies on a number of assumptions, including the subject's occupancy, ratio of food and beverage revenue to rooms revenue, operating costs, fixed expenses, and capital costs. Properties that do not fit the national norms for these assumptions are apt to require more or less than $1.00 of average rate to justify $1,000 of per room value. For example, assume that this rule of thumb works for hotels with an assumed occupancy level of 72 percent. If the subject property was projected to achieve only a 68 percent stabilized occupancy then it would take more than $1.00 of average room rate to equate to $1,000 of per room value.

The advantages of the rule of thumb method are:

- It is simple to calculate and easy to use.
- It may be used to determine either an average rate based on total value, or the total value based on an achievable average rate.

The disadvantage of the rule of thumb method is that it relies upon a number of inherent assumptions that are not explicitly accounted for. For this reason, it should only be used to establish broad parameters for room rates and project value.

## [d] Market Segmentation Method

The market segmentation method uses a forecasted market breakdown (i.e., commercial, meeting and group, or leisure) for the subject property as a basis for calculating

a weighted average room rate. This method involves multiplying the average room rate per market segment by the anticipated number of occupied room nights for each respective market segment that produces revenue for the hotel. The overall average room rate is then calculated by dividing the total rooms revenue by the total number of occupied rooms. The result is a weighted average room rate that reflects the price sensitivity of each segment of lodging demand. ,

Most hotel market studies and appraisals use the competitive positioning or market segmentation methods for estimating average room rates. Each method works well for all types of existing and proposed lodging facilities. However, neither of the methods are purely objective; they both rely heavily on the experience and judgment of the appraiser who conducts them.

HVS

CHAPTER 11

# Revenue Forecast


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## » 11.01 INTRODUCTION

Forecasting the revenue of a lodging facility is best accomplished in a step-by-step fashion that follows the format set forth in the *Uniform System of Accounts for Hotels* (Hotel Association of New York City, Inc., 8th ed. HANYC Inc., 1986). In this system, sources of income are categorized and estimated separately before they are combined in one complete statement of both revenue and expense. Most hotels follow this uniform procedure; it has become the standard format for forecasting.

The major categories of revenue in this system are room, food service, beverage, and telephone. A miscellaneous category of other income—in which smaller amounts of revenue from sources such as rentals, forfeited advance deposits, and vending machines are combined—is also usually forecasted.

The build-up cover approach and the fixed and variable component approach are the two most commonly used methods for projecting food and beverage revenue. While the build-up cover approach is used only to forecast food and beverage revenue, the fixed and variable component approach is also used to estimate other types of revenue. Where possible, appraisers use both methods as a means of verifying the accuracy of a forecasted estimate.

The build-up approach forecasts food and beverage revenue by developing estimates of individual revenue components such as patronage, number of meals served,

and average price per meal. The fixed and variable component approach is based on the anticipated relationship of food revenue to rooms revenue and beverage revenue to food revenue. The build-up approach requires knowledge of local market conditions, and it takes into account the specific facilities offered by the subject property. The fixed and variable component approach depends on data from a directly comparable hotel, but can easily be adjusted to reflect differences in occupancy levels.

This chapter explains the theory behind the fixed and variable component approach and demonstrates its application in revenue forecasts. Chapter 12 shows how it is used to make expense projections. The procedure used in the fixed and variable component approach is identical for both revenues and expenses.

## » 11.02 ROOMS REVENUE

The estimated total rooms revenue is the most important component of the overall revenue forecast because it is the major source of profit for any lodging facility. It is also important because it sets the benchmark from which other revenues are projected. The procedure for forecasting rooms revenue is relatively straightforward. The appraiser multiplies the projected occupancy rate for the subject property as determined by the room-night analysis conducted earlier in the market study (see Chapter 9) by the forecasted average room rate (see Chapter 10). The result is then multiplied by the room count of the property, which is in turn multiplied by 365 days. These computations yield the total rooms revenue.

## » 11.03 FOOD AND BEVERAGE REVENUE

Most full-service lodging facilities provide both food and beverage outlets for the use of their guests as well as local residents. The primary outlets found within most lodging facilities are restaurants, lounges, bars, banquet rooms, and room service. These outlets generate two kinds of income: food revenue and beverage revenue.

Food revenue is defined as revenue derived from the sale of food, including coffee, milk, tea, and soft drinks. Food sales do not include employee meals charged on hotel employees' checks, which are usually an adjustment to food cost. Beverage revenue is defined in the *Uniform System of Accounts for Hotels* as revenue derived from the sale of alcoholic beverages. In addition to the revenue generated by the sale of food and beverages, hotels generally produce related income from meeting room rental, cover charges, service charges, and miscellaneous banquet revenue.

### [1] Food Revenue

Exhibit 11-1 lists the various revenue categories included in the food department of a hotel. The table also shows whether the category is relatively fixed, occupancy sensitive, rate sensitive, or food sensitive. This information is useful when food revenue is projected through use of a fixed and variable component approach.

Food revenue varies greatly, depending on the number of outlets, the management expertise, and the market orientation of each outlet. External factors such as the competitive environment, proximity to demand generators, and the market segmentation of a hotel also influence the revenue-generating potential of a food outlet.

**Exhibit 11-1 Food Revenue**

*Source: Uniform System of Accounts for Hotels*

| Category | Percent of Sales | Fixed Revenue | Variable Revenue: Occupancy-Sensitive | Variable Revenue: Rate-Sensitive | Variable Revenue: Food- and Beverage-Sensitive |
|---|---|---|---|---|---|
| Food | 60–85 | — | Moderately | — | Highly |
| Beverage | 15–40 | — | Moderately | — | Highly |
| Other income | | | | | |
| Public Room Rentals | 0–2 | — | Moderately | — | Slightly |
| Cover and Minimum Charges | 0–2 | — | Moderately | — | Highly |
| Sundry Banquet Income | 0–2 | — | Slightly | — | Highly |

Food revenue is calculated by multiplying factors for demand and average check. The unit of demand used to quantify food volume is the cover, which represents one meal served to one person. This term originates from the cover plate in each place setting that is removed just prior to the appetizer course. The number of patrons served during each meal period is simply determined by counting the cover plates that were used. The average check is similar in concept to average room rate and is calculated by dividing the total food revenue for a period of time by the number of covers served. (Generally, the average check is calculated separately for food revenues and beverage revenues.)

## [a] Build-Up Cover Approach

The build-up cover approach is a means of forecasting demand for food service by estimating the total number of covers a property is expected to sell. The forecast of food revenue is then determined by multiplying the total number of covers by the estimated average check. The appraiser can project demand (i.e., number of covers) by analyzing either restaurant activity or lodging activity.

The analysis of restaurant activity also involves multiplying turnover—the number of times a seat is occupied during a given meal period—by the number of seats available per meal period. By totaling the number of covers for each meal period for all of the food services of a property during the projection period, the appraiser can approximate total food demand.

Eating- and drinking-place sales statistics are used to formulate two restaurant market indexes for approximately 300 U.S. metropolitan areas. Since 1968, Market Statistics, a division of Bill Communications, Inc., has published restaurant data and statistics in *Restaurant Business* magazine. This information is summarized in two indexes.

1. Restaurant Activity Index (RAI)
2. Restaurant Growth Index (RGI)

The restaurant activity index (RAI) measures an area's eating-place sales activity relative to its food store sales and compares this ratio with the national average. More specifically, it is the ratio of an area's eating-place sales (expressed as a per-

centage of total U.S. eating-place sales) to the area's food store sales (expressed as a percentage of total U.S. food store sales). Eating-place sales include retail sales of restaurants and lunch rooms, cafeterias, fast-food sales, banquets, and sales of specialty foods such as those found in ice cream and frozen yogurt stands. Drinking-place sales are excluded.

The national average is the index base, expressed as 100, and a specific area is compared with the national average by the following formula.

RAI = Percentage of U.S. Eating-Place Sales Located in the Market/ Percent of U.S. Food Store Sales Located in the Market

If the resulting number is larger than 100, it indicates a greater than average propensity to eat away from home. Some of the reasons why a restaurant activity index may be greater than 100 include the fact that local citizens dine out more than the national average or that local restaurants receive non-local patronage from sources such as transient vehicular traffic, hotel guests, conventioneers, vacationers, or residents of nearby communities.

An index lower than 100 indicates that an area's percentage of dining out sales is lower than that of the nation as a whole. This may be attributed to an insufficient number of restaurants, which forces residents to dine out in neighboring metropolitan areas, and restaurants situated in neighboring metropolitan areas that draw patronage away from local outlets.

The purpose of the restaurant activity index is to indicate the current level of dining-out activity, and further analysis must be made to identify the reasons for this level.

The restaurant growth index (RGI) presents the relationship between restaurant supply and demand in the form of an index. When supply equals demand, the index is 100. The mathematical equation used to calculate RGI is as follows.

RGI = Demand/Market's Percentage of U.S. Total Eating Place Sales X 100

In the foregoing equation, demand is an average of the market's share of the following five variables: the number of working women (this figure is multiplied by two to give it extra weight), U.S. households with effective buying incomes of $25,000 or more, U.S. eating-place sales, U.S. hotel and motel receipts, and the U.S. population under the age of 14 and between the ages of 25 and 44. Multiplying by 100 ensures that the final figure will be in an index form.

The amount by which the RGI exceeds 100 indicates the growth potential that is present. For example, an RGI of 120 indicates that the current market area is underdeveloped and could support an approximate 20% increase in the number of food and beverage facilities. When the market is saturated, the index will drop below 100. The lower the number, the more saturated the market.

Both the RAI and RGI should be evaluated concurrently in order to make a proper determination of an area's future restaurant potential.

Turnover is generally estimated by determining the actual past turnover experienced by the subject property if it has an operating history; if not, by that of similar facilities in the market area.

If the appraiser has no operating history to refer to, data for similar outlets can be used. The necessary information can usually be obtained through discussions with the management of the hotels in which the outlets are operated or by actually surveying and counting the number of patrons served during specific meal periods in such outlets. Once the turnover has been estimated for each of the food outlets, it is multiplied by the number of seats, meal periods, and business days to arrive at a forecast of the total number of covers the property will sell.

There are, however, two drawbacks to the analysis of restaurant activity. The first is that it can be difficult to obtain accurate turnover ratios from competitive facilities. The second is that adjustments must be made to the data that are needed to reflect the attributes of the subject property. This procedure requires a number of subjective decisions on the part of the appraiser and can become quite complicated.

Projecting food demand by the analysis of lodging activity is justified by the fact that the number of covers sold by a hotel is directly related to guestroom usage (room-night demand) and market segmentation. Through statistical analysis and knowledge of the frequency with which each market segment makes use of a hotel's facilities, the total in-house demand can be estimated. The appraiser then combines the in-house forecast with a factor for demand created outside the hotel (i.e., meeting and banquet business) to forecast the total number of covers the property will sell.

The analysis of lodging activity takes into account the total house count (number of people occupying the guestrooms) and the patronage patterns of the different market segments into which the guests fall. Since in-house demand typically accounts for 60 percent to 80 percent of the food and beverage sales for a hotel (depending on hotel type, location, and proximity to alternative dining facilities), the analysis of lodging activity generally produces a more supportable estimate of food demand than does the analysis of restaurant activity.

To project future total food revenue using an analysis of lodging activity, the appraiser must take the following steps:

1. Calculate the total house count by market segment using the projected occupancy and double occupancy estimates derived during the room-night analysis and the average room rate analysis.
2. Apply the percentage of each market segment that patronizes each of the proposed subject's food outlets by meal period to the total house count to yield the approximate future in-house food service demand in each of the market segments.
3. Estimate the out-of-house demand generated from non-hotel guests using a hotel's restaurant facilities either on a per-cover basis or as a percentage of total demand to yield out-of-house restaurant demand.
4. Estimate total banquet covers served to non-hotel guests based on the product of the average number of banquets per week and the average number of covers per banquet or the average number of banquet covers per day.
5. Determine total food service demand by adding together in-house food service demand, out-of-house restaurant demand, and non-hotel guest banquet demand.
6. Estimate the average check for each meal period based on the operating history of either the subject property or similar competitive food facilities in the marketplace.
7. Multiply the average check for each meal period by the estimated total number of covers (per year) for that meal period to yield the total food revenue.

[i] **House count.** The term "house count" refers to the number of guests that stay at a hotel over a specific period of time (usually one year). This quantity is used to determine the rate of double occupancy, which is the average number of guests occupying one guestroom. The double occupancy rate is calculated by dividing the house count for the year by the number of occupied rooms for the same period of time, as in the following example:

House Count/Occupied Rooms = 85,252/64,659 = 1.32

Thus, every guestroom sold within this hotel had an average of 1.32 occupants. The commercial market segment is typically composed of individual business travelers; as a whole, therefore, it has a low rate of double occupancy (1 to 1.4). Meeting and convention demand generally has a higher rate. Commercial groups (i.e., business meeting attendees) typically have a lower double occupancy rate (1.35 to 1.50) than social groups, which are sometimes more price sensitive and thus produce a range of double occupancy of 1.5 to 2.0. Leisure travelers are typically families, for which the double occupancy rate is 1.7 to 2.5.

[ii] **In-house capture.** In-house capture is based on the propensity of each hotel guest to use the property's food outlets. Capture differs depending upon the market segment, meal period, and type of food facility available.

For example, commercial travelers exhibit a higher than average propensity to take breakfast at the property's facilities, especially from room service. The meeting and convention segment exhibits mixed propensities to dine at the subject's facilities, depending on whether the meeting or convention is held within the hotel, and whether a planned breakfast is provided to the group. Similarly, leisure travelers also show a mixed propensity to use in-house facilities. This segment tends to forgo breakfast on weekdays, but has a high tendency to order breakfast or brunch on the weekends.

In-house capture also varies by meal period. In most hotels there is a fairly strong breakfast demand from guests, especially on the weekends if the restaurant offers brunch. Typically, the lunch meal period captures little in-house traffic. Because few guests are in the hotel at midday, lunch demand is predominantly from local business people and shoppers, depending on the hotel's location and proximity to office buildings and retail outlets. The hotel's dinner demand usually depends on the dining alternatives in the local area. If suitable alternatives exist, commercial and leisure travelers do not usually dine at the hotel's food outlets. Meeting and convention guests often have planned functions at night and will therefore create little dinner demand.

[iii] **Out-of-house restaurant demand.** Food service patronage from local clientele (outside capture) includes demand generated by nearby residents, business people, and transients passing through the area. Out-of-house restaurant demand can be calculated as a percentage of total food service demand excluding banquet patronage. Typical ranges of out-of-house demand percentages are listed in Exhibit 11-2.

**Exhibit 11-2 Out-of-House Demand Percentages**

| Meal Period | Percentage of total food demand excluding banquet patronage |
|---|---|
| Breakfast | 5%–15% |
| Lunch | 30%–70% |
| Dinner | 20%–60% |

Out-of-house restaurant demand is generally lowest during breakfast and highest at lunch. Dinner demand is variable, depending on the quality of the facilities of the subject property and the local dining alternatives.

Most new hotels typically experience a high out-of-house restaurant demand during the initial year or two as local residents and business people try out the new

food outlets. As the appeal of the hotel's novelty subsides, out-of-house usage generally declines. Overall, the percentage of total food demand (excluding banquet patronage) remains constant albeit minimal for breakfast, but generally declines for lunch and dinner.

[iv] **Banquet demand.** Banquet covers are estimated separately and are based on the product of the average number of banquets per week multiplied by the average number of covers per banquet. Banquet covers are assumed to be out-of-house patronage. Use of banquet facilities by in-house meeting and convention patronage is included in estimates of overall food service use.

### [b] Fixed and Variable Component Approach

The second approach that may be used to forecast food revenue is the fixed and variable component approach. The forecasting procedures used in this approach represent one of the most accurate models of hotel financial performance. With proper input, it can produce reliable forecasts of every category of hotel revenue and expense. The fixed and variable component approach forms the basis for most computerized hotel forecasting models employed by hotel appraisal and consulting firms as well as by a number of hotel companies, investors, lenders, and developers.

This approach is based on the concept that most items of revenue and expense within a hotel have a fixed component, which does not vary with a hotel's occupancy or other volume measure, and a variable component, which changes in direct relationship with occupancy or another measure of volume (e.g., total revenue). By estimating the food revenue for a specific level of occupancy and knowing what portion of the revenue is fixed and what portion is variable, the appraiser can calculate the revenue for other different levels of occupancy.

For an existing hotel, the estimate of food revenue at the specific occupancy level is based on past operating history. For a proposed facility, the food revenue estimate is derived from either the actual sales volume of a similar facility or the percentage relationship of food revenue to rooms revenue and beverage revenue to food revenue of a similar facility.

This same procedure can be used to project all categories of revenues and expenses found in a hotel's operating statement. It should be noted, however, that not all categories vary directly with occupancy. For example, food departmental expense varies with food revenue, telephone expense varies with telephone revenue, administrative and general expense varies with total revenue, and energy cost varies with total revenue.

To use the fixed and variable component approach to make financial forecasts, the appraiser must complete the following steps:

1. Obtain actual income and expense data from the subject property for an existing hotel, or from similar properties for a proposed hotel.
2. Make any necessary adjustments to this data so it reflects as closely as possible the individual characteristics of the subject property. These adjustments may include changing the average room rate, modifying income and expense ratios, and altering fixed charges. The end result of these changes should be a one-year profit-and-loss statement that expresses the undiscounted first year average room rate for the subject in current dollars, and income and expense ratios at a level appropriate for the given occupancy percentage. This profit and loss statement is called the base and will serve as the basis for calculating the fixed and variable component relationships.

3. Inflate (or deflate) the revenue and expense numbers in the base to a level that reflects current dollars for the forecast year. The average room rate used in the base comes from the average rate projection. Any discounting of the average rate is disregarded in developing the base for each projected year.
4. Estimate the fixed and variable percentages for each revenue and expense category. Exhibit 11-3 lists typical ranges of fixed and variable percentages along with the index used to measure variable changes.

**Exhibit 11-3 Fixed and Variable Percentages for Revenues and Expenses**

| Revenues and Expense Category | Percent Fixed | Percent Variable | Index of Variability |
|---|---|---|---|
| Revenues | | | |
| Food | 25-50 | 50-75 | Occupancy |
| Beverage | 0-30 | 70-100 | Food Revenue |
| Telephone | 10-40 | 60-90 | Occupancy |
| Other Income | 30-60 | 40-70 | Occupancy |
| Departmental Expenses | | | |
| Rooms | 50-70 | 30-50 | Occupancy |
| Food and Beverage | 35-60 | 40-65 | Food and Beverage Revenue |
| Telephone | 55-75 | 25-45 | Telephone Revenue |
| Other Income | 40-60 | 40-60 | Other Income |
| Undistributed Operating Expenses | | | |
| Administrative and General | 65-85 | 15-35 | Total Revenue |
| Management Fee | 0 | 100 | Total Revenue |
| Marketing | 65-85 | 15-35 | Total Revenue |
| Franchise Fees | 0 | 100 | Rooms Revenue |
| Repairs and Maintenance | 55-75 | 25-45 | Total Revenue |
| Energy | 80-95 | 5-20 | Total Revenue |
| Fixed Expenses | | | |
| Property Taxes | 100 | 0 | Total Revenue |
| Insurance | 100 | 0 | Total Revenue |
| Reserve for Replacement | 0 | 100 | Total Revenue |

5. Calculate the fixed component by multiplying the appropriate base revenue or expense category for the projected year by the fixed percentage estimated in Step 4.
6. Calculate the variable percentage change. Variable revenues or expenses are assumed to vary directly with some index of variability. Exhibit 11-2 shows the appropriate index of variability for each revenue and expense category. The variable expense change is calculated by dividing the projected index of variability by the base index of variability for the projected year.

7. Calculate the unadjusted variable component by multiplying the appropriate base revenue or expense category for the projected year by the variable percentage estimated in Step 4.
8. Adjust the unadjusted variable component for variability by multiplying it by the variable percentage change calculated in Step 6. The resulting product is the adjusted variable component.
9. Total the forecasted revenue or expense for that specific category, in the projected year, by adding the fixed component calculated in Step 5 to the adjusted variable component calculated in Step 8.

### [c] Test for Reasonableness

After making a financial projection, the appraiser should evaluate the result for reasonableness. The appraiser must determine whether the result is sensible (i.e., whether it is supported by the results achieved by similar hotels), whether it is likely that the subject property can actually achieve the projected figures, and finally, whether the individual projection is in line with all of the other projections.

To evaluate financial operating information, the appraiser generally uses various categories of data—for example, percentage of total revenue, percentage of rooms revenues, dollars per available room, and dollars per occupied room. These units of comparison put the financial data on a common base (e.g., amount per room) so that the operating results of many hotels can be compared and contrasted.

Each unit of comparison is better suited to certain revenue or expense categories than others. The applicability of certain units is due to specific relationships that cause various revenues and expenses to react differently to changes in occupancy, average room rate, and food and beverage volume. For example, if a revenue or expense category is primarily fixed, then greater emphasis should be placed on the dollars per available room as a unit of comparison, since it remains fixed even when revenues change. If the category varies in relation to changing occupancy levels or average room rates, the appropriate unit of comparison would be percentage of rooms or total revenue data, which will change in accordance with changes in revenues. Exhibit 11-4 shows the primary units of comparison used in the analysis of hotel financial data along with the factors that affect the sensitivity of these units. Listed next to each unit of comparison are the revenue and expense categories best suited for the particular form of comparison.

## [2] Beverage Revenue

Beverage revenue is derived through the sale of beverages (generally alcoholic) from a hotel's restaurants, lounges, banquet rooms, and room service. In accordance with the *Uniform System of Accounts for Hotels,* beverage revenue should be given a category separate from food revenue (although it should share the same expense category).

Beverage revenue can be forecasted in a manner similar to food revenue by using either a build-up cover approach or a fixed and variable component approach. The main difficulty in preparing forecasts of beverage revenue is estimating the future success of an in-house bar or lounge. Because the bulk of beverage revenue generally comes from a lounge outlet, the appraiser should have a clear understanding of the various dynamics that create success or failure in this type of business. Lounge customers tend to be fickle, so one year's "in" spot may be unpopular the next. Much

of the success has to be attributed to the skills and expertise of management, which means there is a high degree of business risk (and opportunity) in operating a hotel lounge,

**Exhibit 11-4 Primary Units of Comparison**

| Unit of Comparison | Sensitivity Factors | Revenue and Expense Categories Analyzed |
|---|---|---|
| Percentage of total revenue | Occupancy<br>Average room rate<br>Food and beverage revenue | Administrative and general<br>Management Fee<br>Marketing<br>Property Operations and maintenance |
| Percentage of rooms revenue | Occupancy<br>Average room rate | Food revenue<br>Telephone revenue<br>Other income<br>Rooms expense |
| Percentage of food and beverage revenue | Food and beverage revenue | Food and beverage revenue |
| Per available room | Fixed categories | Administrative and general<br>Marketing<br>Property operations and maintenance<br>Energy<br>Insurance<br>Property taxes |
| Per occupied room | Occupancy | Food revenue<br>Beverage revenue<br>Telephone revenue<br>Other income<br>Rooms expense<br>Energy |

### [a] Build-Up Cover Approach

The build-up cover approach for forecasting beverage revenue is handled in a manner similar to that for projecting food revenue. The appraiser first looks at the percentage of the business that will be generated by in-house guests and the percentage that will originate outside the property. If the hotel lounge has any degree of success, a substantial portion of the beverage revenue will come from patrons who are not hotel guests. In addition to the demand generated from the beverage outlets, a certain amount of beverage revenue originates from liquor consumption by in-house restaurant-goers.

### [b] Fixed and Variable Component Approach

As with food revenue, the fixed and variable component approach is generally the preferred procedure for forecasting this category of income. Exhibit 11-2 shows that beverage revenue is typically 70 percent to 100 percent variable and 0 percent to 30 percent fixed. Because of this high variability, which is attributable to the direct relationship between food and beverage revenues, an assumed 100 percent variable component is normally used.

## » 11.04 TELEPHONE REVENUE

Telephone revenue is derived from fees paid by hotel guests for local and long distance calls and from out-of-house patrons' use of public telephones. As part of the deregulation of the telephone industry, hotels are now permitted to resell telephone services to their guests at a reasonable profit. Prior to deregulation, hotels could collect only a 15 percent commission on long distance telephone calls, which was usually inadequate compensation, and many hotels suffered losses as a result of providing telephone service. At present, hotels have highly sophisticated telephone systems that incorporate automatic billing and posting to guest accounts, least-cost routing, and use of various providers of long distance services (e.g., AT&T, MCI, and US SPRINT). Hotel telephone departments are now more likely to show some profit, although revenues depend largely on the usage characteristics of the guests.

In recent years, long distance telephone charges billed by hotels to individual guests have decreased significantly because many long distance carrier services can be accessed by either a toll-free local call or an 800 number. Callers are generally charged merely an access fee rather than the normal long distance tariff. As a result, profits from telephone service have not grown as rapidly as the hotel industry had expected with telephone deregulation.

As a rule, telephone revenue varies directly with changes in occupancy. A small portion is fixed, representing pay station revenue generated by out-of-house patronage of food and beverage outlets and meeting rooms. The appropriate units of comparison are a percentage of rooms revenue or an amount per occupied room. Exhibit 11-5 lists the various categories of telephone revenue and describes their individual characteristics.

**Exhibit 11-5 Telephone Revenue**

*Source: Uniform System of Accounts for Hotels*

| | | | Variable Revenue | | |
|---|---|---|---|---|---|
| Category | Percent of Sales | Fixed Revenue | Occupancy-Sensitive | Rate-Sensitive | Food- and Beverage-Sensitive |
| Local | 25-60 | — | Highly | — | — |
| Long distance | 35-60 | — | Highly | — | — |
| Service charge | 0-20 | — | Highly | — | — |
| Pay station | 0-20 | Somewhat | — | — | Somewhat |

Telephone revenue is normally projected through the fixed and variable component approach, with 10 percent to 40 percent of the revenue being fixed and 60 percent to 90 percent occupancy-variable. The fixed component represents the out-of-house use of pay phones as well as telephone service for meetings and conferences.

## » 11.05 OTHER INCOME

Other income is revenue derived from sources other than guestroom, food and beverage, or telephone sales. The following is a list of the most common categories of other income with examples of specific sources:

- Rentals: Stores, office space, concession space, showcases, clubs, and storage.
- Commission: Auto rental, photography, telegram, and vending services.

- Concessions: Gift shops, barber shops, and beauty salons.
- Cash discounts earned: Discounts from creditors' accounts for payment within the discount period (does not include trade discounts, which count as a deduction from cost of goods sold).
- Electronic games and pinball machines.
- Forfeited advance deposits and guaranteed no-shows.
- Service charges: Charges added to customer's account for service.
- Interest income: Interest from moneys invested.
- Salvage; Revenue from the sale of old and obsolete items.
- Vending machines.

Other income is highly occupancy sensitive and slightly food-and-beverage sensitive, which means that the appropriate units of comparison are a percentage of rooms revenue adjusted for any unusual food-and-beverage volume and other income per occupied room. Care must be taken when projecting other income to evaluate all the potential sources of revenue. Hotels with extensive retail space or recreational amenities should divide other income into several categories so as to recognize and properly account for significant revenue generators.

## » 11.06 TOTAL REVENUE

Total revenue is the sum of the rooms revenue, food revenue, beverage revenue, telephone revenue, and other income for the subject property. Projected total revenue is an important data point because it will serve as a unit -of comparison and an index of variability for several expense categories.

# CHAPTER 12

# Expense Forecast

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## » 12.01 INTRODUCTION

After the forecasted revenue for a proposed property has been determined, the next task for the appraiser is to project the expenses that the property would be likely to incur. Expenses for lodging facilities should be categorized according to the standardized system outlined in *Uniform System of Accounts for Hotels* (Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.), HANYC, Inc., 1986). The accounts in this system include rooms, food and beverage, telephone, other, administrative and general, management fees, marketing, property operations and maintenance, energy, property taxes, insurance, and reserve for replacement.

Each expense account should be analyzed separately and projected independently of any other, because each account has unique fixed and variable characteristics. As part of this process, the appraiser divides each major account into its component categories. Each category should then be evaluated on the basis of

whether it is fixed or varies with differing levels of occupancy, room rate, or food and beverage volume. The fixed and variable method of forecasting expenses, which can also be used to forecast revenues, is discussed in Chapter 11.

The fixed and variable approach to forecasting hotel revenues and expenses involves the following steps:

1. The financial statements of comparable hotels form the basis for forecasting revenue and expense items. If the subject property is an existing hotel, its historical operating performance is considered in formulating projections. For proposed hotels, the appraiser must rely on the operating results of comparable properties.
2. The comparable financial statements are adjusted to reflect the unique characteristics of the subject property, so as to create a one-year financial statement using the subject property's undiscounted first-year's average income and expense ratios representing the occupancy level actually experienced by either the subject or comparable hotels. This procedure yields a base-year profit-and-loss statement that can be used to determine the relationship between the fixed and variable components.
3. The base-year revenue and expense amounts are inflated or deflated to reflect current dollars for each projection year. The rate of inflation reflects the anticipated price change for the individual line item in the income and expense statement. This step is performed to adjust the comparable financial data that constitutes the base to the inflated dollars anticipated for that particular year.
4. The fixed and variable percentages of each income and expense item are estimated. Exhibit 12-1 illustrates typical fixed and variable percentages and the index used to measure change in the variable component.

The index of variability refers to a factor that controls the movement of the variable component. For example, the variable component of food revenue changes with occupancy; beverage revenue is tied directly to food revenue; and food and beverage expense is largely dependent on food and beverage revenue. The variable component of undistributed operating expenses and fixed expenses is correlated with revenue.

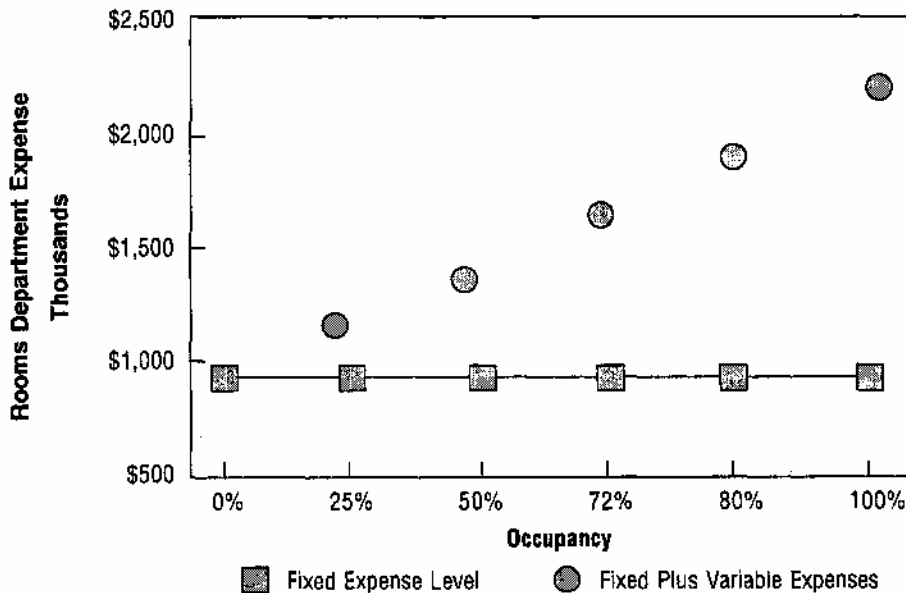
5. Each individual line item is projected separately. The fixed component is estimated by multiplying the appropriate fixed percentage by the inflated base-year revenue or expense for the corresponding projection year.
6. The variable components are assumed to be in accordance with the index of variability set forth in Step 4. The amount of change is quantified by dividing the appropriate projected index of variability by the index of variability for the base year.
7. The unadjusted variable component is calculated by multiplying the appropriate base revenue or expense category for the projection year by the variable percentage estimated in Step 4.
8. The unadjusted variable component is adjusted for variability by multiplying the results of Step 7 by the variable percentage change calculated in Step 6. The resulting product is known as the adjusted variable component.
9. The forecasted revenue or expense is the total of the fixed component calculated in Step 5 and the adjusted variable component calculated in Step 8.

The fixed and variable approach can be illustrated graphically. Exhibit 12-2 shows the subject's rooms department expense as of the stabilized year.

**Exhibit 12-1 Range of Fixed and Variable Expenses**

| Revenue and Expense Category | Percent Fixed | Percent Variable | Index of Variability |
|---|---|---|---|
| Food | 25-50 | 50-75 | Occupancy |
| Beverage | 0-30 | 70-100 | Food Revenue |
| Telephone | 10-40 | 60-90 | Occupancy |
| Other Income | 30-60 | 40-70 | Occupancy |
| Departmental Expenses | | | |
| Rooms | 50-70 | 30-50 | Occupancy |
| Food and Beverage | 35-0 | 40-65 | Food and Beverage Revenue |
| Telephone | 55-75 | 25-45 | Telephone Revenue |
| Other Income | 40-60 | 40-60 | Other Income |
| Undistributed Operating Expenses | | | |
| Administrative and General | 65-85 | 15-35 | Total Revenue |
| Management Fee | 0 | 100 | Total Revenue |
| Marketing | 65-85 | 15-35 | Total Revenue |
| Franchise Fees | 0 | 100 | Rooms Revenue |
| Repairs and Maintenance | 55-75 | *25-45* | Total Revenue |
| Energy | 80-95 | 5-20 | Total Revenue |
| Fixed Expenses | | | |
| Property Taxes | 100 | 0 | Total Revenue |
| Insurance | 100 | 0 | Total Revenue |
| Reserve for Replacement | 0 | 100 | Total Revenue |

**Exhibit 12-2 Illustration of Fixed and Variable Relationship of Rooms Expense**



## » 12.02 ROOMS EXPENSE

Rooms expense consists of all the costs involved in the sale and upkeep of guestrooms and public space. The individual categories of rooms expense are moderately occupancy-sensitive and slightly rate-sensitive, which means that a portion of the overall expense is fixed and the remainder is occupancy-variable.

Salaries, wages, and employee benefits represent a substantial portion of rooms expense. Although part of the payroll cost is occupancy-variable, because management can schedule maids, bell personnel, and house cleaners to work on an as-needed basis when occupancy requires, much of the rooms payroll is actually fixed. Many positions, including front desk personnel, public area cleaners, and the housekeeper and other supervisory staff, must be maintained at all levels of occupancy. As a result, salaries, wages, and employee benefits are only moderately occupancy-sensitive.

Commissions represent remuneration to travel agents for booking rooms business. Because these charges are usually based on a percentage of rooms revenue, they are very sensitive to occupancy and average room rate. Reservations incur a similar expense that reflects the cost of a franchise reservation system, which is typically a certain percentage of rooms revenue. Other rooms expense categories such as laundry, linen, supplies, and uniforms are also somewhat affected by volume and are therefore slightly occupancy-sensitive.

Rooms expense is strongly influenced by changes in occupancy and average room rates, so the appropriate units of comparison that the appraiser should use to project rooms expense are a percentage of rooms revenue and an amount per occupied room. The projection derived from these quantities is then compared with a similar hotel's rooms expense.

The ratio of rooms expense to rooms revenue, the "rooms expense ratio," is an important statistic that often is a key indicator of the skill and effectiveness of management. Unless a hotel suffers from an extremely low level of occupancy or an unusually depressed average room rate, rooms expense should not exceed 25 percent of rooms revenue. If rooms expense is greater than this amount, problems may exist that warrant ownership investigation.

Rooms expense projections are usually made using the fixed and variable component approach, with 50 percent to 70 percent of the expense being fixed and 30 percent to 50 percent occupancy-variable. For example, it is estimated in Exhibit 12-3 that 60 percent of rooms expense is fixed and 40 percent varies with occupancy.

## » 12.03 FOOD AND BEVERAGE EXPENSE

Food and beverage expense consists of the expenditures that must be made to operate the food, beverage, and banquet facilities of a hotel. Although food revenue and beverage revenue are normally projected individually and entered separately in an income and expense statement, the expenses for these two revenue sources are combined into a single entry.

The majority of food and beverage expense is made up of the cost of sales, salaries, and wages. These components are moderately to highly food-and-beverage-sensitive in that they vary directly with changes in food and beverage volume. The other associated costs (e.g., laundry and dry cleaning, operating supplies, and uniforms) tend to be either slightly food-and-beverage-sensitive or moderately fixed (i.e., they vary only slightly with changes in occupancy or room rates, or food and beverage volume). Given the nature of the components of food and beverage expense,

**Exhibit 12-3 Forecast of Rooms Department Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Rooms Expense | $1,400 | $1,456 | $1,514 | $1,575 |
| Percent Fixed | 60% | 60% | 60% | 60% |
| Rooms Expense Fixed Component | $840 | $873 | $908 | $945 |
| Base Rooms Expense | $1,400 | $1,456 | $1,514 | $1,575 |
| Percent Variable | 40% | 40% | 40% | 40% |
| Unadjusted Variable Component | $560 | $582 | $606 | $630 |
| Unadjusted Variable Component | $560 | $582 | $606 | $630 |
| Variable Percentage Change | 0.9854 | 1.0157 | 1.0612 | 1.0915 |
| Adjusted Variable Component | $552 | $591 | $643 | $687 |
| Fixed Component | $840 | $873 | $908 | $945 |
| Adjusted Variable Component | $552 | $591 | $643 | $687 |
| Total Rooms Expense | $1,392 | $1,465 | $1,551 | $1,632 |
| Percent of Rooms Revenue | 23.5% | 23.1% | 21.7% | 20.5% |
| Amount Per Available Room | $5,352 | $5,634 | $5,966 | $6,278 |
| Amount Per Occupied Room | $22.57 | $23.04 | $23.35 | $23.88 |

the appropriate unit of comparison is a percentage of food and beverage revenue. When this unit of comparison is used, the appraiser should select comparable hotels with similar ratios of beverage to food. The profit margin from the sale of beverages is considerably higher than that from the sale of food, so a hotel with a higher ratio of beverage to food should have a lower food and beverage expense ratio. The reverse is true as the ratio of beverage to food sales declines.

As with rooms expense, the ratio of food and beverage expense to food and beverage revenue is a benchmark that can be used to evaluate the skill and effectiveness of a hotel's management. Many hotel operators run a highly efficient rooms department but lose thousands of dollars through poorly managed food and beverage service. Unless a hotel has an extremely low volume of food and beverage revenue or suffers from an unusually high cost of labor, food and beverage expense should not exceed 80 to 83 percent of food and beverage revenue. Food and beverage expense in excess of this amount may indicate poor management.

Food and beverage expense is normally projected through the fixed and variable component approach, with 35 percent to 55 percent of the expense being fixed and 45 percent to 65 percent variable. The appropriate index of variability for food and beverage expense is food and beverage revenue. This means that the variable portion of the food and beverage expense category will vary directly with changes in food and beverage revenue.

Exhibit 12-4 assumes that 55 percent of food and beverage revenue is fixed and that 45 percent varies with food and beverage revenue in its calculation of the subject property's food and beverage expense.

| Exhibit 12-4 Forecast of Food and Beverage (F&B) Department Expense ($ thousands) | | | | |
|---|---|---|---|---|
| | **1994** | **1995** | **1996** | **Stabilized** |
| Base F&B Expense | $1,221 | $1,270 | $1,321 | $1,374 |
| Percent Fixed | 55% | 55% | 55% | 55% |
| F&B Expense Fixed Component | $672 | $699 | $726 | $756 |
| Base F&B Expense | $1,221 | $1,270 | $1,321 | $1,374 |
| Percent Variable | 45% | 45% | 45% | 45% |
| Unadjusted Variable Component | $550 | $572 | $594 | $618 |
| Unadjusted Variable Component | $550 | $572 | $594 | $618 |
| Variable Percentage Change | 0,9890 | 1.0116 | 1.0464 | 1.0690 |
| Adjusted Variable Component | $543 | $578 | $622 | $661 |
| Fixed Component | $672 | $699 | $726 | $756 |
| Adjusted Variable Component | $543 | $578 | $622 | $661 |
| Total F&B Expense | $1,215 | $1,277 | $1,348 | $1,416 |
| Percent of Food and Beverage Revenue | 93.3% | 92.2% | 90.5% | 89.5% |
| Amount Per Available Room | $4,674 | $4,910 | $5,186 | $5,447 |
| Amount Per Occupied Room | $19.70 | $20.08 | $20,29 | $20,72 |

## » 12.04 TELEPHONE EXPENSE

Telephone expense consists of all of the costs associated with the operation of a hotel telephone department. For smaller hotels with automated phone systems, the telephone department may be as simple as an additional responsibility for the front desk personnel; in large properties, the telephone department usually has one or more full-time telephone operators to provide the necessary service to the guests.

The bulk of telephone expense is the cost of local and long distance calls that are billed by the telephone companies that service the hotel. Because most of these calls originate from in-house guests, these expenses are moderately occupancy sensitive. Unless a particular department has unusually heavy telephone usage, the normal use of telephone services by hotel employees is charged to the telephone expense account. The remaining costs, such as salaries and wages, miscellaneous expenses, and printing, are all moderately fixed. In light of a recent modification of accounting categories in the *Uniform System of Accounts for Hotels* that reallocates equipment rental expense from the telephone expense account to that of rent, taxes, and insurance, the appraiser should take careful note of the accounting for telephone equipment rental or lease expense.

Given the nature of the components of total telephone expense and in view of the fact that the cost of telephone service is largely driven by the in-house usage that generates telephone revenue, the appropriate unit of comparison is a percentage of telephone revenue.

Telephone expense is normally projected through the fixed and variable component approach, with the expense being 55 percent to 75 percent fixed and 25 percent to 45 percent directly variable with telephone revenue. The fixed component is the

operational usage of telephone services by hotel employees along with the normal fixed line charges from the telephone companies. The variable expense is the actual usage by hotel guests, which corresponds directly with telephone revenue.

In Exhibit 12-5, telephone expense is estimated to be approximately 60 percent fixed and 40 percent variable.

**Exhibit 12-5 Forecast of Telephone Department Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Telephone Expense | $149 | $155 | $162 | $168 |
| Percent Fixed | 60% | 60% | 60% | 60% |
| Telephone Expense Fixed Component | $90 | $93 | $97 | $101 |
| Base Telephone Expense | $149 | $155 | $162 | $168 |
| Percent Variable | 40% | 40% | 40% | 40% |
| Unadjusted Variable Component | $60 | $62 | $65 | $67 |
| Unadjusted Variable Component | $60 | $62 | $65 | $67 |
| Variable Percentage Change | 0.9881 | 1.0124 | 1.0532 | 1.0818 |
| Adjusted Variable Component | $59 | $63 | $68 | $73 |
| Fixed Component | $90 | $93 | $97 | $101 |
| Adjusted Variable Component | $59 | $63 | $68 | $73 |
| Total Telephone Expense | $149 | $156 | $165 | $173 |
| Percent of Telephone Revenue | 64.9% | 64.0% | 62.5% | 61.5% |
| Amount Per Available Room | $572 | $600 | $635 | $667 |
| Amount Per Occupied Room | $2.42 | $2.45 | $2.48 | $2.53 |

## » 12.05 OTHER INCOME EXPENSE

Other income expense includes all of the costs that are associated with the corresponding other income revenue, such as rentals, forfeited advance deposits, and vending machine revenues. The extent of these expenses depends on the nature of the revenue. For example, if a hotel leases a gift shop in its lobby, the cost to the hotel would be minimal, consisting of such items as rental fees and commissions. If, on the other hand, the hotel operated the gift shop, both the revenue and expenses would be higher; revenue would include the proceeds from products sold, and expenses would include the cost to purchase products to sell, payroll, and so forth.

On the basis of an analysis of the components that constitute other income expense, the appropriate unit of comparison is a percentage of other income revenue.

Other income expense is normally projected by the fixed and variable component approach, with 40 percent to 60 percent of the expense being fixed and 40 percent to 60 percent varying directly with other income revenue.

Exhibit 12-6 presents the calculation of the subject property's Other Income expense. Income expense is estimated to be 70 percent fixed, with 30 percent varying directly with other income.

**Exhibit 12-6 Forecast of Other Income Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Other Income Expense | $81 | $85 | $88 | $82 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Other Income Expense Fixed Component | $57 | $59 | $62 | $64 |
| Base Other Income Expense | $81 | $85 | $88 | $92 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $24 | $25 | $26 | $27 |
| Unadjusted Variable Component | $24 | $25 | $26 | $27 |
| Variable Percentage Change | 0.9943 | 1.0066 | 1.0166 | 1,0295 |
| Adjusted Variable Component | $24 | $26 | $27 | $28 |
| Fixed Component | $57 | $59 | $62 | $64 |
| Adjusted Variable Component | $24 | $26 | $27 | $28 |
| Total Other Income Expense | $81 | $85 | $88 | $92 |
| Percent of Other Income Revenue | 47.8% | 47.4% | 47.0% | 46.6% |
| Amount per Available Room | $312 | $326 | $340 | $355 |
| Amount per Occupied Room | $1.31 | $1.34 | $1.32 | $1.35 |

## » 12.06 ADMINISTRATIVE AND GENERAL EXPENSE

The administrative and general expense of a hotel is made up of all of the managerial and operational expenses that cannot be attributed to a particular department. For example, the general manager might work part of one day solving a problem in the rooms department and devote the remainder of the day to booking an important food and beverage function. It is too difficult to continually keep track of the manager's activities and allocate his or her salary to individual departments, so the category of administrative and general is used to account for it.

Most administrative and general expenses are relatively fixed. The exceptions are commissions on credit card charges, which are highly dependent on occupancy;

cash overages and shortages and provisions for doubtful accounts, all of which are affected moderately by the quantity of transactions or total revenue; and salaries and wages, benefits, and security, which are influenced slightly by volume.

In recent years, several new categories have been added to administrative and general expenses. One example is human resources, which includes the cost of recruiting, relocating, and training. Another example is security, which encompasses the cost of contract security for the property and other related expenses.

The category called "insurance/general" comprises the premiums for policies that cover liability, fidelity, life insurance, theft coverage, and business interruption insurance. Fire and extended coverage insurance on the building and its contents is a separate insurance expense category.

Liability coverage encompasses third-party actions involving bodily injury and personal property and is typically based on rooms receipts, meeting and banquet revenue, and food and beverage revenue. Some of the factors that affect liability insurance expense are the size of meeting, banquet, or restaurant facilities; the amount of

alcohol served as a percentage of total food and beverage sales; and the existence of a lounge dance floor. Factors that can increase liability insurance expense include building design (such as a high-rise structure), swimming pools, lack of life safety support systems (fire and smoke alarms), and any transportation services provided to guests.

Given the nature of the components of administrative and general expense, the appropriate unit of comparison to test for reasonableness is an amount per available room. The result of this test can be verified by using a percentage of total revenue.

Projections of administrative and general expense are normally made using the fixed and variable component approach, with 65 percent to 85 percent of the expense being fixed and 15 percent to 35 percent varying directly with total revenue.

In the example in Exhibit 12-7, it is assumed that approximately 70% of administrative and general expenses is fixed and 30 percent vary in relation to total revenue.

**Exhibit 12-7 Forecast of Administrative and General Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Administrative and General Expense | $675 | $702 | $730 | $759 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Administrative and General Expense Fixed Component | $472 | $491 | $511 | $531 |
| Base Administrative and General Expense | $675 | $702 | $730 | $759 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $202 | $210 | $219 | $228 |
| Unadjusted Variable Component | $202 | $210 | $219 | $228 |
| Variable Percentage Change | 0.9863 | 1.0147 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $200 | $214 | $231 | $247 |
| Fixed Component | $472 | $491 | $511 | $531 |
| Adjusted Variable Component | $200 | $214 | $231 | $247 |
| Total Administrative and General Expense | $672 | $705 | $742 | $779 |
| Percentage of Total Revenue | 8.8% | 8.6% | 8.2% | 7.8% |
| Amount per Available Room | $2,585 | $2,712 | $2,854 | $2,996 |
| Amount per Occupied Room | $10,89 | $11.08 | $11.17 | $11.39 |

## » 12.07 MANAGEMENT FEE EXPENSE

The management fee expense category accounts for the basic fee paid to the management company that will operate the subject property. Management fees differ depending on whether the management company is a first- or second-tier operator. The appraiser should use the actual fee structure negotiated for the management company, if it has been selected, or a fee based on market analysis in the event the operator is

not known. The estimate for the incentive portion of the management fee is generally found at the point in the income and expense statement that forms the basis for the incentive fee calculation. For example, if the incentive management fee is based on a percentage of income before fixed charges, then the incentive fee is located just after this point in the statement.

Basic hotel management fees are almost always based on a percentage of total revenue, which means that they are 100 percent variable. The proper unit of comparison is a percentage of total revenue.

In Exhibit 12-8, the management company is operating the subject property for a basic management fee of 3 percent, which is considered reasonable for this type of company.

**Exhibit 12-8 Forecast of Management Fee ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Projected Total Revenue | $7,620 | $8,153 | $9,101 | $10,016 |
| Management Fee Percentage | 3.0% | 3.0% | 3.0% | 3.0% |
| Management Fee Expense | $229 | $245 | $273 | $300 |

## » 12.08 MARKETING EXPENSE

Marketing expense includes all of the expenses associated with advertising, sales, and promotion of a lodging facility. These marketing activities are designed to attract new customers and retain existing ones through efforts aimed at creating an image for the hotel, developing customer awareness, and stimulating patronage to the property and its various facilities. Unlike most expense categories, marketing is almost totally controlled by management. Hotel operators typically develop annual marketing plans that detail future expenditures. If such budgets are followed, total marketing expenses can be projected accurately.

The hotel operator must consider many factors when compiling a marketing budget. One of the most significant is that the results of marketing expenditures are not always immediately realized. Depending on the type of advertising and promotion, increased patronage may not be seen for months or even years. Over time, however, this lag period tends to be offset, because the benefits of a successful marketing campaign generally continue after the program has ended.

Hotels have unique operating characteristics that must be considered either when developing a marketing plan or when reviewing the effectiveness of an established marketing effort. For an appraiser to forecast hotel revenues, the marketing programs of the past several years (along with anticipated future plans) should be evaluated to determine their potential effect on the income and expenses of the hotel. Some of the unique characteristics that should be addressed are as follows:

- New hotels, especially those catering to the meeting and convention segment, should have a marketing plan that commences before the hotel opens. Organizers of business meetings and conferences typically plan their meeting accommodations three to six months in advance, while large national associations choose their convention sites as far as five years in advance. If a meeting-oriented hotel is not in the marketplace in time to obtain advance business, it will be passed over in favor of the established competition and suffer low occupancy levels during the initial years of its operation.

- Because the effect of marketing tends to be cumulative, the initial marketing efforts for a new hotel may require greater expenditures than those for an established facility in order to achieve the desired results.
- Marketing expenditures are similar to a hotel maintenance program. If an existing property has neglected its marketing efforts for several years, the appraiser may have to allow for a higher than normal marketing budget either to maintain or to increase current revenues. However, if an aggressive marketing program has been in effect, a reduction in marketing expenses may be justified, because revenues will not be adversely affected.
- The marketing budget should be designed for the specific property as well as for the nature of local lodging supply and demand. Characteristics such as location, visibility, chain affiliation, and class and types of market segments serviced can affect the type and amount of marketing expenditures required.

Marketing expense is divided into seven categories: salaries and wages, benefits, sales, advertising and merchandising, reservations, other marketing activities, and fees and commissions. Together they form the entire marketing effort of the property, incorporating both the internal staff and outside agencies. All categories are budgeted, fixed expenses, except for reservations and fees and commissions, which are occupancy and rate sensitive because they are generally based on a percentage of rooms revenue.

Costs related to the marketing of guestrooms, such as reservations and travel agency fees and commissions, have traditionally been charged to rooms expense. However, there is a growing recognition that these costs are elements of the overall marketing activity, and hotels that recognize these functions as marketing responsibilities should charge these expenses to marketing.

The appropriate unit of comparison for marketing expenses is an amount per available room. Sometimes it is helpful to remove the franchise fee cost and make a separate calculation for it because it is generally 100 percent variable, depending on the rooms revenue.

Marketing expense is normally projected through the fixed and variable component approach, with 65 percent to 85 percent of the expense being fixed and 15 percent to 35 percent varying directly with total revenue. The fixed and variable component approach must sometimes be adjusted to account for unique marketing considerations, such as the costs incurred by fees and commissions paid to travel agencies.

Exhibit 12-9 presents a marketing forecast based on a fixed and variable component model in which 70 percent of this expense is considered fixed and 30 percent varies with total revenue. This relationship takes into account the location of the subject property, the local market for transient accommodations, the competitive environment, and the hotel's anticipated market segmentation.

## » 12.09 PROPERTY OPERATIONS AND MAINTENANCE EXPENSE

Property operations and maintenance (PO&M), which is also known as repair and maintenance, is another expense that is largely controlled by management (see Exhibit 12-10). Except for repairs necessary to keep the facility open and precautions against damage, most maintenance items can be deferred for various lengths of time. However, maintenance is an accumulating expense. If a needed repair is merely postponed, it is neither eliminated nor does it go away of its own accord. Rather it becomes what is known as deferred maintenance that must ultimately be attended to at some later date. When an appraiser projects income and expense for an existing lodg-

ing facility, the property operations and maintenance expenses over the past several years should be investigated to determine whether adequate expenditures were made to keep the facility in good condition. This should be done in conjunction with a physical inspection of the property to determine whether the funds that were expended were sufficient for the repairs required.

**Exhibit 12-9 Forecast of Marketing Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Marketing Expense | $540 | $561 | $584 | $607 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Marketing Expense Fixed Component | $378 | $393 | $409 | $425 |
| Base Marketing Expense | $540 | $561 | $584 | $607 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $162 | $168 | $175 | $182 |
| Unadjusted Variable Component | $162 | $168 | $175 | $182 |
| Variable Percentage Change | 0.9863 | 1.0147 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $160 | $171 | $185 | $198 |
| Fixed Component | $378 | $393 | $409 | $425 |
| Adjusted Variable Component | $160 | $171 | $185 | $198 |
| Total Marketing Expense | $538 | $564 | $594 | $623 |
| Percentage of Total Revenue | 7.1% | 6.9% | 6.5% | 6.2% |
| Amount per Available Room | $2,067 | $2,168 | $2,284 | $2,396 |
| Amount per Occupied Room | $8.71 | $8.87 | $8.94 | $9,12 |

The following factors influence the required level of maintenance for lodging facilities:

- *Age of the hotel.* New hotels are typically protected for several years by new equipment and manufacturer's warranties, so PO&M costs during the initial years of operation are reduced. As hotels become older, maintenance costs tend to escalate rapidly.
- *Use of a preventive maintenance system.* Some hotel operators conduct preventive maintenance programs that consist of periodic checks and maintenance of all the important components of a lodging facility. The purpose of preventive maintenance is to anticipate possible maintenance problems early enough so that only minor repairs, rather than major overhauls, are necessary.
- *Quality of initial facilities.* The quality and type of the initial construction can have a direct effect on future maintenance requirements. The use of high-quality building materials and construction methods will generally reduce the need for maintenance expenditures over the long term. During the physical inspection, the appraiser should investigate the condition and quality of the original construction.

Property operations and maintenance is considered an operating expense and, as such, under IRS regulations, it can contain only items that can be expensed rather than capitalized. For example, if a table leg breaks, the repair of the leg would be considered an expense and chargeable to property operations and maintenance. If the table was instead replaced, it would become a capital expenditure that would not appear under the property operations and maintenance category. Appraisers account for capital replacements of items such as furniture, fixtures, and equipment reserve for replacement expense.

The items in property operations and maintenance are either fixed or very slightly influenced by changes in occupancy and food and beverage usage. The fact that PO&M is mostly fixed means that the appropriate unit of comparison for this expense category is an amount per available room that is verified by a percentage of total revenue.

Property operations and maintenance is normally projected by the fixed and variable component approach with 55 percent to 75 percent of the expense being fixed and 40 percent to 60 percent varying directly with total revenue. In Exhibit 12-10, it is assumed that 70 percent of the category is fixed to project operations and maintenance expense.

**Exhibit 12-10 Forecast of Property Operations and Maintenance Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Property Oper. & Maint. Expense | $338 | $351 | $365 | $380 |
| Percent Fixed | 70% | 70% | 70% | 70% |
| Property Oper. & Maint. Expense Fixed Component | $236 | $246 | $256 | $266 |
| Base Property Oper. & Maint. Expense | $338 | $351 | $365 | $380 |
| Percent Variable | 30% | 30% | 30% | 30% |
| Unadjusted Variable Component | $101 | $105 | $110 | $114 |
| Unadjusted Variable Component | $101 | $105 | $110 | $114 |
| Variable Percentage Change | 0.9863 | 1.1047 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $100 | $107 | $116 | $124 |
| Fixed Component | $236 | $246 | $256 | $266 |
| Adjusted Variable Component | 100 | 107 | 116 | 124 |
| Total Property Oper. & Maint. Expense | $336 | $353 | $372 | $390 |
| Percentage of Total Revenue | 4.4% | 4.3% | 4.1% | 3.9% |
| Amount per Available Room | $1,294 | $1,357 | $1,430 | $1,499 |
| Amount per Occupied Room | $5.45 | $5.55 | $5.60 | $5.71 |

## » 12.10 ENERGY EXPENSE

Energy consumption within a lodging facility typically takes several forms: water and space heating, air conditioning, lighting, cooking fuel, and other miscellaneous power requirements. The most common sources of energy are electricity, natural gas, fuel

oil, and steam. In addition to these energy uses, energy expense also includes the cost of water service. The total cost of energy varies with the source and quantity of fuel used. Electricity tends to be the most expensive source, followed by oil and gas.

The cost of electrical energy is a function of the amount of energy consumed and the size of the peak demand. The unit of electrical consumption is the kilowatt-hour, which is measured by a watt-hour meter. To calculate the monthly electric bill, the utility company reads the electric meter and determines the number of kilowatt-hours of electricity consumed since the last reading. This amount is multiplied by the appropriate scheduled rate to determine the usage charge. The demand charge reflects the peak number of kilowatts required by the property during a specific, short-term time period. The demand is also read monthly from the utility meter, with the additional charge added to the electric bill on the basis of a demand rate schedule.

Utility charges for other sources of energy, such as gas and oil, are generally based entirely on usage, with no additional expense for demand. The unit of gas consumption is the therm, which is measured by a gas meter. Oil is delivered to the property and stored in tanks. Bills are rendered upon delivery and the unit charge is the gallon.

A large portion of energy consumption is relatively fixed and varies little with changes in occupancy. Restaurants, kitchens, public areas, and corridors must be continually lighted and heated or air conditioned, whether the hotel is full or nearly empty. The energy costs of an additional occupied room (i.e., a few hours of light, television, heat, or air conditioning) are minimal.

To forecast the energy cost for a hotel or motel, estimates must be made for total energy consumption, sources of energy, and utility rates.

The amount of energy consumed in the process of heating, air conditioning, and operating a lodging facility is measured in terms of British thermal units (BTUs). By estimating the number of BTUs a hotel or motel will use over a twelve-month period and multiplying this amount by a cost factor based on local utility charges, an energy cost forecast can be developed.

In order to estimate the amount of energy consumed by a facility, it is necessary to know the conversion factor that relates the unit of consumption (kilowatt-hours, therms, and gallons) to the specific number of BTUs produced. The following table shows the conversion factors for electricity, gas, and oil.

A portion of the energy consumed by hotels and motels is always in the form of electricity. This source is generally supplemented by either gas or oil when these alternatives are available and cost effective. Electrical energy accounts for approximately 40 percent to 60 percent of the total BTU energy consumption for a typical lodging facility, with the supplemental fuels representing the remainder.

Once the total units of consumption have been calculated, the appraiser contacts the local utility company and fuel oil dealer to determine rates and costs. In most instances, utility companies are extremely helpful in providing the necessary data, information, and costs to estimate the energy costs for a lodging facility.

Once the base year energy expense has been estimated, a projection is made using the fixed and variable component approach, with 80 percent to 95 percent of the expense being fixed and 5 percent to 20 percent varying directly with total revenue. In Exhibit 12-11, it is assumed that 90 percent of this category is fixed and 10 percent varies directly with total revenue.

## » 12.11 PROPERTY TAX EXPENSE

Property tax expense includes the taxes paid to local municipalities for governmental services such as highways, schools, parks, sanitation, and other services and facilities. The purpose of property taxes is the allocation of the municipal tax burden on

the basis of value. The weight of the tax burden the owner will assume increases proportionally with the value of the property. The legal term for property tax is "ad valorem" tax, or tax "in proportion to value."

Depending on the policy of the municipality, property taxes can be based on the value of the real property alone (real estate tax) or the value of the personal property in its entirety (personal property tax).

**Exhibit 12-11 Forecast of Energy Expense ($ thousands)**

| | 1996 | 1997 | 1998 | Stabilized |
|---|---|---|---|---|
| Base Energy Expense | $318 | $331 | $344 | $358 |
| Percent Fixed | 90% | 90% | 90% | 90% |
| Energy Expense Fixed Component | $286 | $298 | $310 | $322 |
| Base Energy Expense | $318 | $331 | $344 | $358 |
| Percent Variable | 10% | 10% | 10% | 10% |
| Unadjusted Variable Component | $32 | $33 | $34 | $36 |
| Unadjusted Variable Component | $32 | $33 | $34 | $36 |
| Variable Percentage Change | 0.9862 | 1.0147 | 1.0575 | 1.0863 |
| Adjusted Variable Component | $31 | $34 | $36 | $39 |
| Fixed Component | $286 | $298 | $310 | $322 |
| Adjusted Variable Component | $31 | $34 | $36 | $39 |
| Total Energy Expense | $318 | $331 | $346 | $361 |
| Percentage of Total Revenue | 4,2% | 4.1% | 3.8% | 3.6% |
| Amount per Available Room | $1,222 | $1,275 | $1,322 | $1,389 |
| Amount per Occupied Room | $5.15 | $5.21 | $5.21 | $5.28 |

To establish the proper allocation of the tax burden, municipalities employ assessors to assess, or valuate, all the taxable real estate within their jurisdictions. Theoretically, the assessment bears a definite relationship to market value, so that properties of equal market values will have similar assessments, and properties of higher and lower values will have proportionately larger and smaller assessments.

Because the objective of assessed value is to maintain a specific value relationship among all properties in a taxing jurisdiction, comparable hotel assessments should be evaluated to determine whether the subject property's assessed value is equitable.

Some municipalities assess properties at 100 percent of market, while others use a certain percentage of market value. In any case, the allocation of the tax burden to each property will not change if the relationship between the assessed value and market value is altered. If additional properties are developed within a tax jurisdiction, the tax base increases while the tax rate decreases, assuming that the municipal budget remains constant. Although the assessed value of the properties does not change, the individual tax burden decreases because the additional properties generate tax revenue. If the municipal budget increases, however, the tax rate will increase proportionately.

Projecting property tax expense for an existing hotel is relatively simple. The as-

sessed value is normally on public record and can be found in the appropriate municipal office. Multiplying the assessed value by the anticipated rate yields the estimated property tax burden. The appraiser must determine, however, whether the assessed value might escalate at some future time, as the result either of improving trends in local real estate market values or of a new valuation of the subject property triggered by a recent sales transaction.

Projecting property tax expense for a proposed lodging facility is generally more difficult. Local assessors are often reluctant to provide initial estimates of assessed values until the hotel is complete and operational. They are apt to use a cost approach and say that the assessed value will be based on total project cost. Because the assessor has no incentive to provide an accurate projection of assessed value, there is always a tendency to overstate these initial estimates; consequently, when the final value is placed on the property, a reduced amount is looked upon favorably. The appraiser should, nonetheless, contact the assessor and attempt to obtain an indication of what the assessed value will be, although this estimate should be tempered by the results of research into comparable assessments.

The objective of assessed value is to maintain a specific value relationship among all of the properties in a tax jurisdiction, so that the best way to make an estimate of the assessed value of a proposed hotel is to base it on the actual values of similar hotels. The acumen of the appraiser comes into play in this process when the indicated assessed values must be adjusted to reflect any differences between them and the subject property.

## [1] Real Property Assessment

Because tax jurisdictions provide separate assessed values for real property (i.e., land and improvements), it is advisable to compare the assessed values of only the improvements, not the combined land and improvement values. The combination of the two equals the total property value and forms the basis for calculating the real estate tax burden of an individual property. The assessed value of the land is developed from actual land sales within the jurisdiction. On the basis of these known land sales, the assessor can determine the relative desirability of the parcels; as value declines, so does desirability. Each parcel is assessed on the basis of its desirability relative to the surrounding parcels, which means that assessors are often reluctant to change one land assessment because doing so could alter the assessment grid for all the other parcels in the jurisdiction. As a result, when developing an assessed value estimate of a proposed hotel, the actual assessed value of the land should be considered unchangeable (because any locational advantages or disadvantages have theoretically been accounted for), and only the improvement value should be compared and adjusted. Improvement value does not include such factors as decor, management, franchise, or business value.

## [2] Personal Property Assessment

If a tax jurisdiction imposes a personal property assessment, the appraiser must estimate the value of the furniture and equipment in addition to land and improvements. Because personal property assessment procedures differ widely, guidance from the local assessor is often helpful. In many instances, the assessed value of furniture and equipment is based on actual cost less a mandated depreciation schedule. The key factor for an appraiser working with this type of assessment is a clear definition of what is considered personal property and what is considered real property.

## » 12.12 INSURANCE EXPENSE

Insurance expense consists of the cost of insuring the hotel and its contents against damage or destruction from fire, weather, sprinkler leakage, boiler explosion, and so forth. It does not include liability coverage, which is charged to administrative and general expense. Insurance expenses are generally 100 percent fixed and do not vary with a hotel's volume.

Insurance rates are based on many factors, including building design and construction, fire detection and extinguishing equipment, fire district, distance from fire-house, and the history of fires in the area. Sometimes it is possible to obtain an estimate of insurance cost from a local insurance agent who is familiar with the project and area insurance rates. If this is not possible, the appraiser should use the insurance costs incurred by similar lodging facilities expressed on a per available room basis.

## » 12.13 RESERVE FOR REPLACEMENT EXPENSE

Furniture, fixtures, and equipment are essential to the operation of a lodging facility, and their quality often determines the overall quality of a facility, All non-real estate items that are normally capitalized rather than expensed are included in this category.

The furniture, fixtures, and equipment in a hotel are exposed to heavy use and must be replaced at regular intervals. The useful life of these items is determined by the quality and durability of their construction and the amount of guest traffic and use to which they are subjected.

Periodic replacement of furniture, fixtures, and equipment is essential to maintain the quality, image, and income of a lodging facility. Capitalized expenditures are not included in the operating statement but nevertheless affect an owner's cash flow;
consequently, an appraisal should reflect these expenses in the form of an appropriate reserve for replacement. As a general rule, a reserve of 3 percent to 5 percent of total revenue is usually sufficient to provide for timely replacement of furniture, fixtures, and equipment. The reserve for replacement is based on a percentage of total revenue, so it is 100 percent variable. The unit of comparison is a percentage of total revenue.

## » 12.14 OVERALL STATEMENT OF INCOME AND EXPENSE

From the room-night analysis that produces an estimate of occupancy to the reserve for replacement calculation, the overall forecast must be combined into an overall statement of income and expense covering the appropriate forecasted years. This should be organized in accordance with the *Uniform System of Accounts for Hotels* and contain ratios of total and departmental revenues and amounts per available room.

The appraiser should examine the reasonableness of all the numbers and ratios in the overall statement. Among the numerical relationships that should be verified are the following:

- As occupancy increases, most operating ratios tend to decrease, with the exception of property operations and maintenance expense, which generally increases for a new property.
- As occupancy increases, the increase in the average rate per occupied room generally outpaces inflation.

Hotels with a high food and beverage volume (i.e., ratio of food and beverage revenue to rooms revenue) will tend to have lower profit ratios (i.e., net income to total revenue). However, if the food and beverage departments are operated at a profit, these properties will bring in more revenue. The optimum profit percentage for a lodging facility depends upon the food and beverage volume produced by the hotel (i.e., ratio of food and beverage to rooms). A well-run hotel will make a departmental profit of $.80 for each dollar of rooms revenue and only $.30 for each dollar of food and beverage revenue, so the volume of each department will dramatically impact the overall bottom line percentage. For example, a rooms-only lodging facility may have a net income ratio of 40 percent compared to a 20 percent bottom line for a property with a high food and beverage volume. However, the property with the high food and beverage volume will often generate a greater dollar profit on a per room basis.

HVS

CHAPTER 13

# Property Valuation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## » 13.01 INTRODUCTION

Hotel owners, lenders, and operators frequently require appraisals to establish the value of properties in which they have an interest. In performing a market study and appraisal, a valuation is essential in order to determine whether the subject property is economically feasible. Simply put, a project is considered feasible when its economic value is greater than the cost that was incurred in its development; if the project's value upon completion is less than the cost of its development, then it is considered not feasible. Appraisals are also used to establish prices for sales and transfer, to determine the security for mortgage debt, and to verify assessed value for property taxes.

Professional appraisers use a combination of three approaches in appraising real estate for market value: (1) the cost approach, (2) the sales comparison approach, and (3) the income capitalization approach. Usually, all three are employed in an appraisal, and the appraiser takes into account the inherent strengths of each as well as the nature of the subject property when making the final estimate of market value.

The cost approach is based on a determination of the cost of replacing a property, with adjustments for various forms of depreciation and obsolescence. The sales comparison approach compares the known sales prices of hotels that are similar to the subject hotel. The income capitalization approach capitalizes the anticipated earnings of the property in order to estimate its total value.

In theory, all three approaches result in the same value estimate. In practice, however, the value indicated by the income capitalization approach most closely reflects the type of analysis generally performed by typical buyers and sellers. The results from the cost and sales comparison approaches are generally used to support and verify the results of the income approach.

## » 13.02 COST APPROACH

The cost approach yields an estimate of market value by totaling the current cost of replacing a property. This is accomplished by determining the value of the land when vacant and available and combining it with the estimated cost to construct the improvements. For an existing hotel, depreciation, in the form of physical deterioration or functional or economic obsolescence, must be quantified and deducted from the replacement cost to estimate market value. For proposed hotels, the cost approach is compared with the market value conclusion by means of the income approach to determine project feasibility.

The cost approach may provide a reliable estimate of value for newly constructed properties not suffering from external obsolescence; as buildings and other forms of improvements age and depreciate, however, the resultant loss in value becomes increasingly difficult to quantify.

Knowledgeable buyers of lodging facilities generally base their purchase decisions on such economic factors as forecasted net income and return on investment. Since the cost approach does not reflect any of these income-related considerations but rather requires a number of subjective and unsubstantiated depreciation estimates, it is not commonly used as the primary process in a hotel valuation.

### [1] Replacement Cost

Replacement cost is simply the cost of developing a property similar to the subject property. The replacement cost of several elements must be combined to determine the total replacement cost for the subject property. These elements are: land value;
building construction cost; furniture, fixtures, and equipment (FF&E) cost; soft costs;
opening costs; and developer's costs.

The replacement cost for property improvements, which includes buildings, parking facilities, landscaping, and signage can be estimated with information provided by one of several construction cost services, such as Marshall Stevens, Boecke, or Dow. Other sources of replacement data include local building contractors and developers, architects, engineers, and professional cost estimators. Cost may be estimated by an amount per square foot of improvements (calculator method), as an amount per room, or as an amount per each building component (segregated method).

A developer will typically provide the appraiser with the budgeted development cost of a proposed hotel. As of the writing of this book, the construction of new limited-service and extended-stay hotels has resumed. The development of full-service hotels is not yet feasible in most markets throughout the United States. The valuation of a proposed extended-stay hotel is used as a case study throughout this chapter.

The main element of the replacement cost for property improvements is physical replacement construction cost. Exhibit 13-1 sets forth the estimated construction cost of a proposed extended-stay product, as provided by the developer.

**Exhibit 13-1 Estimated Construction Cost of Proposed Extended-Stay Product**

**Development Budget**

| **Cost Category** | **Amount** |
|---|---|
| **Land** | $1,235,000 |
| **Building** | |
| Construction Contract | 6,800,000 |
| Architectural and Engineering | 180,000 |
| Real Estate Taxes | 30,000 |
| Insurance | 38,000 |
| Permits | 620,000 |
| Contingency | 340,000 |
| **Furniture, Fixtures, and Equipment (FF&E)** | 1,755,000 |
| **Soft Costs** | |
| Legal and Clearing Costs | 110,000 |
| Feasibility and Appraisal | 40,000 |
| Financing Fees | 50,000 |
| Construction Interest | 352,000 |
| Pre-opening and Startup Costs | 225,000 |
| Working Capital | 100,000 |
| Operating Reserve | 325,000 |
| Development Fees | 600,000 |
| | 1,802,000 |
| | $12,800,000 |

A cost analysis performed by the appraiser through the use of Marshall Stevens indicates a basic improvement cost of $68.20 per square feet for the 99,483 square feet of the proposed improvements, yielding an estimated basic structure cost of $6,784,740, supporting the basic building cost estimate provided by the developer.

The replacement cost of the FF&E can be estimated through the use of a cost service or design company or by surveying hotel companies for their typical FP&E expenditure. The Uniform Franchise Offering Circulars (UFOCs) of hotel franchise companies also provide a good source for a range of FF&E costs of different lodging products. For a proposed project the replacement cost for FF&E can be determined by multiplying the amount of money budgeted per room for the proposed project by the final number of rooms in the facility. The FF&E cost for this proposed extended-stay hotel is $12,500 per room or a total of $1,755,000 for the 130 units of the project.

Soft costs include legal and closing expenses, fees for financing and other professionals, as well as construction interest. Pre-opening costs consist of the funds necessary to hire and train personnel prior to the hotel's opening, pre-market the property, and equip the hotel with inventories. Estimates of working capital and funds

for an operating reserve to cover any operational or debt service shortfalls during the initial years of operation can be based on the profile and total cost of the development.

If the project is to be franchised, the initial franchise fee must be included in the cost estimates. In addition, the developer's cost—the fee that must be paid to a developer for providing project administration—must be considered.

A developer's profit of 10 percent to 20 percent of total project cost inclusive or exclusive of land value has historically been included in the cost approach estimate developed by appraisers. In practice, many developers made little or no profit during the last construction cycle. There are differing theories regarding developer's profit, but it is generally accepted that developers require profit in order to do their job. The reality is that development opportunities are often scarce, and a reasonable developer's fee is considered adequate to compensate a developer. Often the development arm of a hotel management or ownership company is motivated by the profits it will garner through its on-going involvement with the property. The earning of management fees or the upside of return on owner's equity can be considered a developer's profit for the entity undertaking the project.

## [2] Land Value

The traditional method of estimating land value, through the review and analysis of comparable land sales, is generally the most accurate method of estimating land value for a particular site, but it is applicable only if enough relevant and recent data is available. Sales of land slated for hotel development are best analyzed in terms of price per room of the project proposed for the site. Comparably located and zoned sites can also be adjusted to the subject site to determine land value.

Because of the real estate depression of the early 1990s, few transactions of land purchased for hotel development occurred between 1990 through 1995. Land sales from the mid- to late-1980s are likely irrelevant in estimating land value today because of the dramatic change in market conditions since that time. The fact that land is worth something to someone only when it can be put to use explains why land values generally decline by a greater proportion than values of improved properties during a real estate downturn. Many markets in the United States are now experiencing the development of limited-service and extended-stay hotels, so land transactions for these projects are providing an indication of market value. However, because full-service hotel development is not yet feasible in many markets, land transactions are scarce for such projects. In the absence of land sales, two alternative approaches are useful in evaluating what a hotel site is worth.

### [a] Ground Lease Approach

When the existing or proposed hotel improvements represent the highest and best use of the property, the ground lease approach is an accurate method for estimating land value because it is readily supported by numerous self-adjusting comparables (e.g., hotels that are constructed on expensive land tend to generate higher rooms revenue), as well as the overall economics of the individual project.

During the past twenty-five years, hotels have been routinely constructed on leased land. Lease terms differ somewhat from hotel to hotel, but the basis for the rental calculation is usually tied to a percentage of the revenue generated by the hotel. By using the forecasted stabilized revenues for the subject property and applying a typical hotel ground lease rental formula, the appraiser determines the hotel's economic rental, or what can be termed the income attributed to the land. The land value

is then estimated by dividing the economic rental by an appropriate capitalization rate.

One advantage of this method is that rental formulas are tied directly to a percentage of revenue that inherently reflects both the locational attributes of the site (occupancy and rate) and the allowable density of development, so the resulting economic ground rental justly represents the greatest net return to land over a given period of time. This self-adjusting aspect is one of the main reasons for the reliability of the ground lease approach.

Recalculating a data base of lease formulas as a percentage of only rooms revenue results in a range of 3 percent to 4 percent for areas in the United States outside of California and Hawaii, and 4 percent to 7 percent within desirable areas of these two states. Some local submarkets will fall outside of these norms because of specific market conditions. Applying the ground rental percentage to an estimate of rooms revenue results in the net income attributable to the land. Applying an overall capitalization rate of 7 percent to 11 percent, depending on the market and location, results in a land value estimate.

Assume, for example, that the proposed hotel, were it open and stabilized today, could be expected to achieve a $92 average rate. Exhibit 13-2 sets forth a land estimate using the ground lease approach, a 1996 average rate of $92, a 3.5 percent ground rental percentage and a 9 percent capitalization rate.

**Exhibit 13-2 Ground Lease Approach**

| | |
|---|---:|
| Stabilized Average Rate ($ '96) | $92 |
| Days in the Year | 365 |
| Stabilized Occupancy | 80% |
| Projected Rooms Revenue Per Room | $26,864 |
| Ground Rent % | 3.5% |
| Projected Income Attributable to Land | $940 |
| Capitalization Rate | 9% |
| Estimated Land Value Per Room | $10,447 |

## [b] Land Residual Approach

An alternative method of estimating a hotel site's value is the land residual approach. This method, if used with accurate variables, is the most appropriate for determining what the developer can afford to pay for the land for a specific project. A market feasibility study is performed to estimate what the economic value of the hotel will be once it is open and operational. The development costs of the hotel, including all soft costs (e.g., interest and pre-opening expenses, as well as a developer's fee) are estimated. A developer's profit may or may not be generated, depending on the project's profile and market conditions.

The amount by which the economic value of the hotel, based on projected future cash flow, exceeds the hotel's estimated development cost is what determines the net residual value to the land. In our example, the developer's consultants have estimated that the hotel will be worth $105,000 per room once it is open and operational in 1998. The developer estimates that the total development cost of the hotel, exclusive of land costs and a developer's profit, will be $89,000 per room. The residual value of the land and developer's profit is equal to the value of the total project upon completion of $105,000 per room less the project's development cost of $89,000 per

room, or $16,000 per room. Assuming a developer's profit of 10 percent of the project cost exclusive of land value raises the total project cost to $98,000, leaving a residual to the land of $105,000 less $98,000 or $7,000 per room. Reducing the developer's profit to 5 percent raises the residual value of the land to $11,500.

Applying these two approaches to our example results in an estimate of land value ranging from $7,000 to $11,500, or 7.1 percent to 11.7 percent of total project cost. For this case study, we will conclude at the value derived by means of the ground lease approach, $10,500 per room or a total of $1,235,000. Once the hotel has been developed, the value of the land component may rise to represent a greater proportion of total value. However, the challenging economics of hotel development will likely reduce land values to below the traditional range of 10 percent to 20 percent of total project cost for the near term. While the choice of variables used in such an analysis is subjective, a careful consideration of the attributes of the market, the proposed project, and the site can lead to a prudent analysis and conclusion. Developers attempting to build new hotels should be careful not to pay too much for the land component in this current economic environment of low inflation and slim developer profits.

## » 13.03 SALES COMPARISON APPROACH

The sales comparison approach is used to estimate the value of a property by comparing it with similar properties recently sold in the open market. To obtain an accurate estimate of value, the sales price of a similar property must be adjusted to reflect any differences between it and the subject property,

During the early 1990s, hotel sales transactions were scarce. The lack of data made this approach difficult to apply in the valuation process. In 1994 the market was revitalized, and sales activity picked up considerably. Today, hotel investors and developers keep current on hotel sales transactions, looking for the dollar amount per room for which a hotel has transacted and the capitalization rate at which the hotel has sold. Historical fiscal year, trailing twelve-month or first forecasted year net income before depreciation and income taxes but after deducting management fee and a reserve for replacement, is divided by the sales price to derive the capitalization rate. While these indicators are of interest to participants in the hotel industry, they do not serve as a basis for their own valuation conclusions regarding a specific project because of inherent limitations in the sales comparison approach.

The sales comparison approach can provide a usable value estimate for simple forms of real estate, such as vacant land and single-family homes, where the properties are homogeneous and adjustments are few in number and relatively simple to compute. However, for larger and more complex investments such as shopping centers, office buildings, and hotels, where the adjustments are numerous and difficult to quantify, the sales comparison approach becomes considerably less reliable,

As with the cost approach, hotel investors typically do not use the sales comparison approach to reach final purchase decisions. Various factors, such as the lack of timely hostelry data, the number of insupportable adjustments, and the difficulty involved in determining the true financial terms and human motivations of comparable transactions, usually render the results of the sales comparison approach somewhat questionable. The sales comparison is best used as a means of providing a range of values that bracket and support the income capitalization approach. Any reliance on its results, however, beyond the establishment of broad generalizations, is not normally justified by the quality of data.

The market-derived capitalization rates used by some appraisers (which rely on data derived from the sales comparison approach) are susceptible to the same shortcom-

ings inherent in the sales comparison approach itself. To substantially reduce the reliability of the income capitalization approach by employing capitalization rates obtained from unsupported market data not only weakens the final estimate of value but also ignores the normal investment analysis procedures employed by typical hotel purchasers.

## » 13.04 INCOME CAPITALIZATION APPROACH

Appraisers and participants in the hotel industry use the income capitalization approach to value property by analyzing the local market for transient accommodations, examining existing and proposed competition and developing a forecast of income and expense that reflects current and future anticipated income trends and area cost components up through a stabilized year of operation or for a specific holding period.

The forecast of income and expense is expressed in current dollars as of the date of each forecasted year. The stabilized year reflects the anticipated operating results of the property over its remaining economic life, including the normal stages of buildup, plateau, and decline. A stabilized year level of occupancy and average rate should inherently take into consideration normal economic fluctuations that cause cyclical increases and decreases in the net income of a hotel investment. Any abnormal transitory or nonrecurring conditions that result in unusual revenue or expenses for the property are excluded from consideration in the selection of a stabilized year of operation.

The forecast of income and expense is then converted into a value through an income capitalization process that reflects the rate of return required by market participants. One of the considerable benefits of real estate ownership is that the investment may be leveraged (i.e., the buyer may finance a major portion of the purchase price and therefore significantly increase the yield on the equity invested in the project. One year of forecasted net income may be capitalized into an estimate of market value if the hotel's upside potential and downside risks can be adequately reflected through a single-year forecast. The overall capitalization rate applied to the net income may be derived from the market (i.e., calculated by dividing the historical or forecasted net income of a hotel that has recently been sold by the sales price). Since such a method is rarely reliable because of the numerous conditions affecting net income and transaction prices, an alternative method—the band of investment method—is often used. The band of investment is a calculation of the weighted cost of capital. The debt component, typically representing 50 percent to 75 percent of an investment, and the equity component, representing the remainder of the purchase price, are weighted at their respective rates of return. The resultant capitalization rate is divided into the forecasted net income to derive an estimate of market value.

Hotels, because of their large business and personal property components, are typically in some form of transition. Buyers generally look to enhance the value of the hotel they are acquiring by physically improving or changing the management of the property. Hotel markets are also often in flux because of additions to supply and changes in the make-up of existing supply. For these reasons, a multi-year forecast of income and expense is generally preferred to reflect future fluctuations in occupancy, average rate, and net income. Ten-year forecasts have become the norm for real estate valuations, because they represent typical holding periods and are used to analyze and value other real estate investments that require complete lease rollovers to accurately reflect market rents. A multi-year forecast of net income may be converted into an estimate of market value through a discounted cash flow analysis whereby the net income forecasted for the ten-year holding period plus the net sales proceeds at the end of the holding period are discounted back to the date of value by an appropriate discount rate. One overall discount rate that considers the varying costs of cap-

ital used in the market may be derived through surveys of market participants or through an analysis of actual sales. This simple discounted cash flow model may be further refined through the use of a mortgage-equity technique that considers the different cost of capital required by the debt and equity components.

Because of the compounding inherent in rates of return required over multi-year holding periods, the simple weighted cost of capital utilized in the band of investment is mathematically inaccurate for the development of an overall discount rate that accurately reflects the debt and equity components of an investment.

To estimate the value of the subject property, we have used a ten-year discounted cash flow analysis in which the cash flow to equity and the equity reversion are discounted to the present value at the equity yield rate, and the income to the mortgagee is discounted at a mortgage interest rate. The sum of the equity and mortgage values is the total property value. To convert the forecasted income stream into an estimate of value, the anticipated net income (before debt service and depreciation) is allocated to the mortgage and equity components on the basis of market rates of return and loan-to-value ratios. The sum of the mortgage component and the equity component equals the value of the property. The process of estimating the value of the mortgage and equity components is as follows.

1. The terms of typical hotel financing are set forth, including interest rate, amortization term, and loan-to-value ratio.
2. An equity yield rate of return is established. Numerous hotel buyers base their equity investments on a ten-year equity yield rate projection that takes into account ownership benefits such as periodic cash flow distributions, residual sale or refinancing distributions that return any property appreciation and mortgage amortization, income tax benefits, and various nonfinancial considerations (e.g., status and prestige). The equity yield rate is also known as the internal rate of return on equity.
3. The value of the equity component is calculated by first deducting the annual debt service from the forecasted net income before debt service, leaving the net income to equity for each projection year. The net income as of the eleventh year is capitalized into a reversionary value. After deducting the mortgage balance at the end of the tenth year and the typical brokerage and legal costs, the equity residual is discounted back to the date of value at the equity yield rate. The net income to equity for each of the ten projection years is also discounted to the present value. The sum of these discounted values is the value of the equity component. Adding the equity component to the initial mortgage balance yields the overall property value.

   Because the mortgage and the debt service amounts are unknown but the loan-to-value ratio was determined in step 1, the preceding calculation can be solved through an iterative process or by use of a linear algebraic equation that computes the total property value.
4. The value is proven by allocating the total property value between the mortgage and equity components and verifying that the rates of return set forth in steps 1 and 2 can be met from the forecasted net income.

## [1] Mortgage Component

Data for the mortgage component is generally developed from statistics pertaining to actual hotel mortgages made by long-term permanent lenders. The American Council of Life Insurance, which represents twenty large life insurance companies, publishes

quarterly information pertaining to the hotel mortgages issued by its member companies. Exhibit 13-3 summarizes the average mortgage interest rate of the hotel loans made by these lenders. The AA utility bond yield as reported by Moody's Bond Record is shown for purpose of comparison.

**Exhibit 13-3 Typical Hotel and Motel Mortgage Rates**

*Source: American Council of Life Insurance; Moody's Bond Record*

| Year | Average Interest Rate | Average AA Utility Bonds |
|---|---|---|
| 1995 | 8.94 | 7.77 |
| 1994 | 9.50 | 8.22 |
| 1993 | 9.13 | 7.44 |
| 1992 | 9.73 | 8.55 |
| 1991 | 10.42 | 9.09 |
| 1990 | 10.53 | 9.65 |
| 1989 | 10.11 | 9.56 |
| 1988 | 10.27 | 10.31 |
| 1987 | 9.94 | 9.77 |
| 1986 | 9.83 | 9.30 |

(Data not shown for limited number of loans.)

The average interest rate of a hotel mortgage and the concurrent yield on an AA utility bond have a close mathematical relationship. Through regression analysis, this relationship is expressed as follows:

$$Y = 2.9040 + 0.77650X$$

where Y = Estimated hotel/motel mortgage interest rate
X = Current average AA utility bond yield (coefficient of correlation is 95.5%).

If, for example, the current yield on AA utility bonds, as reported by Moody's Bond Record, is 7.68 percent, the equation produces an estimated hotel/motel interest rate (Y) of 8.9 percent.

In addition to the mortgage interest rate estimate derived from this regression analysis, the terms of hotel mortgage loans made by institutional lending clients are constantly monitored. There has been a significant increase in the availability of debt financing since 1994, though one would not yet characterize capital as "free flowing" for hotel investments, particularly for new construction. Projects are able to secure mortgage financing at interest rates ranging from 8 percent to 11 percent, depending on the location, affiliation, and operator, and loan-to-value ratio. Underwriting is much stricter than it was during the 1980s, and lenders are looking for minimum debt coverage ratios of 1.4, and loan-to-value ratios rarely exceed 65 percent. Amortization schedules have also decreased from the thirty-year norm prevalent during the 1980s to anywhere from ten to twenty-five years, with twenty years being the most prevalent. Lenders are now more aware of the short life cycles and high risks associated with hotel investments and thus are requiring that debt be retired more rapidly than in the past.

For the proposed extended stay property, we have assumed that a 9.00 percent interest, twenty-year amortization mortgage with a 0.109769 constant, and a 65 percent loan-to-value ratio is appropriate,

## [2] Equity Component

Additional capital required for a hotel investment is generally supplied by an equity investor. The rate of return that an equity investor expects over a ten-year holding period is known as equity yield. Unlike the equity dividend, which is a short-term rate of return, an equity yield specifically considers a long-term holding period (generally ten years), annual inflation-adjusted cash flows, property appreciation, mortgage amortization, and proceeds from a sale at the end of the holding period.

It is difficult to quantify the rate of return required by equity investors seeking to purchase hotel properties. To establish an appropriate equity yield rate, two important sources of data are past appraisals and investor interviews.

### [a] Past Appraisals

Appraisers can derive equity yield rates from the market when they appraise hotels that sell on or about the time at which they are appraised. In the case of hotels that were actually sold after appraisal, it is possible to determine an appropriate equity yield rate by inserting the projection into a valuation model and adjusting the appraised value to reflect the actual sales price by modifying the return assumptions. Exhibit 13-4 shows a representative sample of hotels that were sold shortly after they were appraised, along with the imputed equity dividend and equity yield returns based on the valuation approach.

**Exhibit 13-4 Summary of Derived Rates and Yields**

| Hotel | City and State | Date of Sale | Overall Rate (%) | Total Property Yield (%) | Equity Yield (%) |
|---|---|---|---|---|---|
| Warner Center Marriott | Woodland Hills, CA | 12/95 | 9.1 | 11.7 | 14.8 |
| Westin Bonaventure | Los Angeles, CA | 12/95 | 1.9 | 17.8 | 24.2 |
| Hilton at the Club | Pleasanton, CA | 12/95 | 10.5 | 13.4 | 17.0 |
| The Plaza | New York, NY | 6/95 | 7.0 | 11.0 | 14.0 |
| Residence Inn | Baton Rouge, LA | 6/95 | 12.7 | 14.8 | 21,2 |
| Residence Inn | Overland Park, KS | 6/95 | 8.9 | 14.7 | 20.8 |
| Residence Inn | Des Moines, IA | 6/95 | 9.8 | 14.1 | 19.6 |
| Residence Inn | Hunt Valley, MD | 6/95 | 12.3 | 13.6 | 18.3 |
| Residence Inn | Kansas City, MO | 6/95 | 10.4 | 13.2 | 19.8 |
| Residence Inn | Lincoln, NE | 6/95 | 10.0 | 13.7 | 18.5 |
| Fullerton Suites | Fullerton, CA | 5/95 | 12.9 | 18.7 | 28.5 |
| Savoy Hotel | San Francisco, CA | 3/95 | 5.8 | 14.4 | 19.6 |
| Marriott Fisherman's Wharf | San Francisco, CA | 12/94 | 10.8 | 13.4 | 19.4 |
| Sheraton Inn | Napa, CA | 12/94 | 8.9 | 13.7 | 19.8 |

Exhibit 13-4 Summary of Derived Rates and Yields *(cont.)*

| Date of Hotel | City and State | Sale | Overall Rate (%) | Total Property Yield (%) | Equity Yield (%) |
|---|---|---|---|---|---|
| Marriott Hotel | Portland, OR | 12/94 | 12.9 | 17.4 | 30.0 |
| Radisson Inn | Springfield, MO | 12/94 | 8.2 | 10.1 | 11.3 |
| Williamsburg Hilton | Williamsburg, VA | 12/94 | 15.4 | 19.0 | 32.0 |
| Marriott Tech Center | Denver, CO | 12/94 | 13.7 | 16.4 | 27.1 |
| Holiday Inn Sunspree | Singer Island, FL | 12/94 | 8.6 | 10.6 | |
| Sheraton Hotel | Hasbrouck Heights, NJ | 11/94 | 18.3 | 21.1 | 30.7 |
| Marriott East Side | New York, NY | 10/94 | 8.5 | 9.7 | 11.1 |
| Marriott Resort | Vail, CO | 10/94 | 14.2 | 18.9 | 30.5 |
| Radisson Mark Resort | Vail, CO | 9/94 | 8.9 | 15.8 | 24.1 |
| Marriott SFO | Burlingame, CA | 8/94 | 10.2 | 13.2 | 19.0 |
| Best Western Otay Valley Inn | Chula Vista, CA | 7/94 | 13.2 | 21.1 | 31.8 |
| Sheraton Hotel | Cypress Creek, FL | 7/94 | 9.0 | 13.3 | 19.4 |
| Hampton Inn | Islandia, NY | 7/94 | 12.6 | 16.6 | 28.2 |
| Hampton Inn | Willow Grove, PA | 7/94 | 11.0 | 14.3 | 23.0 |
| Hampton Inn | West Palm Beach, FL | 7/94 | 10.8 | 10.8 | 14.3 |
| Hampton Inn | Naples, FL | 7/94 | 11,4 | 11,5 | 24.9 |
| Hampton Inn | Albany, NY | 7/94 | 9.3 | 11.5 | 24.9 |
| Westin Kauai | Lihue Kauai, HI | 6/94 | (1.9) | 8.1 | 7,2 |
| Residence Inn | Binghamton, NY | 6/94 | 10.8 | 13.9 | 21.9 |
| Hotel Millenium | New York, NY | 6/94 | 9.5 | 14.1 | 23.0 |
| Radisson Inn | Orlando, FL | 5/94 | 12.9 | 18.0 | 28.2 |
| Newark-Fremont Hilton | Newark, CA | 5/94 | 8.8 | 14.9 | 20.7 |
| Best Western Fireside Inn | Cambria, CA | 4/94 | 11.7 | 15.8 | 24,3 |
| Checkers Hotel Kempinski | Los Angeles, GA | 4/94 | 3.0 | 18.3 | 27.0 |
| Phoenician Resort | Phoenix, AZ | 4/94 | 6.6 | 9.3 | 8.9. |
| Crescent Hotel | Phoenix, AZ | 3/94 | 6.5 | 7.2 | 2.2 |
| Holiday Inn | Edison, NJ | 3/94 | 6.5 | 7.2 | 2.2 |
| Ritz-Carlton | Phoenix, AZ | 2/94 | 11.0 | 14,6 | 21.7 |
| Sir Francis Drake | San Francisco, CA | 12/93 | 7.7 | 16.9 | 25.6 |
| Omni Chicago | Chicago, IL | 9/93 | 8.5 | 14.3 | 20.4 |
| Seven Peaks Excelsior Hotel | Provo, UT | 8/93 | 8.7 | 15.3 | 20.7 |
| Airport Marriott | Long Beach, GA | 7/93 | 14.7 | 18.5 | 30.1 |
| Doubletree Hotel | Salt Lake City, UT | 7/93 | 10.4 | 16.5 | 26.5 |
| Radisson Pan American | Miami, FL | 5/93 | 8.3 | 12.0 | 17.1 |
| Hyatt Hotel Airport | Atlanta, GA | 4/93 | 8.0 | 10,7 | 11.7 |

### [b] Investor Interviews

Institutional and individual hotel investors, as sources of equity funds, have definite return requirements that can be expressed as an equity yield rate based on a ten-year projection of net income before incentive management fees but after debt service. Based on surveys and investor interviews, Exhibit 13-5 is an illustration of the equity yield requirements of a cross-section of hotel investors.

**Exhibit 13-5 Surveys and Investor Interviews**

| Source of Equity | Equity Yield Requirements |
|---|---|
| Private Placement | 20%–24% |
| Institutional | 18%–22% |

Upward adjustments are indicated where expense and/or revenue projections substantially deviate from historical data, proposed properties, properties located in seasonal markets (which increase cash flow volatility), leasehold interests, properties located in very small markets, older hotels, properties that rely on only a few demand generators or cyclical demand generators, properties in areas that lack economic diversification, properties or markets that are particularly dependent on one demand segment, and properties located in areas characterized by a declining population and employment base. An upward adjustment is also indicated when a property has the potential to lose its franchise, when rooms revenue constitutes a small portion of total revenue, and when the penetration rate is high, to reflect its vulnerability.

Downward adjustment of the yield rate is indicated in primary market areas or hotels located in markets that have strong barriers to entry (making new supply unlikely beyond the stabilized year). Factors considered indicative of new competition include strong areawide occupancy and average rate levels and the availability of vacant land with favorable zoning and pricing.

Given an assumed 65 percent loan-to-value ratio, which is the risk inherent in achieving the projected income stream and anticipated market position of the subject property, it is likely that an equity investor would require an equity yield rate of 20 percent before payment of incentive management fees. This estimate is well supported by the equity yield requirements presented previously.

## [3] Terminal Capitalization Rate

Inherent in the valuation process is the assumption of a sale at the end of the assumed ten-year holding period. The estimated reversionary sales price at that time is calculated by capitalizing the projected eleventh year's net income by an overall terminal capitalization rate. From this sales price, a percentage is deducted for the seller's brokerage and legal fees. The net proceeds to the equity interest (also known as the equity residual) are calculated by deducting the outstanding mortgage balance from the reversion.

In estimating the residual value of a property, the appraiser must select a terminal capitalization rate and an allocation for brokerage and legal fees. The terminal capitalization rate is an overall rate applied to one stabilized year; it thus incorporates the cost of debt and equity capital. The terminal capitalization rate can be derived through a mortgage equity band of investment technique, which calculates the weighted average cost of the capital used in a hotel investment. Exhibit 13-6 com-

bines the previously derived mortgage financing terms (a 65 percent loan-to-value ratio and a 0.109797 debt service constant) with a cash-on-cash equity dividend rate of 9 percent to calculate an overall capitalization rate.

**Exhibit 13-6 Calculating an Overall Capitalization Rate**

| | Percent of Value | | Rate of Return | Weighted Average |
|---|---|---|---|---|
| Mortgage | 0.65 | x | 0.1070797 | 0.07018 |
| Equity | 0.35 | x | 0.09000 | 0.03150 |
| Overall Capitalization Rate | | | | 0.10168 |

Because the overall rate will be used to capitalize net income ten years from the date of value, an upward adjustment is appropriate to reflect the uncertainty inherent in this extended time period. For the purpose of this valuation, an 11 percent terminal capitalization rate will be used.

As a point of reference, the terminal capitalization rate may be compared with the going-in rate implied by the value estimated for the subject property. The going-in rate reflects the capitalization rate that would be applicable if a hotel were operating at a stabilized level as of the date of value. This rate is calculated by dividing the stabilized net income, expressed in current dollars as of the date of value, by the value indicated by the income capitalization approach. Generally, the terminal capitalization rate is approximately 100 to 200 basis points above the going-in rate.

## [4] Valuation of Mortgage and Equity Components

Up to this point in the analysis, a number of objective decisions and some subjective evaluations of market data have been made; the remainder of the valuation analysis is purely mathematical. An algebraic formula equation calculates the amount of debt and equity that the hotel will be able to support given the anticipated cash flow derived from the forecast of income and expense and the specific return requirements of the mortgage lender (interest) and the equity investor (equity yield). As an alternative to an algebraic formula, the value (based on the previously defined terms) may be calculated on an iterative basis, as described in the proof of value that follows.

The process of solving for the value of the mortgage and equity components begins by deducting the annual debt service from the projected income before debt service, leaving the net income to equity for each year. The net income as of the eleventh year is capitalized into a reversionary value using the terminal capitalization rate. The equity residual, which is the total reversionary value less the mortgage balance at that point in time and less any brokerage and legal costs associated with the sale, is discounted to the date of value at the equity yield rate. The net income to equity for each projection year is also discounted back to the date of value. The sum of these discounted values equals the value of the equity component.

The amount of the mortgage and the debt service are unknown; however, the terms and loan-to-value ratio of current financing applicable to the subject property have been derived. The annual debt service and resultant net income to equity cannot be calculated without knowing the property's total value, the very unknown that we are attempting to calculate. In essence, the property's value must be determined by forecasting the net income available for debt service, and by calculating, through an iterative or algebraic process, the mortgage amount that the net income is capable of

supporting at the assumed interest rate and a specified loan-to-value ratio. This process computes total property value on the basis of market-derived mortgage and equity return requirements.

A proof of value is established by allocating the total property value between the mortgage and equity components and verifying that the rates of return set forth can be met from the projected net income. Using a computerized mortgage/equity model to perform the necessary iterative calculations results in the following estimate of value.

The value is proven by calculating the yields to the mortgage and equity components during the projection period. If the mortgage achieves its 9 percent yield and the equity yield is 20 percent, then $13,695,000 is the correct value by the income capitalization approach. Using the assumed financial structure set forth in the previous calculations, market value can be allocated between the debt and equity as follows:

| | |
|---|---|
| Mortgage Component (65%) | $8,902,000 + |
| Equity Component (35%) | $4,793,000 Total |
| $13,695,000 | |

The annual debt service is calculated by multiplying the mortgage component by the mortgage constant:

Mortgage Component ($8,902,000) X Mortgage Constant (0.107967) = $961,123

The cash flow to equity is calculated by deducting the debt service from the projected net income before debt service, as shown in Exhibit 13-7.

**Exhibit 13-7 Cash Flow to Equity Calculation**

| Year | Net Income Available for Debt Service | | Total Annual Debt Service | | Net Income to Equity |
|---|---|---|---|---|---|
| 1997 | $1,124,000 | – | $961,000 | = | $163,000 |
| 1998 | 1,418,000 | – | 961,000 | = | 457,000 |
| 1999 | 1,663,000 | – | 961,000 | = | 692,000 |
| 2000 | 1,709,000 | – | 961,000 | = | 748,000 |
| 2001 | 1,769,000 | – | 961,000 | = | 808,000 |
| 2002 | 1,833,000 | – | 961,000 | = | 872,000 |
| 2003 | 1,898,000 | – | 961,000 | = | 937,000 |
| 2004 | 1,962,000 | – | 961,000 | = | 1,001,000 |
| 2005 | 2,032,000 | – | 961,000 | = | 1,071,000 |
| 2006 | 2,103,000 | – | 961,000 | = | 1,142,000 |

The equity residual at the end of the tenth year is calculated as follows:

Reversionary Value ($2,175,000/0.1100) = $19,773,000 - (Brokerage and Legal Fees (593,000) + Mortgage Balance (6,323,000)) = $12,857,000

Exhibits 13-8, 13-9, and 13-10 demonstrate that each of the components actually received their anticipated yields, providing that the $30,493,000 value is correct given the assumptions used in this approach.

**Exhibit 13-8 Total Property Value**

| Year | Net Income before Debt Service | | Present Worth of $1 Factor @ 14.1% | | Discounted Cash Flow |
|---|---|---|---|---|---|
| 1997 | $1,124,000 | x | 0.876490 | = | $985,000 |
| 1998 | 1,418,000 | x | 0.768234 | = | 1,089,000 |
| 1999 | 1,653,000 | x | 0.673349 | = | 1,113,000 |
| 2000 | 1,709,000 | x | 0.590184 | = | 1,009,000 |
| 2001 | 1,769,000 | x | 0.517290 | = | 915,000 |
| 2002 | 1,833,000 | x | 0.453399 | = | 831,000 |
| 2003 | 1,898,000 | x | 0.397400 | = | 754,000 |
| 2004 | 1,962,000 | x | 0.348317 | = | 683,000 |
| 2005 | 2,032,000 | x | 0.305296 | = | 620,000 |
| 2006 | 21,283,000* | x | 0.267589 | = | 5,695,000 |
| Total Property Value | | | | = | $13,694,000 |

*10th year net income of $2,103,000 plus net sales proceeds of $19,180,000

**Exhibit 13-9 Mortgage Component**

| Year | Total Annual Debt Service | | Present Worth of $1 Factor @ 8.9% | | Discounted Cash Flow |
|---|---|---|---|---|---|
| 1997 | $961,000 | x | 0.918465 | = | $883,000 |
| 1998 | 961,000 | x | 0.843578 | = | 811,000 |
| 1999 | 961,000 | x | 0.774798 | = | 745,000 |
| 2000 | 961,000 | x | 0.711625 | = | 684,000 |
| 2001 | 961,000 | x | 0.653603 | = | 628,000 |
| 2002 | 961,000 | x | 0.600311 | = | 577,000 |
| 2003 | 961,000 | x | 0.551365 | = | 530,000 |
| 2004 | 961,000 | x | 0.506410 | = | 487,000 |
| 2005 | 961,000 | x | 0.465120 | = | 447,000 |
| 2006 | 7,284,000* | x | 0.427196 | = | 3,112,000 |
| Value of Mortgage Component | | | | | $8,904,000 |

*10th year debt service of $961,000 plus outstanding mortgage balance of $6,323,000

**Exhibit 13-10 Equity Component**

| Year | Net Income to Equity | | Present Worth of $1 Factor @ 20.0% | | Discounted Cash Flow |
|---|---|---|---|---|---|
| 1997 | $163,000 | x | 0.833322 | = | $136,000 |
| 1998 | 457,000 | x | 0.694426 | = | 317,000 |
| 1999 | 692,000 | x | 0.578681 | = | 400,000 |
| 2000 | 748,000 | x | 0.482227 | = | 361,000 |
| 2001 | 808,000 | x | 0.401851 | = | 325,000 |
| 2002 | 872,000 | x | 0.334871 | = | 292,000 |
| 2003 | 937,000 | x | 0.279056 | = | 261,000 |
| 2004 | 1,001,000 | x | 0.232543 | = | 233,000 |
| 2005 | 1,071,000 | x | 0.193784 | = | 208,000 |
| 2006 | 13,999,000* | x | 0.161484 | = | 2,261,000 |
| Value of Equity Component | | | | | $4,794,000 |

*10th year net income to equity of $1,142,000 plus sales proceeds of 12,857,000

## » 13.05 BREAK-EVEN ANALYSIS

A break-even analysis identifies the point at which the level of sales for a lodging facility produces neither a profit nor a loss from operations. Basically, for hotels and motels the break-even point is the occupancy level at which all cash outlays necessary for the operation can be met. The break-even point can be established either before or after debt service, although most lenders require a calculation of the break-even point after debt service to determine the security of their loan.

The break-even occupancy level can be estimated by using a computerized analysis of the fixed and variable components of revenue and expense items. Programs have been written that are able to take an achievable occupancy percentage (and the corresponding operating ratios) established by an appraiser for a subject property and, through a series of steps, drop the occupancy level and automatically adjust the operating ratios to reflect the lower revenues that would be achieved. The calculations continue until the break-even point for occupancy, before and after debt service, is attained. The appraiser then compares the break-even figures with those for the projected stabilized year for the subject property in order to determine whether there is enough leeway to cover debt service during low points in the occupancy cycle.

## » 13.06 FEASIBILITY

The key to determining the economic feasibility of a lodging facility is the value estimate derived from the income capitalization approach. A new hotel is feasible if the economic value of the hotel as determined by the income capitalization approach exceeds the total replacement cost for the facility by a wide enough margin so as to provide the developer and the investors in the project with a satisfactory profit.

The same type of feasibility analysis is carried out each time a hotel is bought or sold. Essentially, the buyer performs an analysis based on the income capitalization approach and establishes a maximum price that he or she is willing to pay. If the

selling price demanded by the seller is less than the value set by the buyer's analysis, the deal is made.

## » 13.07 PROPERTY TAX ASSESSMENTS FOR HOTELS AND MOTELS

Among the significant expenses incurred by hotels are the property taxes paid to local municipalities. Because hotel owners may pay as much as 8 percent of their total revenue in real estate taxes, hotel owners and operators should constantly monitor their hotels' tax assessments to ensure that their property tax burden is kept to a minimum.

Property taxes are levied by municipalities to generate revenues to pay for essential government services. The purpose of real estate taxes is to allocate the municipal tax burden on the basis of real estate value. The higher the value of the real estate owned by a taxpayer, the larger the proportion of the tax burden the individual must assume. The concept underlying this tax is known as ad valorem, or in proportion to value. To establish the proper distribution of the tax burden, municipalities employ tax assessors to value all the taxable property within their jurisdiction. Theoretically, the assessed value of a property should bear a definite relationship to market value, so that properties of equal market value have similar assessments and properties of higher or lower value have proportionally larger or smaller assessments.

### [1] Estimation of Market Value

The goal of the entire property tax assessment process is the accurate estimation of market value. This goal is fairly easy to achieve for real estate such as vacant land and single-family homes. However, the issues involved in developing a supportable estimate of value for more complex properties become highly complex. Leading the list of property types that are difficult to value for assessment purposes are hotels and motels. Assessors must understand that lodging facilities comprise more than the traditional property components of land, bricks, and mortar; they are retail-oriented, labor-intensive businesses necessitating a high level of managerial expertise. In addition, hotels require a significant investment in personal property (furniture, fixtures, and equipment) that has a relatively short useful life and is subject to rapid depreciation and obsolescence. Characteristics specific to lodging facilities must be taken into consideration during the hotel assessment process in order for an accurate value assessment to be determined.

### [2] Improvement Value Evaluation

Hotel owners should monitor their property assessments on an ongoing basis to ensure that a favorable assessment relationship with other hotels in the taxing jurisdiction is maintained. This can be accomplished by evaluating the assessed values of all comparable hotels within the local market area. Assessors generally provide separate values for land and improvements. Since it is usually difficult to successfully appeal the land portion of the assessment, only the improvement value portion of the property assessment must be evaluated.

The first step in the evaluation process is equalizing the improvement assessment by using a common unit of comparison, which for a hotel is the assessed value per available room (i.e., the improvement assessment divided by the room count). The assessed values (per room) of all the comparable hotels are then compared with the

owner's to determine whether the properties have been fairly assessed relative to each other. Adjustments related to differences such as quality of facilities, number and types of amenities, product class, and markets served should be considered. At this point in the analysis, owners should be looking for glaring discrepancies between the assessed value of their property and that of other hotels in the market area.

Comparing the assessed values of hotels within a taxing jurisdiction by means of this technique only pinpoints inequities between hotel assessments; it does not verify that the assessed value placed on a property is fair relative to its market value or the value of other types of real estate.

To evaluate the relationship between a property's market value and its assessed value, hotel owners should use the income capitalization approach, as previously set forth in this section, to aid in determining a fair assessment of the value of their lodging facility.

HVS

CHAPTER 14

# Investment Strategies


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## » 14.01 REASONS FOR INVESTING

The following is a list of reasons to invest in hotel real estate:

1. Hotel real estate is typically countercyclical to stocks and bonds and provides portfolio diversification.
2. Hotels are an inflation hedge because hotel rates can be adjusted daily, within the constraints of market conditions.
3. Hotel real estate provides a refinancing opportunity that can generate tax-free return of capital from appreciating assets. Mortgage amortization also creates equity.
4. Hotel investing can be tax efficient because of associated depreciation and amortization write-offs.

5. Hotel real estate provides a competitive total return, and includes a current income component.
6. Hotel real estate is less volatile than equities.
7. Real estate is the single largest asset class available for investment.
8. Travel and tourism is the world's largest employer and industry. According to the Wharton Economic Forecasting Associates Group (WEFA), travel and tourism accounts for 10.2 percent of global gross domestic product, or $2.6 trillion; 183 million employees or one in every ten workers; 11.2 percent of capital investment (US $613 billion) and 11.0 percent of consumer spending worldwide. Travel and tourism is expected to increase over the next ten years.

## » 14.02 HISTORICAL PERSPECTIVE

Rarely can an investor or company succeed through imitation or cost cutting. Creativity is necessary. However, creativity usually does not mean a truly new or revolutionary idea. What is generally needed is a new combination of ideas, an extrapolation of what is already known. This chapter reviews the recent history of the hotel industry from the perspective of hotel investment, describes the investment objectives that hotel real estate is most suited to achieve, and, finally, develops a series of investment guidelines.

The various participants in a typical hotel investment do not usually have the same goals or interests. Most participants, with the exception of the owner, are geared toward up-front fees, short-term benefits, and maximizing annual fees based on total revenue rather than toward profitability of the asset. The following sections consider the goals of some of the participants in the traditional hotel investment.

### [1] Hotel Chains and Management Companies

In the early 1960s, companies such as Hilton and Sheraton created management contracts as a means of expanding into overseas markets. Once the viability of management contracts as an expansion vehicle was demonstrated, most US hotel groups emulated this strategy during the 1970s and the 1980s to capitalize on the advantages of third-party ownership. These management contracts featured up-front pre-opening fees and annual base management fees, generally ranging from 3 percent to 4 percent of total revenue. While many of these contracts included provisions for an incentive management fee, some management companies had no expectations of ever realizing them. The 3 percent to 4 percent base management fee, in many cases, was sufficient to allow management companies to realize a 50 percent net operating income after all operating and fixed charges.

The revenue-based (as opposed to profit-based) fees led to a continual upgrading of a chain's amenities and services, which increased revenue (and the fees) but not necessarily profits for the owner. Most of these management contracts lasted for long periods of time (more than twenty years) and did not provide any performance clauses or mechanisms for replacing inappropriate or incompetent operators.

As the real estate industry expanded in the 1980s, both foreign and US hotel groups were pursued by investors and owners in what was generally regarded as a "sellers' market" for management companies. Today, however, there is much competition between and among hotel groups and other management companies, and the market has turned in favor of the buyer of management services.

## [2] Developers, Syndicators, and Architects

The short-term goal of developers during the 1960s and 1970s was to earn an up-front development fee or profit. Limited partners, brought into a deal by a fee-taking syndicator, were motivated primarily by tax write-offs. Their short-term goal was to shelter personal income with accelerated depreciation write-offs. Architects, frequently unburdened by such tedious concerns as economic budgets, designed properties that satisfied the egos of developers and provided syndicators with a salable image. Property amenities, room sizes, and construction quality increased (only partly as a result of a more competitive environment), whereas consumers' willingness to pay for these improvements did not rise at the same rate.

## [3] Lenders

The desire of savings and loans to compete with commercial banks, their new authority to lend money to nonresidential borrowers, and their desire to increase volume and achieve higher levels of fee income resulted in excessive financing during the 1980s. Many savings and loans made a profit with up-front points and fees, in addition to high interest rates on near 100 percent loan-to-value financing. Other underwriting deficiencies included the failure to obtain accurate independent and timely appraisals, and lenders operating with incomplete or nonexistent "in-substance" foreclosure rules. In-substance foreclosure occurs when the debtor has little or no equity remaining and loan repayment is doubtful but the mortgagee has not taken possession of the asset.

## [4] Highs and Lows

During the past nineteen years, occupancies peaked in 1979 at 72 percent and declined to 61 percent in 1987 and 1991. The average occupancy for the nineteen-year period from 1976 to 1994 was 65.7 percent. The average occupancy in 1995 was 65.5 percent. With the exception of the five-year period from 1988 to 1992, room rate growth has exceeded inflation for the twenty-year period from 1976 to 1995, demonstrating that hotel investments, unlike stocks and bonds, are a good inflation hedge (countercyclical), and a good investment for inflationary economies. In 1970, only 35 percent of US hotels were chain affiliated. **By** 1995, roughly 75 percent of US hotels were chain affiliated.

Hotels are retail-oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. The hotel industry is cyclical, event sensitive, and volatile. Hotels can be high-risk investments, especially if the management company, developer, syndicator, architect, and lender do not have congruent interests and goals. As a result of divergent interests among these participants, many hotels have been built in markets that did not need additional hotel capacity, and at escalated costs resulting from up-front fees, which meant that while many hotels were not profitable, many of the participants in hotel deals made money, at the expense of the hotel owner.

The US lodging industry during the 1980s was characterized by a massive building boom (product segmentation), favorable tax laws (syndication), strong economy, a rising stock market, extremely strong capital markets with declining interest rates, significant increase in hotel debt levels, and foreign participation (globalization), which drove up purchase prices. Net interest payments increased from less than 7 percent of total revenue during the late 1970s and early 1980s to more than 14 percent by 1991.

From mid-1990 to late-1993, the US lodging industry suffered through a worldwide recession and was further hurt by the junk-bond market collapse in late 1990, the Persian Gulf war in early 1991, illiquidity in the capital markets, and overbuilding. Overseas lenders and investors substantially reduced their activity in the US, and the Financial Institution, Recovery, Reform and Enforcement Act of 1989 (FIRREA) required more stringent capital standards for thrift institutions,

In addition to the changes in lending policies mandated by FIRREA, many newly conservative institutions reduced new real estate funding levels as a response to large increases in their nonperforming real estate loans. Because banks and savings and loan associations had historically been the source for roughly half the financing for commercial properties, a material reduction in loan activity significantly affected real estate markets. The shortage of debt financing occurred at a time when many 1980s bullet loans and mini-perms were approaching maturity. According to a national accounting firm, more than $2 billion in hotel loans was delinquent or in the process of foreclosure as of September 1990. More than 40 percent of the mini-perms and construction loans held by US banks were scheduled to mature by the end of 1992.

Hotel values eroded considerably during the recession, and capable buyers typically dictated price and terms of a hotel sale. Sales of foreclosed hotel assets by the Resolution Trust Corporation and the Federal Deposit Insurance Corporation during the early 1990s, regardless of the poor condition of the capital markets, resulted in liquidation pricing. In short, the market favored hotel buyers.

The industry returned to profitability in 1993 through a reduction in interest (lender write-offs), payroll (downsizing), property taxes (lower values), and food and beverage expenses and reductions in management fees. In 1993, for the first time in five years, average rate increased at a rate greater than inflation. By late 1993, a flurry of activity in the market began as investors slowly realized that hotel values had hit the bottom of the cycle. It appears that in 1996 the greatest inflow of capital into the hotel industry in more than a decade will have occurred. From 1994 to today, a rising US stock market, favorable interest rates, an expanding economy, and a lack of new hotel supply (particularly in the full-service segment) have helped the hotel industry.

### [5] Current Environment

New full-service hotel construction in the US is currently inhibited because (1) development costs exceed value; (2) there is limited capital availability for new full-service construction, and (3) many projects require multi-year development lead times. Most industry sources do not expect significant new, full-service hotel construction in the US between now and 1999. Nationally, room starts have already increased 250 percent from 1993 (excluding Las Vegas casino starts—see Chapter 23) to 1995. Currently there is a shortage of decent hotels available for sale. At the same time, large pools of qualified potential buyers are seeking new acquisitions.

## » 14.03 VALUE DRIVERS: INDUSTRY FUNDAMENTALS VS. CAPITAL MARKETS

Capital availability is a prime determinant of values in the hospitality industry. Liquidity facilitates transactions and provides for price discovery. Without liquidity, small capital flows can move pricing.

While occupancy figures receive a lot of publicity, other factors, such as changes

in average rate, investor psychology, financial liquidity, and profitability ratios are also very important. Capital availability and cost affect returns more than industry fundamentals such as occupancy and average rate. Capital availability drives capitalization rates and new construction feasibility and therefore new supply. Supply changes have a higher correlation with capital availability than with demand. Unfortunately, supply growth does not necessarily correlate with demand growth. In the early 1980s, room starts nearly doubled, while occupancy was steadily declining from its 1979 high. The early 1990s crash was a result of a capital crash more than it was a result of a demand crash or overbuilding.

Real estate assets typically exhibit lower volatility (and consequently lower returns) than stocks or bond investments; however, in the short-term, a hotel's performance may vary more than other types of real estate with long-term leases. This variability dictates either longer potential holding periods to smooth out industry cycles or a market cycle timing approach, with the end result of potentially greater equity returns for hotel investments as compared to other real estate.

Hotels, perhaps more than any other type of real estate, display cyclical occupancy trends over the long term. New hotels are built either because of an abundance of capital or because growth in demand causes an increase in area-wide occupancy levels and attracts the attention of developers, lenders, hotel chains, and management companies. When the rate of new property construction outpaces growth in demand, overall occupancy levels decline while demand "catches up" and/or the least competitive facilities drop out of the market.

## » 14.04 INVESTMENT STRATEGIES

### [1] Timing the Market

Unlike stock investing, the best strategy for investing in hotel real estate is market cycle timing, not dollar-cost-averaging or holding for long time periods. Hotel real estate market cycles take years to change, while equities can change in a day. The Tax Reform Act of 1986 removed many of the tax benefits associated with real estate ownership that had assumed greater importance than sound economic underwriting. That the industry remained relatively strong for three to four years after the Act was passed demonstrates how easy it is for an astute investor to time the hotel real estate market.

The hotel real estate cycle historically is eight to twelve years long. The building boom of the early 1920s came to an end with the depression of the early 1930s. The REIT-induced real estate slump of the early 1970s was forgotten by the time of the peak of 1979 and the early 1980s. That peak ended in the early 1990s. Many investors that purchased hotels at or near the bottom of the 1970s cycle and sold in the early and mid-1980s realized large returns. Those investors that purchased hotel property in the early 1990s will earn huge returns when as they sell in 1996 and beyond.

The most prudent time for hotel acquisition, as demonstrated by the 1970s and 1990s real estate cycle, is not when the market is achieving strong occupancies and many new properties are under development, but rather when new construction has peaked and occupancies and average rates are improving.

### [2] Risk Avoidance

An approach that not only analyzes investment opportunities prospectively but also assesses potential risk complements this market cycle timing strategy. Controlling

downside risk maximizes portfolio yields, in the same way that the baseball batter that consistently hits doubles and triples will outperform the "home-run or strikeout" hitter. Risk is managed with adequate cash reserves, intelligent renovation plans, low property break-even levels, and an asset diversification strategy.

The selection of hotel properties may be the most important aspect of a combined market cycle timing/risk avoidance strategy. Recognizing current and future value, buying "right," enhancing value with effective asset management, negotiating well-structured property management and franchise agreements, and selling at or near the peak in the real estate cycle is a strategy that has proven successful.

## [3] Appreciation Maximization

**It** is a good idea to focus on appreciation and seek to maximize total return and not just current yield, because yield can be more than offset by capital losses. Current income is not always a true indicator of underlying asset value. A high current dividend strategy favors premium-priced performing hotels in strong markets. These properties often have minimal upside, if they have any at all. Because at the time of acquisition these assets are maximally productive, they sometimes have only one direction in which they can move—downward—and are therefore higher-risk investments than they appear. The reliance of the pension fund community on this investment strategy is a significant reason for its poor performance in hotel investments. Strong hotels in strong markets sell at premium and may be at the peak of their life cycle. Appreciation maximization strategy seeks strong market positions with defensible niches. High penetration rates or profit margins are indicative of a dominant competitive position. However, when the market is very strong, it can attract competition.

Secondary markets are sometimes better markets in which to execute this strategy because they sometimes attract less notice, and therefore less new competition.

Performing hotels in recovering markets are hard to value, because market changes are beyond the hotel owner's control. The greater the percentage value attributable to future market behavior, the greater the likelihood that value will vary over time. However, market recovery bets can be very profitable—hotel investors that bought well-located, strong property in the oil-producing, depressed areas of Texas and parts of Colorado in the late 1980s have demonstrated this with huge earned appreciations since that time.

Some hotels are underperforming and are located in weak markets. Weak hotels in weak markets face two questions: will the asset improve and will the market improve? Such hotels are too risky.

## [4] "Fixer Uppers"

The most consistent way to maximize returns and minimize risk is to find hotels that have a problem that can be fixed. The fixable requirement generally excludes locational problems. Buying underperforming hotels in sound markets is less risky because the investor is not dependent on factors out of his control. If the market is sound or even strong, he does not have to wait for the market to turn around—he needs only to turn the property around. Five basic strategies for purchasing hotels include:

1. Look for properties that are receiving their fair share of revenue but have high expenses that can be reduced with competent management. Increases in cash flow from expense reductions are generally less risky than forecasted

revenue increases. Historical statements should be recast to provide an example of potential cost savings and the effect on value. Roughly 40 percent of all the expenses at a hotel are labor. An expense reduction strategy should focus on the number of employees currently at the hotel, their wages and benefits, and labor productivity based on sales. Characteristics of under-performing properties may include rising expenses, expanded accounts payable, accelerated staff and management turnover, erosion of guest services, sales and marketing cutbacks, and deferred maintenance.

2. Properties that need capital expenditures are good acquisition candidates. One strategy is to buy well-located property in poor condition, and completely renovate and reposition. Pressure to sell is often strongest when the immediate need for property refurbishment clashes with owner illiquidity, loss of confidence, disinterest, and pressure from bankers.

A variation of this strategy is to purchase run-down, de-franchised hotels at the end of their economic life cycle for little more than land value, say $10,000 to $20,000 per room. In many cases these old properties have the best locations in a market, and after renovation the investor is left with a franchisable mid- or upper-level hotel in a strong location at one-half the cost basis of its competitors. One of the challenges with this variation is that many municipalities require that a property, upon a major renovation, be brought back into compliance with current codes. Compliance-type improvements rarely provide an adequate financial return.

3. Reposition properties at a lower level, if it will increase net operating income.
4. Buy hotels with excess development capacity or excess land in markets in which additional development is warranted. This provides immediate cash dividends from the existing asset and future development potential upside.
5. Buy hotels with clearly definable and divisible wings and replace with multiple brands at different price points.

## [5] Buying Below Replacement Cost

The principle of substitution—essentially, that the buyer will evaluate available purchase options with equivalent utility and select the property with the lowest price—is the driving force behind hotel real estate values. In the income approach, it is embodied as the concept that a prudent purchaser would not accept a return on a property that would be below an alternative investment of similar risk. In the sales comparison approach, the principle of substitution means not paying more for a property than the cost of acquiring an equally desirable substitute. In the cost approach, the principle of substitution is expressed as not paying more for a property than the amount for which a site can be acquired and improvements that have equal desirability and utility constructed.

In most markets, supply and demand conditions eventually generate investment returns that justify new construction. When this occurs, existing buildings that are of comparable quality to new construction command similar rents (RevPAR), and thereby generate greater returns to the extent that the asset was originally purchased below replacement cost. The critical variables determining profitability include the duration of time for market supply and demand balances to change, capital adequacy, and the quality and life cycle position of the facilities.

A secondary advantage to buying below replacement cost is the fact that the feasibility of new construction is limited, which protects current yields.

Hotels are often mispriced because of limited data and inefficient capital markets. Often, too, value distortions are psychologically based. Common psychological distortions include overpaying for investments that appear secure (pension funds, for instance, are mistakenly drawn to assets with high dividend yields), overestimating risks, and overcompensating others for those risks.

A good way to separate value from emotion is to emphasize fundamental research, disciplined valuation techniques, and strict buy-and-sell rules when making a buying decision. While it is important to be able to identify unrecognized opportunity, one must avoid the tendency to overestimate the likelihood of a favorable but unlikely occurrence.

Financial projections should not automatically project that each year will be better than the preceding one. Recessions do occur. Real estate is a depreciating asset with a finite economic life that includes not only a growth phase, but also maturity and decline. Few operating histories trend steadily upward. Most properties move upward and downward.

Stabilization is an important concept in this regard. A stabilized occupancy and average rate is the average performance for the property *over its remaining economic life,* and not a point reflecting the hotel's current life cycle position. The danger occurs when a property is incorrectly stabilized at a peak level during the acquisition analysis, but the holding period is for a longer term. The buyer often ends up trying to exit the investment at a performance level below the level at acquisition, resulting in a loss. It is important to realize that most projection periods are longer than the ability to project new supply. Consequently, it is a good idea to have short holding periods, as well as an exit strategy developed prior to acquisition.

## [6] Short-Term Holding Periods

Hotels have a definite functional life. Because exterior architectural styles change regularly, many lodging facility exteriors appear dated after seven to ten years. Major exterior renovations are usually required after twenty years.

Asset values decline exponentially after the mid-life point of a hotel. However, major renovation and repositioning can postpone a hotel's mid-life for many years, depending on the strength of its location and market.

The industry uses a standard 4 percent replacement reserve, which some claim is less than half what it should be. The naysayers, however, demonstrate an incomplete understanding of hotel valuation. First, the 4 percent replacement reserve is meant to cover only the costs of replacing the furniture and equipment. It specifically excludes so-called short-lived building components. Short-lived building components are building systems such as a roof, parking lot, or boiler that will need to be replaced before the end of the asset's useful life. Real estate theory holds that if short-lived building component replacements are not, by industry convention, deducted from cash flow, then those costs are considered by the market in its selection of an equity yield. In this respect, short-lived building components are not unlike the asset management function and incentive fees. All three of these items are costs implicitly considered in the selection of an equity yield rate. If short-lived building components are to be deducted from cash flow, then equity yield rates must be adjusted to reflect this new assumption.

Over the long term, all investment returns trend toward the mean. Short-term holding periods accomplish the following:

- Mitigate illiquidity because of increased stability in the forecast horizon. Short-term cash flows are more reliably projected, resulting in lower risk.

- Force a full evaluation of the exit strategy before committing to the investment.
- Reduce the potential for negative event volatility.
- Reduce the likelihood of short-lived building component (e.g., roof, boiler) replacements, which rarely result in increased profitability.

Beyond the stabilization period, value increases occur at a lower (inflationary) rate. The risks inherent in owning a hotel and associated required capital expenditures are generally not adequately compensated with a 3 percent to 4 percent annual inflation-driven increase in cash flow and value. The exception is a well-diversified portfolio that is investing in hotels purely as an inflation hedge.

## [7] When to Sell

Signs that selling a hotel may be appropriate include:

- When a value estimated using the market data approach (comparable sales) exceeds that arrived at using the income approach or cost approach valuations.
- When national occupancy levels exceed 68 percent-70 percent;
- When gross domestic product (GDP) declines materially;
- When new construction occurs at a rate above demand growth;
- When comparable sales occur at or near historically high levels;
- When sales occur at capitalization rates that exceed the normal cap rates of the industry over a long-term period.

Exit strategies for investments in the fee, leasehold, or leased fee estates of real property can include, but are not limited to, the following:

- Sale of assets individually, as a group or a combination of group and individual sales;
- A public offering as a real estate investment trust (REIT) or other public offering;
- A securitization or other refinancing;
- Contributing the equity value in the assets to capitalize a new investment;
- A leveraged buyout;
- A syndication; and
- Conversion to time share, an alternative use, or term interval ownership (time share for a limited number of years which then reverts back to original estate interest).

Investments that have a high likelihood of being acquired by strategic buyers and/or are likely candidates for public offerings enhance the potential profitability of the exit or residual return.

## [8] Public vs. Private Ownership

Does real estate belong in a public company? Should it be privately held, either wholly or with others? Consider the following when answering these questions:

- Depreciation depresses earnings and therefore stock prices.
- The public market historically has had difficulty measuring unrealized asset appreciation and value changes.
- Hotels have an earnings volatility that is greater than other forms of real estate because of high fixed costs, high leverage, and event sensitivity. An aberrational quarterly earnings report can dramatically change a company's stock price. This causes a drive to consistently improve each quarter's cash flow. The danger of this situation is that it may change management's focus from a value creation and appreciation maximization strategy to a high current cash-on-cash yield acquisition strategy. Current income is often not a true indicator of underlying asset value, and current yield can be more than offset by capital losses.
- Because of quarterly earnings pressure, public companies are more likely to hold a property for a period beyond a one-to-three-year turnaround-and-stabilize period. This is antithetical to short-term holding periods and locking in gains, and it may minimize the value of underlying assets.
- Public market pricing often results in a significant premium over market value of the assets. Public hotel companies are currently trading at multiples of 15 to 20 times earnings before interest, taxes, depreciation, and amortization (EBITDA). EBITDA is roughly the public market equivalent of the private market's net operating income or the REIT market's funds from operations (FFO). The reciprocal of an earnings multiple is a cap rate, and therefore the reciprocal of a 20 EBITDA multiple is a 5 percent capitalization rate (1/20 = .05). The assets held by the companies that are trading at 20 multiples would not be worth a 5 percent cap rate if sold in the private markets. For this reason going public can be an excellent portfolio exit strategy. The execution of this strategy however, will require a growth story.

The current difference between public and private market hotel valuation creates the question: Why are the public markets valuing these hotel companies so highly? The standard answer is that they will grow quickly and that today's 5 percent cap rate will grow into a 15 percent cap rate. The second question is What distinguishes a public company's growth prospects from a private company's growth prospects? The answer to this question is simply that public companies typically have greater access to capital. In essence, today's public companies are realizing a value arbitrage that doubles their value simply because they have ready access to capital.

In order to maintain this value arbitrage, public companies must meet the market's growth expectations. This can put pressure on the acquisition and development strategy at public companies. Valuations of public companies are often based on a single quarter's or a single year's performance. Therefore, fluctuation in revenues and cash flows leads to increased risk and volatility of share values. To attract investors, properties may be chosen on the basis of their *current* cash, which translates into the desired yield. As a result, sourcing product on the basis of high current yields may favor short-term, high-risk properties over high-quality, but developing, long-term prospects.

The public markets are fickle and do not completely understand real estate. Today's favorable valuation could easily be tomorrow's unfavorable valuation. The public markets are best used either as an exit vehicle or as a means to fund an aggressive growth plan and achieve critical mass.

Because of high fixed costs, marginal revenue creates disproportionate increases in net income. Publicly held companies, whose critical mass (growth) is supplemented by ready access to capital, should increase market share.

## [9] Equity Leveraging

Equity leveraging, like debt leveraging, is designed to maximize the impact and return of equity capital. Equity leveraging generally consists of either (1) selling a partial interest in an asset, or (2) making acquisitions through a joint-venture arrangement. A joint-venture arrangement may consist of a new joint venture with, for example, one-third of the funding coming from an operator contributing the equity value of its owned real estate and a passive capital source contributing two-thirds in the form of cash. The advantage to the capital source in its investment is, for example, one-third specified, and is not completely blind. This arrangement provides an immediate cash-on-cash return. Presupposing that both joint venture partners receive the majority of their compensation on the same bottom line, this arrangement is very effective in aligning the interests of the operator and the passive capital source.

Selling a partial interest is a similar idea applied to a single asset. By selling a partial interest in an asset, generally 49 percent to 90 percent, the seller is able to free up equity for additional investment while still retaining a portion of a property's future appreciation. Equity leveraging is particularly useful when an investment strategy includes a market recovery bet. Equity leveraging a single asset occurs most often with larger more expensive hotels.

## [10] Diversification Strategy

Because of event sensitivity, several smaller investments of any type are better than a single big bet. Because hotels are market- and management-sensitive, diversification is particularly beneficial. A strategy designed to accumulate a well-balanced portfolio that spreads market and product risk among different hotel types, affiliations, and sizes in a variety of locations reduces volatility. Diversification by strategic objective, quality of facilities, age, types of demand generators, financial structure, and seasonality as well as market segmentation increases stability and reduces risk.

## [11] Miscellaneous Strategies

### [a] Broker Relations

It is important to maintain regular and honest communication with the brokerage and investment banking community. A steady and consistent deal flow ensures that an investor is in tune with market conditions. Additionally, strong personal relationships with the agency community means that investors will be exposed to listings with short marketing periods.

Often the highest bidder is not the prevailing party. Issues such as speed and track record are important considerations. A personal relationship with your broker can help you in these "soft" considerations.

### [b] Brand Creation and Critical Mass

Buy assets that can be leveraged into chains. Critical mass in the hotel industry is central to the success of most hotel companies and essentially separates the major chains from the minor ones. It may best be defined as the minimum number of hotels and hotel rooms that will economically support a full-service corporate structure. Typically, one hundred hotels in the US constitutes critical mass. Included in the full-service corporate structure are the advertising and consumer brand awareness of the

chain as a whole, a central marketing staff, and a central reservations system. Additional benefits that might be derived from critical mass include the availability of chain-wide purchasing contracts for both goods (furniture and equipment as well as consumables) and services (notably advertising and marketing services), and may also include such items as insurance.

When critical mass is achieved, having your own brand is cost-effective. Royalties paid to franchise companies are usually 3 percent of rooms revenue and generally represent the franchise's profit. Three percent of the rooms revenue for 100 hotels represents a substantial expense savings. The development of a brand also creates franchising as an option. Upon reaching critical mass, franchising can be very profitable. One of the criteria for a hotel to be a trophy hotel is whether its name is well-known enough to merit development as a brand name. If this criterion is met, part of the purchase price may be allocated to launching a brand as opposed to the acquisition of real estate,

Devotion to expanding a brand, however, might slow the pace of growth and cause an investor to miss good hotel real estate and business investment opportunities. The ideal situation, provided there is sufficient capital, is to have the ability to grow both a proprietary brand and other brands.

#### [c] Barriers to Entry

Because supply increases are driven by capital availability and not by industry fundamentals, it is a good idea to search for markets with high barriers to entry. The premium hotel in a premium market strategy should be combined with high market barriers to entry to justify the premium price paid. Barriers to entry include hotel mortgage financing and hotel equity availability, market values that are less than replacement cost, tax laws, interest rates, environmental issues, local protectionist sentiment, prevailing mechanisms for project approval, and local politics.

## » 14.05 MANAGEMENT ISSUES

### [1] Aligning With a Hotel Management Company

The investor should carefully choose and then limit the number of people he does business with. Funding long-term relationships and not deal-by-deal transactions and aligning with a value-adding management company willing to be compensated on the bottom line are ways to accomplish this. The profit on management fees enables management companies to pay more (10 percent-20 percent) than passive investors, to whom management/affiliation fees are simply an expense.

#### [a] Congruent Interests

Passive institutional investors, the public capital markets, and savvy but passive, high net-worth individuals are now focused on aligning their interests with management's interest. These entities generally recognize hotels as retail-oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. They acknowledge that unlike hotel operators, they are not industry insiders and are not comfortable relying solely on the management contract to align their interests with management's. Therefore, many passive investors require, or are attracted to, the following:

1. Management that has enough confidence in itself to invest in the asset.
2. Management compensation that is based on net income rather than gross revenue.

One way to align the interests of operators and passive investors is for the passive capital source to purchase a majority interest in the real estate and a minority interest in the management company. This feature, ownership in both the operator and asset, is similar to the paired-share real-estate investment trust (REIT) now known as Starwood Lodging Trust. Starwood purchased its predecessor REIT, Hotel Investor Trust, not for its poor-quality assets, but because it is the only hotel REIT in the United States that pairs shares in the operator and asset with every share purchase. This structure provided investors with such confidence that they were able to raise almost one-half billion dollars. Several REIT initial public offerings, including Hospitality Investors Trust, were not successful because the market was concerned about the nonaligned interests of the passive investors (shareholders) and management.

Investment performance is maximized by aligning the goals of the owner and manager so that both entities benefit mainly from residual capital appreciation and equity cash flows rather than from front-end and ongoing fees that are unrelated to financial performance. Management contracts with competent operators should be structured at reduced base fees (2 percent or less), for much shorter lengths of time (one to five years is not uncommon now), with meaningful incentive payments (a percentage of improved cash flow after debt service and after a preferred equity return) and performance clauses and guarantees. Earnout provisions by which the management company forgoes some cash flow in exchange for a percentage of the residual and/or refinancing proceeds are also a good idea. The manager, for example, may be compensated with a percentage of the return earned by the investment, after a 9 per-cent-15 percent preferred return to the investors. There should be no charges for acquisition or asset management and no placement fees of any kind for property selection, underwriting, due diligence, or technical service fees for the management of property renovations.

To maximize capital return upon divestment, management contracts should be cancelable without penalty upon a sale. That way, property can be sold unencumbered by a management agreement. Meaningful performance clauses should be negotiated where possible so that non- or underperforming management companies can be terminated. Considering the recent consolidations of management companies, an investor should attempt to eliminate the right of any management company to sell, transfer, or assign its rights, except to a wholly owned subsidiary.

## [b] Selecting a Management Company

Selecting a hotel management company with the specific capabilities necessary for running a particular property is a key step in a hotel investment. Knowledge of the financial and market capabilities of a variety of management companies is helpful in selecting appropriate management companies. One should match the various characteristics of the asset (e.g., size and type of hotel, class, geographic representation in local and feeder markets, critical mass, market segments served, and facilities offered) with the operator that has the best track record, operating performance, and experience in handling these characteristics profitably. Factors to consider when selecting a management company include the following:

- Geographically clustered hotel companies with strong centralization tend to outperform the median.

- Because of high fixed costs, incremental business is most profitable. Therefore, marketing skills add the most value.
- Technology (yield management) can improve marketing, income, and value.

The investor should also consider the management company's rate of growth, expertise and track record, depth of management, turnover of corporate staff and key personnel, years that management has been together as a team, present and future company profile and philosophy, reasons for any past contract terminations, operating policies and procedures, owner references after a competitive bidding process, and fee structure.

## » 14.06 CONSOLIDATION

Mergers and strategic alliances can enhance returns through synergy, economies of scale, a harvest strategy (otherwise known as milking the cash cow), and risk-pooling. Principal reasons for mergers include access to capital for future growth, improved critical mass and economies of scale, and shareholder value enhancement. When two complementary companies are brought together with minimal initial cost, earnings may receive an immediate boost.

Mergers can be a quick way to grow, but they are not without risks. Mergers present the risk of an unsolicited, and possibly hostile, offer from a third company. Another problem with mergers is that the number of reasonably priced available suitor companies with real growth potential is often quite small. Early on, a decision should be made as to whether the goal is simply to acquire real estate assets at favorable pricing or whether the acquisition of an ongoing effective company is the goal. It is a good idea to seek valuable business assets locked inside weak capital structures. If there is a desire to keep the target company operating, then issues such as the following are important:

- Cultural fit, style, trust, similar philosophy;
- Product compatibility, with manageable hotel location overlap;
- Credibility and reputation;
- Financial strength, performance, and value of assets.

Tender offers for REITs and public hotel companies when their stock market capitalization is less than the value of the assets also constitutes an attractive consolidation strategy.

## » 14.07 MEZZANINE FINANCING

Mezzanine financing is supplemental debt financing that is either (1) wrapped around an existing first mortgage, like a bridge loan or second mortgage; or (2) a single debt instrument tranched (split) into a first mortgage component and a mezzanine, earnout, subordinated, or "B-rated" component. Generally, mezzanine financing is flexible and customized and provides for a high loan-to-value ratio (ratios in excess of 90 percent are not uncommon) or a below-market interest rate. In return, the provider of mezzanine financing receives interest payments and a significant portion of a property's future appreciation. Additionally, the mezzanine financing provider may receive other "equity-like" rights, including management contracts and affiliation agreements. A

mezzanine financing arrangement, which generally includes a sharing of future appreciation, can be structured so that appreciation sharing is a percentage split, pre-determined fees paid upon maturity, or as a negative amortization loan. Mezzanine debt is usually short term (two to five years). Mezzanine financing can be used in the following ways and under the following circumstances:

- To bridge the gap between low loan-to-value public bonds and equity down-payments.
- When the buyer does not have sufficient cash, or chooses to deploy his cash resources elsewhere.
- For asset repositionings that involve a renovation.
- To achieve full or partial takeout of existing financing at a higher loan-to-value.

In many cases the operator/owner becomes the prevailing bidder when buying hotel assets because they receive the additional benefit of management and/or affiliation fees and are able to economically offer a higher price than the non-operator. This "operator arbitrage" could be applied to the debt markets.

Buying nonperforming debt, with a subsequent foreclosure planned, is another way to gain control of property. However, foreclosure laws vary by state and this strategy is more viable in certain states. Further, this strategy carries the additional risk that the foreclosure may not be successful and the debt buyer will remain a debt buyer. In a worst-case scenario, some or all of the debt buyer's expenditure could be dismissed by a bankruptcy court. This strategy works best when the principals have legal backgrounds.

## » 14.08 DUE DILIGENCE

As discussed in detail in Chapters 6 through 10, the following market and site/ property items should be reviewed.

### [1] Market Analysis

The economic vitality of the area encompassing the subject property and its feeder markets is an important consideration in forecasting future demand and income potential. Trends that foreshadow probable future economic patterns of the market as well as the vulnerability of the lodging market to economic trends should be evaluated. The size of the market and the demand for transient accommodations should be investigated to identify the various generators of visitation operating within the local market. The current and anticipated potential of these demand generators should be evaluated. An investigation should be made of the respective strengths of the market in terms of seasonal volatility and other demand fluctuations, price sensitivity, required facilities and amenities, and changes in travel patterns and other related factors. The market's diversity, or reliance on a few demand generators, and the economic volatility, seasonality, and prospects of significant demand generators should also be analyzed.

Economic diversity within the local market has an important effect on the area's stability, growth, and risk. Economically diversified markets generally have reduced volatility. Seasonality creates volatility and risk. Large variations between months or daily occupancies and weekday versus weekend occupancies limit upside.

In analyzing demand, the overall transient lodging market should be subdivided into individual segments based on the type or nature of travel because individual classifications generally exhibit unique characteristics. Market segmentation helps to define major types of demand and to estimate future growth rates and customer characteristics. The market's and the subject property's reliance on or diversification by market segment, including contract business, should also be evaluated.

Competitive lodging facilities should be evaluated to determine their position, rank, and other pertinent operational characteristics with respect to the subject. An analysis of existing and proposed competition provides an indication of the current accommodated and latent demand, relative market shares and penetration, and price/value relationships for customers. Some of the competitive factors that should be specifically reviewed include:

- Number of rooms;
- Average rate;
- Occupancy;
- Market orientation and segmentation;
- Location;
- Chain affiliation;
- Age;
- Quality;
- Condition;
- Rate structure and pricing strategies;
- Class and type of facilities;
- Size of meeting facilities;
- Level of services and recreational amenities;
- Type of food and beverage outlets;
- Management difficulty and expertise;
- Frequent guest programs;
- Travel agent commission policy; and
- Market perceptions and the comments of property management.

The nature and status of projects under construction, proposed or merely rumored, that might be competitive with the subject property should be evaluated. Barriers to entry for new competition should be evaluated. The probability that existing, older, noncompetitive lodging facilities will receive substantial capital upgrades and thereby increase their level of competitiveness should also be considered.

## [2] Site and Neighborhood Analysis

A thorough inspection should be made of the subject site that takes into account its physical and functional utility for hotel use, including its size, shape, topography, utilities, access, visibility, zoning, neighborhood, and other relevant location factors (e.g., proximity to both transportation systems and lodging demand generators). The supportive nature of surrounding land uses and patterns reflecting growth, stability, or decline should also be evaluated. The subject hotel's location, as compared with

competitor locations and vacant developable hotel sites and relative to current and future demand generators, is a prime location issue. Plot plans including frontages, total site dimensions, access points, orientation of the improvements, and survey and legal descriptions should be reviewed. In addition, soil tests and seismographic studies may be advisable.

## [3] Subject Property Analysis

The physical improvements, facilities and amenities, should be inspected for their quality, style, design, layout efficiency, functionality, and effect on operating efficiencies and profitability. An evaluation considering size, condition, and suitability relative to the local market demand, segmentation, and competitive supply is necessary. As-built architectural/floor plans detailing the layout and relationship of spaces and areas within the property should be reviewed. This evaluation should include public areas, meeting facilities, restaurant and lounge facilities, back-of-the-house areas, mechanical equipment, and a sample of all guestrooms. Furniture and equipment are essential to the operation of a lodging facility, and their quality often influences class, image, and income. An assessment of the subject property's remaining useful life and the quality of its construction and materials used, including furniture and equipment, should also be required.

Historical refurbishment, FF&E and capital expenditures, maintenance records and programs, current budgets, engineering studies, ADA Compliance Reviews, and Phase I and II environmental studies should be reviewed. Deferred maintenance and other mechanical, building, or FF&E issues that require remedial attention must be identified. The sufficiency of proposed capital budgets, PF&E reserves, and insurance coverages should also be evaluated.

Franchise agreements; reservation reports; franchise inspection and deficiency reports; health, fire and building inspection reports and employee manuals should be reviewed as aids in evaluating the probability of losing or changing the current chain affiliation.

It is important to inspect the subject property's technology. This technology includes systems for yield management, accounting, property management, point of sale, building operations, sales and catering, life safety, security, and guestroom access. Yield management maximizes the ability to sell more higher-priced rooms during times of peak demand periods by specifying a varying number of rooms available at discounted rates during a given period, depending on overall demand. This technique reduces the likelihood of turning away guests who are willing to pay a higher rate because the units are occupied by patrons paying lower rates.

## [4] Supply-and-Demand Analysis

A supply-and-demand analysis should be used to understand and quantify the subject property's competitive positioning with respect to other lodging facilities. This analysis integrates all information regarding the data and information gathered during the fieldwork inspection, such as the subject site and facility analysis, area hotel and economic trends, demand characteristics, and competitive analysis. The supply and demand analysis results in a quantification and documentation of probable future trends in the subject property's market share, occupancy, average rate, and overall rooms revenues. Markets in which competitors have a lower cost basis should be carefully evaluated, because the competitors can then profitably afford to undercut your rates.

## [5] Financial Analysis

All practices and procedures involving financial management and results should be reviewed. In particular, the following items should be analyzed:

- Historic income and expense statements with full supporting schedules for the past three years (if available). Any audits or financial reviews should also be considered when available;
- Balance sheets (audited when possible);
- Operating budgets and projections;
- Annual reports (if a public company);
- Actual operating data from comparable lodging facilities;
- Marketing plans;
- Reservation system reports;
- Current definite and tentative pre-bookings and rate structures;
- Historic pre-booking conversion rates, booking pace, and rate structures;
- Occupancy and average rate summaries by month;
- Local expense factors relating to items such as labor, food and beverage costs, energy rates and bills, assessed values and taxes;
- Contractual obligations under frequent traveler programs;
- The relationship between rooms revenue and total revenue; and
- The level of fixed costs.

A projection of income and expenses representing future expectations of income potential, and corresponding to the level of activity and quality of operations indicated by the projected occupancy and average rate, should be developed. Various scenarios or "stress tests" (including best and worst case) should also be developed to test the sensitivity of various assumptions and projections. Actual inflation that varies significantly from projections can alter anticipated yields. The sensitivity of projected investment yields at different inflation rates should be tested. Because of the effects of compounding, a small deviation in assumptions can have a large impact on value.

## [6] Other Analyses

Any property, equipment, ground or tenant leases or subleases, management contracts, union agreements, service contracts and key supplier relationships, or trademarks/trade names and any documentation pertaining to in-lieu of property taxes or other property tax concessions should be reviewed by a hotel real estate professional for business issues, as well as by an attorney for legal issues. Appraisals, market and feasibility studies, and impact studies should also be reviewed to discover any previously unknown facts, and to evaluate the reasonableness of the assumptions and conclusions. An accountant should be used for financial audits and reviews and to evaluate tax returns and other relevant tax and accounting considerations.

Payroll is generally a lodging property's greatest expense. The current staffing level, any wage and benefit surveys, qualifications, and compensation of on-site management should be reviewed and compared to industry norms, as should existing labor control systems.

A detailed ownership record and history of the subject property with names of legal owners is important. Legal due diligence should include all contracts and current letters of intent, including any existing mortgages to be assumed or wrapped, title reports and insurance, stock or partnership agreements, major group booking contracts, frequent traveler programs, and service and maintenance contracts. A zoning and life safety compliance analysis should also be undertaken and any Hart Scott Rodino and tax issues investigated. The existence of any violations and the transferability of all licenses, permits, franchises, and other documents also must be evaluated.

In the case of mortgage due diligence, the borrower's credit history and reports, track record, and references should be reviewed, along with the history of any existing indebtedness, both secured and unsecured. If due diligence is for a purchase, an inventory list of all furniture and equipment, supplies, and consumables will be necessary, as will a list of all employees and appropriate personnel information. Due diligence for acquisitions should also include a detailed list of advance room and catering reservations and bookings, including the name of the party, deposit received, rate guaranteed, dates, status, and other relevant information.

Understanding and staying current with the hotel industry is a full-time endeavor. Third-party due diligence is not a substitute for full investigation by principals to a transaction. Instead it is an extra set of trained eyes and independent confirmation that appropriate questions have been asked, answered, and understood. In addition, third-party due diligence may save time for principals by focusing their time and efforts on areas of greatest need. Due diligence is analogous to insurance in that it reduces, but does not necessarily eliminate, risk.

HVS

# CHAPTER 15

# Ownership Considerations


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## » 15.01 OVERVIEW OF OWNERSHIP ENTITIES

The form of hotel ownership is a very important decision that must be made in the early stages of the hotel development process. Usually the decision is based on tax, legal, or business considerations. For example, an owner might choose to form a corporation instead of individual ownership in order to limit his personal liability. In this chapter, the following forms of business entities are discussed:

1. Individual ownership
2. Concurrent ownership (by two or more individuals)

3. Partnership (general and limited)
4. Regular corporation (C corporation)
5. S corporation
6. Limited liability company (LLC)
7. Trusts
8. Real Estate Investment Trust (REIT)

## [1] Tax Considerations

Each form of business entity has its own tax consequences; therefore, it is important to study each entity's tax impact on the hotel venture before deciding on a particular business entity. A brief description of the tax treatment for each type of ownership follows:

- *Individual ownership* lumps income, gain, and loss from hotel properties together with the owner's other items of income, gain, and loss.
- *Concurrent ownership* taxes each owner as an individual owner to the extent of his percentage interest in the property.
- *Partnerships,* whether general or limited, are not taxable entities, but are merely tax conduits; taxable income, gain and loss is passed through directly to the individual partners, who then treat these items as though they were individual owners of the property.
- *Regular (C) corporations* are taxable entities separate from their shareholders; they report income, gain, and loss separately. Consequently, corporate income and gain is subject to a double tax, once on the corporate level and again on the shareholder level when the income or gain is distributed as dividends.
- *S corporations, LLCs, and REITs* are separate legal entities that distribute income and losses in a way similar to partnership forms. There are, however, very specific statute requirements in the Internal Revenue Code that must be met to qualify for these entities.
- *Trusts* are taxable entities separate from their beneficiaries and thus similar to regular (C) corporations.

## [2] Business and Legal Considerations

It is important for the hotel owner to look at the various business situations that he is likely to encounter and to determine thereby what form fits best. The wrong choice could mean missing a business opportunity that could cost the hotel owner severely. Some of the more important nontax considerations to review when choosing an entity are as follows:

- Cost of formation
- Number of people and type of management needed to run the hotel
- Degree of flexibility required to conduct the activities
- Extent of and probability of exposure to liability
- Ease of transferability of interest in the entity

- Estate planning
- Ease of transferability of the hotel property
- Expected duration of the venture

## » 15.02 INDIVIDUAL OWNERSHIP (SOLE PROPRIETORSHIP)

The simplest business form is individual ownership (sole proprietorship). A sole proprietorship is any business that is owned by one person as an individual. As such, there is no legal distinction between the owner and his business. The owner establishes the sole proprietorship simply by opening up his hotel for business.

Under sole proprietorship, the owner keeps track of his business income and expenses and reports the results on his schedule C federal tax form along with other income and deductions that he has on his individual tax form. A major tax disadvantage of sole proprietorship is that the owner is responsible for paying both the employer and employee portion of the social security tax on earnings from the hotel. However, the owner is allowed to deduct half the payments on his federal tax return.

Sole proprietorships are usually found in small family-run businesses where the hotel property is the major asset of the owner. Most potential liability claims can be handled by the purchase of insurance. Also, if the owner should need to borrow money to build the property, the lending institution would more than likely require the owner to personally guarantee the loan even if the entity were in a corporate form of business. Thus, there is little incentive for a small operator to incur the expenses of doing business as a corporation.

## » 15.03 CONCURRENT OWNERSHIP

Hotels can be held in one of three forms of concurrent (i.e. multiple) ownership:

- Tenancy in common
- Joint tenancy
- Tenancy by the entirety

Because concurrent ownership requires a high degree of cooperation between co-owners, it is normally used only when property is acquired by members of a family or by a small group of investors who have had a long association. The ownership is reported on each individual's tax return in accordance with the ownership interest and thus is similar for tax purposes to a sole proprietorship.

### [1] Tenancy in Common

A tenancy in common is created when hotel property is transferred to two or more persons without express language creating one of the other two types of concurrent ownership (i.e., joint tenancy or tenancy by the entirety). For example, a tenancy in common is created by either of the following two conveyances: (1) To A and *B* or (2) To A and *B* as tenants in common.

The term "tenant" is used in its original sense as a co-owner of property, not in the sense of one who possesses real estate pursuant to a lease.

When two or more persons hold as tenants in common, each has an "undivided

interest" in the entire property to the extent of his or her ownership share. For example, conveyance to three persons, without designation of any percentage to each, would give each tenant in common a one-third interest in the entire property. Alternatively, the conveyance may allocate different shares to each co-tenant: for example, one of three co-tenants may own a 40 percent undivided share, with each of the others owning a 30 percent share.

All decisions with respect to the co-owned property must be unanimous; the property may not be sold, mortgaged, or leased without the consent of all the co-tenants. For this reason, tenancy in common usually is considered a viable form of ownership only for a small hotel project with very few investors. Co-tenants can agree that one or only a few of them shall have the authority to make all decisions with respect to the property; however, this creates a risk that the relationship may be deemed an association taxable as a corporation.

Each tenant's right to possession of the property is subject to the rights of the co-tenants. Each has the right to an accounting of rents and profits, and in the event any tenant spends money for the payment of taxes, insurance premiums, or necessary maintenance and repair, he is entitled to reimbursement by the other tenants for their share of the expense. If the co-tenants are unable to agree as to the management or disposition of the property, any one of them is entitled to begin a legal proceeding known as an action for partition. If the hotel property cannot be equitably divided, the court can order that it be sold, with the proceeds to be divided among the co-tenants according to their interest.

Each co-tenant may sell, mortgage, or give away his interest during life or transfer it at death. When the interest of a co-tenant is transferred to another, the new owner becomes a tenant in common with the remaining owners.

For tax purposes, each tenant in common reports his share of income, gain, or loss. If a co-tenant makes a gift of his share, the usual rules of gift taxation apply. In addition, a gift is deemed to have been made if one tenant in common pays more than his share of costs and is not reimbursed by the others. The interest of a deceased tenant in common is taxed as part of his estate, according to its value on the date of death or on the optional valuation date. The heirs acquire the interest of the deceased tenant in common at a stepped-up basis equal to the value used for estate tax purposes.

## [2] Joint Tenancy

A joint tenancy is similar to a tenancy in common, with one very significant difference—the right of survivorship. If any joint tenant dies, his interest automatically passes in equal shares to the remaining joint tenants. If three joint tenants had owned the property and one died, each of the two survivors would take one half of the deceased joint tenant's interest. At the same time, in a joint tenancy as in a tenancy in common, all tenants are deemed to have an equal undivided share of the property;

in other words, three joint tenants each own a one-third undivided interest.

A joint tenancy can be created only by express language in a conveyance, for example, "John Jones and Mary Jones as joint tenants with right of survivorship and not as tenants in common." A conveyance merely to "John Jones and Mary Jones" normally creates a tenancy in common, not a joint tenancy. Joint tenancies, because of their unusual survivorship feature, normally are used only among family members. One advantage is that this arrangement not only designates ownership of property, but also can serve as a substitute for a will. Thus, no public record will exist of the transfer of the property and no probate proceeding will be required; this is an attractive

feature to many wealthy people. In addition/except for unusual circumstances, creditors of the deceased joint tenant cannot reach property that has passed into the hands of the surviving joint tenant (or tenants).

However, a disadvantage of the joint tenancy in owning property is that it does not permit other types of disposition at death that may prove more beneficial to the overall estate.

Although a joint tenant cannot devise his interest by will, the interest can be sold or given away during his lifetime. If this is done, the new owner becomes a tenant in common, not a joint tenant, with the remaining owners. This reflects the conceptual basis of early English common law, which conceived of joint tenancy as a merger of four unities: interest, time, title, and possession. The time requirement means that all the joint tenancies must be established at the same moment. Consequently, if one joint tenant later transfers the interest to another, the unity .of time is broken and the new owner becomes a tenant in common. Similarly, any joint tenant (like a tenant in common) may start an action of partition; if the property cannot be equitably divided, the property will be sold and the proceeds will be distributed to the parties.

A joint tenant reports his share of income, gain, and loss from the property. However, unlike the case with tenants in common, if one joint tenant pays expenses in excess of his proportionate share, the full amount of such expenses is deductible.

## [3] Tenancy by the Entirety

A tenancy by the entirety is a joint tenancy between husband and wife. The tenancy carries with it the same right of survivorship as a joint tenancy so that, upon death of either spouse, the survivor takes the entire estate. Unlike a joint tenancy, however, neither spouse can convey any part of the property during their joint lives unless the other spouse joins in the conveyance. Thus, tenancy by the entirety (like the ancient right of dower) acts to protect the rights of the surviving spouse in property owned during the marriage. In most states recognizing the tenancy by the entirety, any conveyance to a husband and wife is presumed to be to them as tenants by the entirety, unless the title is specifically indicated to be otherwise.

Property held under tenancy by the entirety is not subject to levy by creditors of only one of the owners. In the event that the owners are divorced, the tenancy is destroyed and the divorced spouses become tenants in common. Where the spouses choose to file separate instead of joint returns, each tenant by the entirety reports his own share of the income, gain, or loss from the property on his separate return.

The major disadvantage of the joint tenancy or the tenancy by the entirety is their inflexibility with regard to planning to minimize federal estate taxes. Since there is now an exemption of $600,000 for a decedent, a co-owner whose estate is not likely to reach this figure (even after inclusion of the full value of the jointly owned property) need not be concerned. However, in many cases, the estate may exceed $600,000; consequently, a federal estate tax (which begins at 37 percent) may be payable. In discussing this problem, a distinction must be made between jointly-owned property between a married couple and between unmarried persons.

If a husband and wife are joint tenants of property or tenants by the entirety, one half of the property value is included in the estate of the first spouse to die, regardless of the amount each contributed to the purchase. The half so included will receive a "step up" in basis to current market value (thus eliminating any future tax on the appreciated value of that half prior to the date of death). At the same time, the transfer of the decedent's interest to the spouse is tax-free because of the unlimited marital deduction.

*Example: H* and *W* are joint tenants of property worth $1 million that cost $500,000. The property is their sole asset. On *H's* death $500,000 (one-half the value) is included in his taxable estate. No federal estate tax is payable because of the $600,000 exemption (and also because of the unlimited marital deduction). *W* then becomes sole owner of the property. Her tax basis is $750,000, consisting of her one-half share of the original cost, or $250,000, plus *H's* stepped-up basis of $500,000. If she sells the property for $1 million, she will pay tax on only $250,000 of gain,

The situation so far is favorable. However, *W* now is the sole owner of an asset with a value of $1 million. Upon her death, the general $600,000 exemption will be available, but the remaining $400,000 would be subject to federal estate tax. The tax on this amount is approximately $153,000 (assuming no taxable gifts during *W's* life).

The federal estate tax would be eliminated completely in the foregoing example if the property were held by *H* and *W* as tenants in common. Upon *H's* death, his $500,000 share would be exempt from tax, because it is less than the $600,000 exemption. If *H's* share were left to his children (or in trust with income to *W* for her life), the property would not be included in *W's* estate. Thus, on her death, her estate would amount to only $500,000, which would be fully exempt from tax, on the basis of the exemption. In both cases, the value of the real estate would be stepped up to the value at date of death.

If the joint tenants are not married to each other, one important distinction must be made from the previous situation. If one co-tenant dies, only the value of the property representing his contributed share of the original cost is included in his estate. So if a parent and child create a joint tenancy, with the parent contributing 100 percent of the cost, the entire value of the property will be included in the parent's estate. If the child is the first to die, no portion of the property will be included in the child's estate.

## » 15.04 PARTNERSHIPS: IN GENERAL

Partnerships are one of the most common entities used to own hotels. Partnerships are popular for three reasons:

- *Tax factor.* A partnership is not a taxable entity, so no double tax is imposed at the partnership and the partner level; alternatively, tax losses can be passed through directly to the partners in many instances.
- *Legal factor.* The partnership agreement can be amended at any time and thus provides a great deal of flexibility with respect to allocation of profits and losses, division of management responsibility, and the settlement of disputes.
- *Business factor.* A partnership often involves lower organizational costs, state fees and taxes, and administrative costs than a corporation.

A partnership has some disadvantages, notably the absence of limited liability for general partners and the lack of free transferability of ownership interests, both of which are provided in a corporation. In recent years, the limited liability company (LLC) has been chosen by many hotel investors as a preferred alternative to both the partnership and the corporation.

A partnership is a form of business organization in which two or more persons are associated as co-owners in a continuing relationship for the purpose of carrying on a common enterprise or business for profit. A written agreement of partnership

(also called articles of partnership) defines the rights and obligations of each partner and sets forth how profits and losses are to be shared. The two types of partnerships are general partnerships and limited partnerships.

The term "partnership" is sometimes used interchangeably with the terms "joint venture" and "syndicate." Although a joint venture or syndicate may take the form of a partnership (either general or limited), the terms are not synonymous, because a joint venture or syndicate may also use some of the other legal forms of ownership, such a regular (C) corporation, S corporation, tenancy in common, or business trust.

## [1] Legal Characteristics of a Partnership

The legal characteristics of a partnership (both general and limited, except as otherwise indicated) are as follows:

*Separate legal entity.* For most purposes, a partnership is recognized as a legal entity separate from its individual partners. As such, the partnership may sue and be sued, and may hold and convey real property in the partnership name. In actions brought in federal courts, partnerships are recognized as separate legal entities, but diversity of citizenship (often a condition for bringing a federal lawsuit) is determined by looking at the individual partners.

*Agency relationship between partners.* Each individual partner in a general partnership (and each general partner in a limited partnership) has unlimited liability for any and all obligations of the partnership. This follows from the legal principle that every partner is the agent and principal of every other partner. Consequently, any debt incurred by any partner with apparent authority to do so in carrying on the business of the partnership is a debt of every other partner. A partner may have the right, under the partnership agreement, to have other partners contribute a portion of the liability or indemnify the partner held liable. A third party dealing with the partnership without actual notice of a lack of authority is not required to look into a partner's individual authority and thus may look to any of them to satisfy an obligation regardless of the terms of the partnership agreement.

*Management of partnership.* Unless they agree otherwise, all members of a general partnership (or all general partners in a limited partnership) have equal rights in the management of the partnership business.

*Dissolution of partnership.* The agency relations among the general partners is a personal relationship that cannot be changed without the consent of all the partners. Consequently, the partnership is automatically dissolved by the death or withdrawal of any general partner, notwithstanding any other provision in the partnership agreement. In effect, this means that any partner may dissolve the partnership at any time. No partner has the power to substitute another person as partner without the consent of the remaining partners. On the other hand, a partner who dissolves the partnership in violation of the agreement, or who refuses to consent to a substituted partner when such substitution is permitted by the partnership agreement, may be liable for breach of contract to the other partners. Nevertheless, the partnership is dissolved. In the situation in which all partners consent to the addition of a new partner, the partnership is not dissolved under the terms of most partnership laws.

*Nature of interest.* A general or limited partner's interest in the partnership is inheritable personal property consisting of the partner's pro rata rights in the specific partnership property, rights to a share of profits, and the right to participate in management (in the case of a general partner) and inspect the partnership books. The right to profits is expressly made assignable to third parties by UFA, regardless of any partnership agreement to the contrary. The result is that an assignee of profits has a legal right to claim the profits as against the partnership, although the partnership itself may have causes of ac-

tion against the assignor for a breach of contract. The assignee, however, does not become a partner unless the other partners agree. An assignee who is not admitted as a partner lacks the right to participate in management, inspect the books, dissolve the partnership by death of withdrawal, or demand an accounting prior to dissolution of the partnership. It is not clear whether an assignee not admitted as a partner is liable for losses (although it would seem that either the assignor or the assignee must be liable).

## [2] Checklist for a Partnership Agreement

The following checklist includes factors that should be considered in drafting a partnership agreement;

- *Name of the Partnership.* While a partnership can choose any name under which to conduct its operations, its name should not be too similar to that of another business organization. How the participants' individual names are used as the partnership name—whether or not the partnership name will continue to be used after the death or retirement of a partner and whether or not it is permissible to do so under local law—must be considered.
- *Registration of name.* In some states, a partnership name must be registered with a public agency or officer—for example, a county clerk or secretary of state.
- *Nature of business.* The nature of the partnership business must be clearly spelled out.
- *Permits and licenses.* The partnership agreement should provide that it is not to become effective unless and until required licenses or permits are procured.
- *Partners' contributions.* These may be in the form of property, cash, or services, or any combination thereof. In addition to making a capital contribution to the partnership, a partner may make a loan or sell property to the partnership either for cash or on an installment basis. In each instance, the legal, tax, and accounting consequences to the partner and the partnership must be examined and dealt with.

  Where property is contributed, the partners' right to reconcile the tax bases and accounting values of the contributed property in order to prevent distortions should be taken into account.
- *Duration of partnership.* The parties may agree to a definite term, or the partnership may continue at will. As mentioned previously, a partner may terminate his relations with the partnership even if doing so breaches the partnership agreement.

  If the partnership agreement specifies a fixed term, the parties may continue the business beyond that term as a partnership at will, extend the term, or enter into a new partnership agreement.
- *Partnership profits and losses.* In cases in which the partners share both profits and losses, they are usually shared in the same proportion. However, the partners may agree that different kinds of partnership income shall be distributed among the partners in different proportions. Whatever the arrangement may be, it should be carefully set out in the partnership agreement.

  A partnership is not an entity separate from its members for income tax purposes. Each partner is taxed on his share of the partnership income and profits and is entitled to deduct his share of the partnership losses. The part-

nership files only an information return, not the income tax return that an individual or corporation would file.

- *Compensation of partner for services to partnership.* In the absence of an express provision in the partnership agreement to the contrary, a partner is usually not entitled to compensation for his services to the partnership. If a partner is entitled to and does receive compensation for his services from the partnership, this is a deductible business expenditure of the partnership.
- *Withdrawal of capital.* When it is anticipated that the partnership will accumulate a substantial amount of money, the partners should be permitted to withdraw a sufficient sum to meet their income tax obligations. The partnership agreement should clearly spell out the parties' understanding with respect to the partners' rights in this regard.
- *Management of partnership affairs.* All partners have an equal voice with respect to the management and conduct of the business affairs of a general partnership, unless they agree otherwise. The partnership agreement should clearly state each partner's rights and duties as well as the extent to which the partners are authorized to bind the partnership by their contracts.
- *Accounting.* The partnership agreement should require all partners to account to the partnership with respect to all matters affecting the partnership.
- *Partnership property.* Property acquired with partnership funds is partnership property, unless an intention to the contrary is clearly established.
- *Partners' death or withdrawal.* The partnership agreement may provide for the continuation of the business after the death or withdrawal of a general partner. Partners should be careful when Grafting the partnership agreement to provide for the valuation of any partners' partnership interest following death or to withdrawal.
- *Indemnification of partner.* The partnership may be required to indemnify each partner for payments made and personal liabilities reasonably incurred in the ordinary and necessary course of the partnership business.

## [3] General Partnership

The simplest ownership form to use for two people who operate a business is the general partnership. This form of business can be as informal or formal as the partners wish it to be. General partnerships that have been formed with a simple handshake have lasted for many years. Although the requirements for forming the general partnership today have been made more formal by states adopting the Uniform Partnership Act (UPA) and the Revised Uniform Partnership Act (RUPA), hotel developers should be careful when choosing partners. In fact, partnerships among individuals have led to many court battles over such issues as control, valuation, and succession. Therefore, it is extremely important to state as clearly as possible in the partnership agreement all the relevant duties and obligations of the individual partners and the means of dissolving the partnership upon dissolution.

The UPA and RUPA both require that a general partnership file and record in a public office a certificate identifying the names and addresses of each partner. The certificate must be amended in the event of a change in the partners.

However, it is possible for a partnership to exist without the knowledge or the intent of the partners; on the other hand, investors may believe they are in partnership when in fact they are not. Under UPA, the following three rules aid in determining whether a partnership exists:

1. Persons who are not partners with respect to each other are not partners as to third persons except where, by their conduct, they have led others to believe that they are partners and to rely on that belief to their disadvantage so as to create a partnership by estoppel.
2. The mere existence of joint or part ownership of property does not establish that a partnership exists, regardless of whether or not the co-owners share the profits made by the use of the property.
3. The sharing of gross returns from property does not, in and of itself, establish the existence of a partnership, regardless of whether or not the persons sharing the returns have a joint or common right or interest in the property from which the returns are derived.

Proof that an individual shares in the profits of a business is prima facie evidence that he is a partner in the business, unless he receives the profits as payment of a debt (installment or otherwise), wages, rent, an annuity paid on behalf of a deceased partner, interest on a loan (even though the amount of the payment varies with the profits of the business), or consideration for the sale of the good will of a business or other property by installments or otherwise. There are four basic disadvantages in choosing the general partnership form of ownership:

- *Personal liability for partnership debts.* Each partner is personally liable for the partnership debts—that is, all of the partner's assets may be reached by a creditor of the partnership in the event that the partnership assets are not sufficient. For this reason, the general partnership is normally used only by a small group of investors who know each other.
- *Authority of individual partners to bind the partnership.* Those who deal with a general partnership have the right to assume that each partner has broad authority to bind the partnership, provided the transaction fits within the scope of the partnership's business and apparently relates to that business. Because each partner is jointly and severally liable for the partnership's obligations, a partner may find himself in the unenviable position of having to dig into his own pocket to pay an obligation that was incurred by another partner apparently on behalf of the partnership.
- *Limited transferability.* UFA permits a partner to assign his share of the profits from a partnership, but the assignee does not have the right to participate in the management or administration of the partnership business.
- *Less privacy and anonymity.* Generally, a partnership offers less privacy, anonymity, and confidentiality than does a trust or corporation. The requirement of filing a certificate (and sometime publishing it) forces the disclosure of the identity of the owners. In a partnership, any partner may inspect the books; in a corporation, however, the identities of the stockholders are confidential and the contents of the business records rarely have to be disclosed, even to stockholders.

## [4] Limited Partnerships

One of the most popular business forms used for owning and operating hotel properties is the limited partnership. A limited partnership makes it possible for the hotel developer to combine his own skills with the financial resources of passive investors in an organization that allows flexibility of operation, limited liability for his in-

vestors, and the tax benefits of the pass-through of taxable income, gains, and, in certain circumstances, losses to investors.

A limited partnership is one formed by two or more persons, having as members one or more general partners and one or more limited partners. The general partner or partners manage the affairs of the partnership and are personally liable for the debts and obligations of the partnership. The limited partners, who are the passive investors, are not bound by the partnership debts and obligations, except to the extent of their equity investment.

A limited partnership is a hybrid of a corporation and a general partnership. A limited partner's exposure, like that of a corporate shareholder, is limited to his equity investment, and his status as a limited partner does not give him the right to control or actively participate in the affairs of the partnership. A general partner's role and is analogous to that of the director or officer of a corporation.

In other respects, a limited partnership resembles a general partnership. For the most part, the rights and liabilities of the general partners in a limited partnership are similar to those of a partner in a general partnership. Additionally, a limited partnership has the same problems of continuity of existence and transferability of interest as a general partnership.

While it is possible for one person to be, at the same time, both a general and a limited partner in the same partnership, such a person will be in the same position as to the general partners except that, in respect to contributions, this partner will be treated the same as the other limited partners.

States have adopted either the original Uniform Limited Partnership Act (ULPA) or the later Revised Uniform Limited Partnership Act (RULPA). Any hotel developer should check his or her state statute to determine which act controls in the state the partnership will be created. The discussion that follows is based on both the original statute and revision.

## [a] Creating a Limited Partnership

There are four factors to note when creating a limited partnership:

1. *Public filing of certificate.* The ULPA requires that a new partnership make a public filing of a certificate of limited partnership that sets forth its name, capital contributions, and profit shares of the partners.
2. *Use of partners' names prohibited.* Limited partnerships are prohibited from using the name of any of the limited partners' names as part of the partnership name. Also, no name that is deceptively similar to that of any other corporation or limited partnership may be used in the name of the partnership. Both the ULPA and RULPA require that the partnership name include the words "limited partnership" in full. In addition there is a convenient procedure to reserve names for future limited partnerships.
3. *Maintaining office and records.* The ULPA requires that the partnership maintain continuously within the state an office at which basic organizational and financial records are kept. This requirement assures certain minimal contacts between the partnership and its state of organization and assures that the limited partners have access to vital partnership information.
4. *Avoiding liability in case of a defect in forming partnership.* Under ULPA, a person who has contributed to a business (an "equity participant") erroneously believing that he has become a limited partner in a limited partnership, is not liable as a general partner, provided that when he realizes his mistake, he promptly renounces his interest in the profits of the business. Un-

der RULPA, if the equity participant wishes to avoid liability as a general partner, he must withdraw from the business and renounce future profits or file an amendment curing the defect. Nevertheless, this equity participant is liable to any third party who has transacted business with the enterprise before the withdrawal or amendment and in good faith, believes that the equity participant was a general partner at the time of the transaction.

## [b] Status of Limited Partners and Extent of Limitation of Liability

The most appealing feature of a limited partnership is the limited personal liability it offers. However, this protection is subject to three conditions:

1. There must be substantial good-faith compliance with the requirement that a certificate of limited partnership be filed.
2. The surname of a limited partner may not appear in the partnership name.
3. The limited partner may not take part in control of the business.

As long as the limited partners abide by these conditions, their liability for any and all obligations of the partnership is limited to their capital contribution.

A general or managing partner of a limited partnership occupies a fiduciary position with respect to his limited partners. The fiduciary duty imposed upon the general partner protects limited partners who are, as a general rule, at the mercy of the general partners' managerial power.

All the limited partners stand on equal footing vis-a-vis each other as to the return of their contributions, their right to income, and any other partnership matter, unless there is an agreement providing for priority as to such items. Such priority provisions must be stated in the partnership certificate.

Generally, a limited partner cannot bind the partnership by his acts, nor is he liable to partnership creditors; however, this does not mean that he is completely free from obligations arising out of the partnership. For example, he is liable to the partnership for the contributions he has agreed to make to the partnership and for any breach of the partnership agreement by him. Also, he may be held liable to the partnership for a sum equal to the amount he has received, plus interest as a return of his capital contributions where necessary to discharge the partner's liabilities to creditors who extended credit to it, or whose claims arose before his contribution was returned to him.

An important question for a limited partner is at what point would he be considered a general partner and thus lose his limited partner status. RULPA imposes general partner's liability only on a limited partner who takes part in control. If the control exercised by a limited partner is substantially the same as the power of a general partner, then he assumes the liability of a general partner to all third parties who conduct business with the partnership. However, if the limited partner's participation in control of the business is not substantially the same as the exercise of the general partners, his liability extends only to those persons who transact business with the limited partnership with actual knowledge of his participation in control. This approach recognizes the difficulty of determining when the control line has been overstepped and reflects the fact that the purpose of imposing general partner's liability is for the protection of creditor's expectations.

In addition, the RULPA enumerates certain activities that a limited partner may carry on without being deemed to have taken part in control of the business:

- Serving as contractor for an agent or employee of the limited partnership or of a general partner.

- Consulting with and advising a general partner with respect to the business of the limited partnership.
- Acting as surety for the limited partnership.
- Approving or disapproving an amendment to the partnership agreement.
- Voting on one or more of the following matters:
  - —The dissolution and winding up of the partnership.
  - —The sale, exchange, lease, mortgage, pledge, or other transfer of all or substantially all of the assets of the limited partnership other than in the ordinary course of its business.
  - —A change in the nature of the business.
  - —The removal of a general partner.

The death or incompetence of a limited partner does not result in the dissolution of the partnership. The personal representative of a deceased limited partner has all his rights for the purpose of settling his estate, including the right to constitute an assignee of the limited partnership interest as a substituted limited partner. The estate also remains liable for the decedent's liabilities as a limited partner.

## [5] Qualifying as a Partnership for Tax Purposes

An entity formed as a general or limited partnership by following appropriate legal procedures does not automatically qualify as a partnership under the Code. Rather, the classification of the entity as a partnership depends on meeting certain regulatory tests that distinguish a partnership from an "association taxable as a corporation." The determination is based on six criteria. Two of them—whether the entity includes "associates" and whether the entity has an objective to carry on a business for profit—are clearly common to both partnerships and associations (i.e., corporations). Thus the essential distinction rests on the remaining four criteria discussed in the following paragraphs.

The tax rules state that to qualify as a conduit for the pass-through of taxable gains and losses to its investors, a limited partnership must not show more than two of the following four corporate characteristics:

1. *Continuity of life.* Because a limited partnership can provide that death, insanity, or retirement of a general partner terminates the partnership, this characteristic is not usually present. The IRS has taken the position that a partnership subject to UPA or similar statute does not possess continuity of life.
2. *Centralized management.* A fundamental characteristic of a limited partnership is that the general partner (or partners) manages the partnership while the majority ownership usually lies in the passive investors who are the limited partners. Thus management is centralized. Consequently, this corporate characteristic is present in a limited partnership.
3. *Limited liability.* For income tax purposes, limited liability is not present and partnership treatment is indicated if the general partner is personally liable for the partnership's non-mortgage debts and also has substantial assets. Thus, neither a dummy corporation nor an individual who is judgment proof can be made a general partner so as to give the appearance, without the reality, of unlimited liability. Since most real estate partnerships are set up with

a general partner having substantial assets, partnership treatment should be indicated.

When a corporation, rather than an individual, is the general partner in a limited partnership, specific requirements have been set forth by the IRS in connection with the limited liability test. The limited partnership will not pass muster unless the following requirements are met:

—*Net worth requirement.* If the total contributions to the partnership are less than $2.5 million, then at all times during the life of the partnership the corporate general partner must have net assets equal to 15 percent of the total contributions or $250,000, whichever is less. If the total contributions are $2.5 million or more, the corporate general partner must have net assets equal to 10 percent of total contributions.

—*Ownership requirements.* The limited partners cannot own, directly or indirectly, more than 20 percent of the stock of the sole corporate general partner. If there are several corporate general partners, the assets of the corporate general partners can be combined for purposes of the net worth requirement. However, the ownership requirement is applied individually to each corporation; the limited partners cannot own more than 20 percent of the stock of any one corporate general partner.

4. *Free transferability of interest.* There is no free transferability of partnership interest, and partnership treatment is indicated if a limited partner needs the general partner's consent to transfer his partnership interest to a substitute limited partner. A provision requiring the general partner's consent is common in real estate limited partnership agreements. Likewise, there is no free transferability of partnership interests if a partner's right to assign his interest is limited to assigning his share in the profits of the enterprise. Free transferability of partnership interests is also lacking where the transfer of a partner's interest results in the dissolution of the partnership and the formation of a new partnership under state law.

There can be a modified form of transferability of interest under which each partner can transfer his interest in the partnership to an outsider only after offering it to the other partners at fair market value. This modified form of transferability is less likely to be viewed as a corporate characteristic than full transferability.

Because most hotel-formed limited partnerships do not show continuity of life, limited liability, and free transferability of partnership interest, partnership treatment—that is, the pass-through directly to the partners of taxable partnership income, gains, and losses—can reasonably be assured.

## [6] Taxation of Partner's Share of Income, Gain, or Loss

The rules for the taxation of partnerships and partners (constituting Subchapter K of the Code) are among the most complex provisions in the entire tax law, and the advice of professional counsel is always beneficial in connection with partnership tax planning or tax reporting.

Each partner must report his distributive share (whether or not actually distributed) of partnership income, gain, or loss on his income tax return. The distributive shares of partnership items are shown on Schedule K and Schedule K-l of IRS Form 1065.

A partner may deduct his share of partnership losses only to the extent of the

adjusted basis of the partnership interest in the partnership. A partner's tax basis generally includes the amount of money the partner contributes to the partnership, the adjusted basis of any property contributed by the partner, and the partner's share of partnership liabilities that is allocated or assumed by the partner.

A partner's ability to deduct a share of partnership losses is further limited to the amount for which the partner is "at risk," A partner is considered at risk with respect to the sum of money and the adjusted basis of property he contributes to the partnership, including amounts contributed from funds borrowed by the partner or the partnership from third parties, but only to the extent to which the partner is personally liable to repay such amounts. In addition, nonrecourse financing (i.e., under which the partner is not personally liable) will be included as an amount at risk in either of the following two cases:

1. When the loan is from a qualified lender (i.e., one engaged in the business of making loans) or any federal, state, or local government or instrumentality, provided that the lender is not the promoter or seller of the property or a party related to either.
2. When a loan is from a qualified lender that has an equity interest in the venture as long as the terms of the financing are commercially reasonable and on substantially the same terms as loans by lenders that do not have an equity interest in the venture. The terms of nonrecourse financing are commercially reasonably if the following apply:
   —The borrower executes a written unconditional promise to pay on demand or on a specified date.
   —The amount to be paid is a fixed sum of money.
   —The interest rate is a reasonable market rate of interest, taking into account the maturity of the debt.

Another significant limitation on the ability of partners to deduct losses are the passive activity loss rules. When the amount at risk is reduced below zero at the end of a taxable year, the partner must recognize income to the extent that his or her at-risk basis is reduced below zero.

## [7] Organization and Syndication Fees

A partnership often incurs significant expenses in connection with its organization or the sale of a partnership interest. Such costs may not be deducted in the year incurred. However, the partnership can elect to amortize certain of these costs over a period of not less than sixty months, beginning with the month the partnership begins business. If the partnership is liquidated before the end of the sixty-month period, any remaining balance can be deducted as a loss. The costs that may be amortized are organization fees but not syndication expenses.

Organization fees are expenses related to the creation of the partnership and that are chargeable to capital accounts. They include legal and accounting fees related to the organization of a partnership, and filing fees. They do not include expenses of acquiring assets for the partnership, or those connected with the admission or removal of partners other than at the time the partnership is first organized, or those connected with any contract relating to the partnership trade or business. Syndication expenses are specifically nondeductible expenses. These are expenses connected with the issuing and marketing of partnership interests, and include the following:

- Brokerage fees
- Registration fees
- Legal fees of the underwriter or placement agent and the issuer
- Accounting fees in connection with the offering material
- Printing costs of the offering material
- Other expenses relating to selling and promotional material

## [8] Disposition of Partnership Interests

The disposition of a partnership interest generally results in capital gain or loss to the partner. The amount of gain or loss generally is the difference between the amount realized by the partner and the adjusted basis of the partner's interest in the partnership. If the partner is relieved of any liabilities of the partnership, the amount of such liabilities is included in determining the amount realized by the partner.

## » 15.05 REGULAR CORPORATIONS

A corporation is a separate legal entity—an artificial person—created in accordance with the laws of a particular state; the federal government does not have the power to create business corporations. A corporation's charter may provide that it will have a perpetual life, and it establishes its operation through a board of directors elected by the shareholders. However, for business and tax purposes, the corporation is an entity entirely distinct from its stockholders. Thus, the major advantage of, and original purpose for, the corporate form was to limit each shareholder's liability to the amount of his capital investment; a secondary purpose was to make shareholder interest freely transferable by means of assignable corporate shares.

The basic legal and economic incidents and consequences of operating under the corporate form of ownership can be summed up as follows:

- A *corporation:*
  —Can hold and, deal in property in its own name.
  —Can sue and be sued in its own name.
  —Has only those powers and can engage in only those activities that are within the scope of the powers expressly or impliedly granted to it under its state charter or certificate of incorporation.
  —Continues to exist until it is dissolved by law, unless a statute limits its duration.
  —Can raise capital by the sale of new shares, bonds, debentures, or other securities.
  —Can, apart from its shareholders, seek out sources of credit and borrow funds. Also, in a closely held corporation, the corporate shares can be used as collateral for a corporate loan.
- *Corporate shareholders:*
  —Are not, merely by reason of being shareholders, personally liable for corporate debts and liabilities; each shareholder has at stake only the amount of his capital contribution.

- — Can freely sell or otherwise transfer their shares, in the absence of a provision to the contrary.
- —Are not responsible for the management of the corporation or for any venture conducted by the corporation.

- *Corporate Directors:*
  - —Are the repository of the central authority of the corporation. The board of directors manages the affairs of the corporation and acts according to the vote of a majority of its members.
  - —Must account to and are responsible to their stockholders for their acts, or for conduct that is outside the scope of their charter powers, or that is otherwise improper or unlawful.
- *Corporate officers:*
  - —Can exercise only such authority as is delegated to them under the corporate charter or certificate of incorporation.
  - —Can bind the corporation by their acts or conduct that is within the scope of their actual or apparent authority.
  - —Are answerable to the board of directors and must account to the board for their activities.

## [1] C Corporations

The major disadvantage in using a C corporation to own a hotel development is that the corporation is recognized as an independent entity for tax purposes. Thus, tax losses from corporate-owned real estate cannot be passed through to the individual shareholders, but can be used only by the corporation itself; because it may not have any other income against which the losses may be offset, the losses may be of no use.

On the other hand, if the corporate property produces net income, a problem of double taxation must be faced. The corporation first must pay a corporate income tax on its net income; then, to the extent the income is distributed in the form of dividends, the shareholders must pay a personal income tax on such income. In the case of a closely held corporation (known as a close corporation), the problem of double taxation can often be avoided by distributing corporate income to the shareholders in the form of salaries or other compensation. In this situation, the corporation may deduct the cost of such salaries and thus reduce its own income, although the shareholder-employees will be taxed on the income they receive.

In addition, a corporation can accumulate income (up to a point) that can ultimately be passed through to shareholders as capital gain when the shareholders sell their shares at prices that reflect the earnings that have been accumulated. Important tax factors to consider in choosing the C corporate form of ownership include:

- Principals, as officer-stockholders or as employee-stockholders, can have a tax-favored retirement or pension plan set up for them.
- Principals can be paid a salary that the corporation can deduct as an ordinary business expense.
- The compensation paid to a principal as a corporate officer or employee is subject to withholding and social security taxes.
- While a shareholder can assign his shares as he sees fit in the absence of restrictions imposed by agreement, corporate charter, or otherwise, he cannot assign earnings separate from the shares.

- Corporate income is taxable to the corporation and not to the shareholders until it is distributed to them in the form of dividends.
- A corporation is subject to various sate and local taxes, which are deductible on its federal income tax return.
- Death benefits of up to $5,000 can be received tax-free by a stockholder-employee's beneficiaries.
- Income accumulated in the corporation is not taxable to the shareholders, but there is a penalty tax if the purpose of the accumulation is to avoid the corporate surtax and the accumulation is greater than is permissible.
- A corporation may be able to use a loss generated by a hotel investment to offset income from its other properties, or it can carry over the loss to offset future income.
- Low-bracket taxpayers can manage the hotel and be paid salaries by the corporation for their services. The salaries can account for a substantial portion of the corporate income and thus reduce the corporate tax burden. The salaries would be taxed at ordinary income rates, but only at the taxpayers' low tax brackets. The corporation would be entitled to deduct the amounts it paid as salaries from its gross income, provided the salaries are reasonable and are paid for actual services rendered to the corporation.

## [2] S Corporations

The corporate form of ownership has many limitations as far as its use in hotel development. Since hotels are capital-intensive projects that generate substantially early deductions for depreciation and debt service, the hotels usually show losses for many years. Corporate ownership of real estate prevents those losses from being passed through to the individual shareholders. In addition, if the corporation begins to generate income sufficient for distribution, then the hotel earnings are taxed twice, once at the corporate level and again when distributed as a dividend.

However, for many closely held corporations, the Internal Revenue Code provides for loss and income passthrough similar to a partnership, if the owners have elected the S corporation. As will be demonstrated subsequently, the S corporation is ideal for the hotel development when either the investors contribute proportionally, or are family members using the S corporation as a means of splitting income among family members.

S corporations are organized for the purpose of insulating their shareholders from personal liability for corporate obligations, and for making the transfer of ownership of stock certificates a simple matter. At the same time, they are not independent tax entities and, just as a partnership, are able to pass through to shareholders the profits and losses from operations.

### [a] Eligibility Requirements

The following are five requirements for S corporation status:

1. *Domestic corporation.* This category includes any incorporated organization taxed as a corporation.
2. *Number of shareholders.* The maximum number of shareholders is thirty-five, but spouses holding shares are treated as one shareholder. Shareholders must be individuals, estates, or grantor trusts; they cannot be nonresident

aliens or foreign trust. Shares cannot be held in a custodial account for a minor.

3. *Shares.* An S corporation must have only one class of outstanding stock, and all outstanding shares must carry identical rights to share in corporate profits and assets. Differences in voting rights in common stock, however, are permissible. In addition, a debt instrument may not be reclassified by the IRS as stock, so as to constitute a disqualifying second class of stock, if it complies with the safe-harbor rules for debt instruments provided by the Sub-chapter S Revision Act of 1982.
4. *Affiliation.* A member of an affiliated group of corporations cannot be an S Corporation.
5. *Companies eligible for special tax treatment.* Banks, financial institutions, and insurance companies cannot elect S corporations status even if they can meet the eligibility requirements of the act.

## [b] Election and Termination of Status

An S Corporation election made on or before the fifteenth day of the third month of a corporation's taxable year is effective beginning with the year made if all eligibility requirements are met during the preelection period, and all persons who held stock during that period consent to the election. The reason for requiring such unanimous consent is to prevent the allocation of income or loss to preelection stockholders who are either ineligible or do not consent to such allocation. If the eligibility requirements were not met during the preelection period or if the election is made late, it does not become effective until the following taxable year.

The following events will cause the S corporation status to be terminated effective on the date on which the event occurred:

- Exceeding the maximum number of shareholders
- Transfer of stock to an ineligible shareholder
- Creation of a second class of stock
- Acquisition of a subsidiary

In addition, an S corporation can be voluntarily revoked by its shareholders. If holders of more than 50 percent of the voting stock agree, the corporation may voluntarily revoke the S corporation status of the corporation. A revocation, filed up to and including the fifteenth day of the third month of a taxable year is effective for the entire taxable year unless a prospective date is specified. A new shareholder cannot terminate an election by refusing to consent to the election, unless he owns more than 50 percent of the voting stock.

## [c] Comparison With Limited Partnerships

Many people assume that the limited partnership and S corporation are the same, but there are some major differences that usually make the limited partnership the preferred form of hotel ownership. Some of the more important differences are listed as follows:

- *Allocation of income and losses.* Both the S corporation and the limited partnership are conduits for tax purposes. However, the limited partnership has a greater flexibility in allocating income and losses to its partners than S cor-

porations. A limited partnership can allocate income and losses to the partners providing economic substance to the transaction. For example, a partner contributing property to the partnership may receive the depreciation expense, whereas the S corporation must allocate income and losses to each shareholder in direct proportion to their percentage of stock ownership.

*Unlimited members.* A limited partnership has no specified limit on the number of partners, while the S corporation is limited by law to thirty-five shareholders.

*Tax basis.* A major distinction between an S corporation and a partnership involves the tax basis for the investment. In a partnership, each partner receives a tax basis in his partnership interest equal to his capital contribution plus his share of partnership debt. Even limited partners share in partnership nonrecourse debt (but they may share in recourse debt only to the extent of any unpaid capital contributions). By comparison, S corporation shareholders receive only basis for their capital contributions plus their loans to the corporation.

Basis is important because losses may be taken by the individual investors only to the extent of their basis (assuming other hurdles, such as allocations, at-risk, and passive loss limitations, are overcome). In addition, excess financing and refinancing proceeds can be distributed tax free only to the extent of basis.

*Tax status.* The Subchapter S Revision Act of 1982 simplified the rules affecting S corporations, making it far less likely that an S corporation's status as such will be challenged by the IRS. Partnerships are subject to a somewhat greater risk of challenge. In either case, a successful challenge by the IRS would bar the pass-through of taxable losses to investors, because the corporation or partnership would be considered a C corporation and taxable as such.

## » 15.06 LIMITED LIABILITY COMPANIES

The Limited Liability Company (LLC) is a fairly recent entity development that has been adopted in many states. The LLC can limit liability more effectively than a limited partnership and is less restrictive than an S corporation; for certain hotel developments, it may become the preferred form of ownership.

An LLC is an entity formed under state law to conduct a business or investment activity. It is created by filing articles of organization with the appropriate state agency in a manner similar to that required for corporations. Its bylaws are called regulations and its participants are called members. The three major advantages of an LLC are as follows:

1. *No double taxation.* When properly structured, an LLC is treated for federal income tax purposes as a partnership; therefore, no tax is payable at the partnership level but only by the individual partners.
2. *Flexible ownership.* Like a partnership, the LLC permits its members significant freedom in making disproportionate allocations of income, gain, loss, and cash flow. A major advantage of the LLC over an S corporation is that no limitations are imposed on the types and numbers of owners. For example, corporations and partnerships may be members of an LLC, but are ineligible to the shareholders of an S corporation. More than thirty-five individuals and/or entities may be members of an LLC, whereas S corporation shareholders are limited to that number. (However, an LLC must have more than one member as compared with an S corporation, which can have a single shareholder).

3. *Limited liability.* As its name indicates, an LLC puts only the assets of the company at risk. In comparison with a partnership, in which the general partner or partners must accept personal liability, all members of an LLC are protected against personal liability. Furthermore, any member of an LLC can be active in the management of the business while still retaining limited liability; in a limited partnership, the limited partners must be careful not to step over the line between passive investment and active management.

The four significant disadvantages of an LLC are as follows:

1. *State taxation.* Although an LLC is generally exempt from federal income tax, state tax rules may differ. For example, in Florida (which does not have an individual income tax), LLCs are treated as corporations subject to the Florida corporate income tax rate. At the same time, partnerships and S corporations are exempt from Florida income taxation. In addition, a state may seek to apply its franchise tax, which does not normally apply to a partnership, to an LLC.
2. *No perpetual life.* As in the case of a partnership, the LLC cannot have a perpetual life. For example, in several states, an LLC dissolves upon the earlier of the following:

   —Expiration of its state term

   —Agreement of all members to terminate

   —Death, retirement, insanity, bankruptcy, or expulsion of a member (unless all remaining members consent to continue the business pursuant to rights stated in the organizing articles).
3. *Limits on transfer ability.* The LLC (like a partnership) lacks the easy transferability of corporate share. Recipients of membership interests in an LLC often do not have full rights of ownership or management participation unless consent to the transfer is received from all members, thus restricting free transferability.
4. *Lack of legal precedent.* Finally, the short existence of the LLC as an entity means very few court decisions have been rendered. Thus, a good deal of uncertainty exists as to the legal status of the LLC and its members. Furthermore, it is not all clear as to the status of LLC members in states not having LLC statutes. For example, would a member of an Florida LLC be protected from personal liability for LLC obligations incurred while the LLC was operating in a state without an LLC statute? Additionally, the application of the partnership's tax concepts to an LLC may become complex. For example, allocating liabilities to determine tax basis and amounts at risk may produce unexpected results.

Trusts are the least frequently used form of ownership entity for hotels. A trust is a legal relationship in which a trustee holds legal title to property (the hotel property or otherwise) with the responsibility of administering it and distributing the income for a beneficiary who is deemed to be the holder of the equitable title.

Three kinds of trusts can be distinguished. The first is a real estate investment trust (REIT), which is a creation of the federal tax laws. This form of business entity will be discussed in more detail in the following section.

## » 15.07 TRUSTS

Personal trusts are those set up for the benefit of members of a family, particularly the spouse or children of the grantor of the trust. They can be an effective means of shifting the tax burdens of property to persons in lower tax brackets, while at the same time reserving essential control of the property to the grantor or his associates. However, the Tax Reform Act of 1986 (TRA) limits the tax benefits formerly available from trust. Because the subject of trust and estate taxation is highly specialized, and because such taxation is applicable to all forms of property, not merely hotel development, a discussion of trust and estate taxation is not included here.

The third type of trust, the business trust (also known as the Illinois Land Trust, because it originated there), has a long history as a real estate-owning entity. However, its use today is limited to five states besides Illinois: Florida, Virginia, North Dakota, Hawaii, and Indiana. The land trust is a device by which a hotel or other real estate is conveyed to a trustee under an arrangement reserving to the beneficiaries of the trust the full management and control of the property. The trustee executes deeds and mortgages or otherwise deals with the property at the written direction of the beneficiaries, who exercise all rights of ownership, other than holding or dealing with the legal title.

The benefits of a land trust include the following five points;

1. *Secret ownership.* In states that recognize the use of a land trust, the identity of the beneficiaries is not contained in any public record. Only the name of the trustee, the date of the trust agreement, and the number of the trust is disclosed in the deed in trust. By comparison, all other states require that the name of an owner of real property, be it an individual, corporation, or other legal entity, be shown on the deed and be available for public inspection in the appropriate records office.
2. *Transfer tax avoidance.* In those states that recognize the land trust, the use of the entity may permit the avoidance of payment of a real estate transfer tax, since the real estate in the trust is not transferred as such; instead, the beneficial interest in the trust is assigned or sold, and these are designated as personal property.
3. *Insulation from judgment liens.* In Illinois, and possibly in other states that recognize the land trust, a judgment against a beneficiary does not create a lien against the title of the real estate held in the trust. The trust property, in effect, is insulated from the legal process (although the judgment creditor may be able to claim against the beneficial interest).
4. *Ease of transfer.* Because the beneficial interest in the land trust is treated as personal property, it may be transferred from one party to another by means of an assignment rather than by the more cumbersome process involved in transferring real estate, which involves examination of title, agreement as to covenants and warranties by the seller, and so forth.
5. *Not subject to partition.* Unlike other forms of concurrent ownership (i.e., tenancy in common and joint tenancy), land held in trust is not subject to the remedy known as partition, by which one co-owner may seek to have the property sold and receive his share of the proceeds. Usually, the withdrawal of a beneficiary from a land trust is a matter of voluntary agreement among all the beneficiaries.

## » 15.08 REAL ESTATE INVESTMENT TRUST

Real Estate Investment Trusts (REITs) have been around since 1960, when they were made part of the Internal Revenue Code. A REIT is strictly a creation of the federal

tax laws. It must have at least 100 shareholders to qualify for special tax treatment, and more commonly is in the form of a corporation, rather than a trust. A qualified REIT is entitled to conduit tax treatment (i.e., it may distribute income to its shareholders without the imposition of a corporate tax, thus avoiding the "double tax" burden on regular business corporations). The congressional purpose for creation of REITs was to make real estate investments more accessible to the general investing public; at the same time, REITs enabled real estate developers and owners of large real estate portfolios to tap the general capital markets for financing.

As Exhibit 15-1 indicates, REITs have shown a high rate of return in recent years. It will be interesting to see if they are able to maintain that high level of return.

**Exhibit 15-1 Total REIT Returns (1990–1997)**

*Source: NAREIT. (NAREIT reported a total return of 30.09% for lodging REITs in 1997.*

| Year | All | Equity |
|---|---|---|
| 1990 | (17.35)% | (15.35)% |
| 1991 | 35.68 | 35.70 |
| 1992 | 12.18 | 14.59 |
| 1993 | 18.55 | 19.65 |
| 1994 | 0.81 | 3.17 |
| 1995 | 18.31 | 15.27 |
| 1996 | 35.75 | 35.27 |
| 1997 | 18.86 | 20.26 |

## [1] Organizational Requirements

A REIT must be a corporation, trust, or association managed by one or more trustees or directors. Many REITs have chosen the corporate form over the business trust form, because it is simpler in terms of state law considerations.

The REIT must have beneficial interest represented by transferable shares or certificates of beneficial interest. There may be two classes of stock or shares (e.g., a second class with a preference as to dividends and liquidation). A REIT must be beneficially owned by at least 100 persons for at least 335 days of a tax year of 12 months, or a proportionate part of a short year. The attribution rules under the Code are not applied in making the determination; consequently, the number of shareholders, not the relationship among them, is the only determinant of whether the test is made.

The tax year must be the same as the calendar year.

At no time during the last half of the REIT's tax year can more than 50 percent of the value of a REIT's outstanding stock be owned by five or fewer individuals. Certain attribution rules are applied in this determination.

A REIT can be self-managed or can operate through an external adviser. A self-managed REIT operates in much the same manner as a corporation, with a board of directors (or trustees), officers, and employees. A REIT may also contract for an external entity to manage its operations and investments. Both types of management forms are widely used—the objective of the REIT determines which form is more desirable. A self-managed REIT is more logical for an active organization needing full-time operators, while an externally advised REIT is probably more useful in instances in which the REIT is one element of a larger organization.

## [2] Income Requirements

REITs are required to receive 95 percent of their gross income from the following sources: dividends; interest; rents from real property; gains from the sale or disposition of stock, securities, and real estate; abatement and refunds of real property taxes;
income from foreclosure property; commitment fees; and gains from the sale of real estate assets that are not prohibited transactions (i.e., assets that were held primarily for sale, with the exception of foreclosure property).

Of the foregoing, 75 percent of the gross income of the REIT must be derived from the following income sources; rents from real property; abatements and refunds of real property taxes; foreclosure sales; commitment fees; gains from the sales of real estate assets; interest on obligations secured by mortgages on real property or interests in real property; gains from the sale of real property not held primarily for sale to customers; dividends or other distributions and gain from the sale of shares in other REITs.

Income derived from rents contain a number of restrictions, the most important of which is that any amount received with respect to property is not rent if the REIT furnishes services to the tenant or manages or operates the property without an independent contractor. The independent contractor may be affiliated with the adviser to the REIT; however, the independent contractor cannot hold more than 35 percent of the shares or beneficial interest in the REIT. In addition, the REIT is not to receive any income from the independent contractor.

Less than 30 percent of the REIT's gross income can be derived from the sale or other distribution of the following: stock or securities held for less than six months;
sales or dealer property; and real property (including interests in real property and interests in mortgages on real property) held less than four years, other than foreclosure property or involuntarily converted property.

## [3] Asset Requirements

At least 75 percent of the value of the REIT's total assets must consist of real estate assets, including land, interests in real property mortgages, shares in other REITs, and partnership interests to the extent of the interest's proportionate share of partnership real estate assets; cash; cash items (including receivables); and government securities. Mortgage-backed securities qualify as real estate investments.

No more than 25 percent of the value of the REIT's total assets can be securities (other than those included in the 75 percent asset test above). The securities of any one issuer cannot be more than 5 percent of the REIT's total assets, and the REIT's interest in an issuer's stock cannot be more than 10 percent of the outstanding voting securities of the issuer.

## [4] Dividend Distributions and Taxation

To avoid paying taxes at the corporate level, the REIT must distribute to the shareholders dividends in the amount of 95 percent of its taxable income, less net long-term capital gains, any net income from foreclosures, and certain other items. If the REIT does not distribute at least 95 percent of its taxable income during each taxable year, it is subject to a 3% excise tax on the amount of the underdistribution.

There is generally no tax liability for a REIT, because its income is taxed only at the shareholder level. The REIT is not a true pass-through entity like a partnership, but it is still effectively not subject to taxation because it is eligible for a deduction

for dividends distributed and must distribute nearly all of its taxable income as dividends, As a result, the typical REIT has an insignificant amount of taxable income, taxed at the corporate level.

Dividends received by the shareholders are ordinary income to the extent of the REIT's earnings and profits. The earnings and profits of a REIT are computed using a forty-year straight-line depreciation. Distribution of greater than 100 percent of earnings and profits, however, are treated by the shareholder as return of capital.

The sale of a shareholder's interest in a REIT is taxed in the same manner as the disposition of stock. The return of capital, as opposed to payment of dividends, reduces the shareholder's basis.

## [5] Types of REITs by Asset Holdings

In terms of the type of assets held, REITs are of three types: equity REITs, mortgage REITs, and hybrid REITs.

### [a] Equity REITs

An equity REIT is one that owns real estate directly. The purpose of an equity REIT is primarily to generate rental income that will be passed through to shareholders. The vast majority of REITs are considered equity REITs.

Some equity REITs invest in a diversified portfolio of income-producing real estate, while others specialize in a single category of property (e.g., hotels). Similarly, some REITs concentrate their investments in one geographic area of the country while others buy properties in various locations.

### [b] Mortgage REITs

Mortgage REITs are lenders involved in financing real estate rather than owning it. Only a small percentage of REITs engage in this form of lending activity. However, because traditional lenders to the hotel industry have reduced their lending activities, mortgage REITs could play an important role in the future.

Mortgage REITs have one major advantage over traditional lenders in that REITs are subject to virtually no regulation as to the type of mortgages that they can make. Thus, a mortgage REIT can make loans in the form of participating mortgages that not only provide the REIT with a fixed return on invested capital, but also offer the prospect of a share in future growth or a share in the proceeds from any subsequent sale or refinancing of the property. REITs also are in a position to make the various forms of subordinate loans, including second mortgages, wraparound loans, and various forms of refinancing. They can also be a source for gap or bridge loans and other forms of interim financing for borrowers unable to find other lenders, particularly when interest rates are high.

Some mortgage REITs have engaged in land purchase—leaseback arrangements, whereby the REIT purchases the land on which income-producing property has been constructed. The REIT then leases the land for a long term (up to ninety-nine years). With various equity features built into the purchase-leaseback, the REIT can return in the form of ground rent. Finally, REITs still are involved to some degree in short-term construction and development lending.

### [c] Hybrid REITs

As its name implies, a hybrid REIT combines the features of both an equity and a mortgage REIT. The hybrid attempts to structure a mixed portfolio that includes ownership interest in income-producing property, financing of property through mortgage loans, and holdings of short-term government securities and mortgage pass-through securities. The object is to create a balanced portfolio that provides a fixed income return to investors as well as the prospect of future growth in income.

## [6] Structuring a Hotel REIT

A number of hotel chains are currently weighing the advantages of going public, possibly as REITs. The major benefit would be the ability to raise large amounts of equity capital to finance ongoing renovations and new development while avoiding the burden of high debt-service costs. The incentive for public investors would be the opportunity to participate in the enormous growth in travel that is anticipated by the end of the century.

It is true that hotel chains in the past often did not meet standard investment criteria for publicly traded companies. The returns from hotels, as already noted, often come as much from appreciation in value and tax benefits as from operating earnings. Ratios used to measure performance of public companies, however, focus almost exclusively on earnings (in the form of such ratios as price/earnings, return on equity, and return on assets). These and similar factors ignore the appreciation element and the prospects of tax-free distributions resulting from debt refinancing. Finally, earnings of many hotel chains often are extremely volatile because of their highly leveraged position and high level of fixed costs.

If hotel chains can raise equity capital via REITs or other public structures, earnings volatility would be substantially lessened. At the same time, hotel earnings could stabilize at relatively high levels if the trend to increasing travel materializes. The result could well be transformation of a hotel investment from one fraught with risk for the investor to one that compares favorably with other forms of real estate investment.

Hotel REITs are unique because hotel profits are considered "unqualified" income, i.e., not the type of passive income that a REIT is permitted to earn. Thus, instead of a REIT operating its hotels, that REIT must enter into participating leases with an outside entity. To comply with REIT tax rules, the participating lease payments made by the lessee to the REIT must be based on gross revenues (rather than net cash flow).

The debate concerning this structure is whether the lessee should be an independent third party having no interest in the REIT or an entity affiliated with the REIT sponsor. Each structure has its advantages and disadvantages.

The primary appeal of an independent lessee is that the lease terms are negotiated at arm's length and thus gives greater assurance that the lessee's profits are not excessive. The practical problem with this approach is that few, if any, creditworthy lesses are available. Furthermore, even an independent lessee would want a substantial share of the operating profits in light of the risks involved; this would require the REIT to give up a substantial portion of the upside potential. The net result is that the REIT would, in effect, hold a net lease with limited upside potential.

Historically, hotel management companies receive a fee (e.g., 3 to 4 percent) of gross revenues rather than of net cash flow. One cause of the hotel problems of the late 1980s was that third-party lessees were motivated to increase gross revenues without regard to bottom-line performance. The result was that their fees increased while the owners' return declined. For this reason, many investors now favor a lessee affiliated with the owner.

Leasing to an affiliated party has a reverse set of advantages and disadvantages. If the REIT sponsor is also the lessee, questions of fairness can arise from negotiations not made at arm's length. On the other hand, an affiliated lessee offers two advantages to the REIT. First, if the lessee has a substantial investment in the REIT itself (which usually should be the case), it not only has a fiduciary duty to the REIT but also is likely to earn more through REIT dividends than through a management fee. Second, an affiliated lessee is much more likely to accept a rent structure that mirrors the operating performance of the underlying hotel properties, passing as much upside (or downside) as possible to the REIT.

Possibly the best approach is to combine an affiliated lessee with various credit-enhancing structures that reduce the risks of conflicts of interest. For example, the lessee may be required to maintain a substantial reserve to guaranty lease payments before any profits can be retained by the lessee.

## [7] The REIT Modernization Act

One of the most important changes to REIT structures will occur on January 1, 2001 when the REIT Modernization Act of 1999 (RMA) takes effect. This wide sweeping law will affect the lodging industry in a number of ways. The most important change is that it will permit lodging REIT's to own up to 100% of the stock of an independent entity or taxable REIT subsidiary (TRS) that engages in non-REIT activities. The practical application of the TRS provision to the lodging industry is that lodging REITs will now be able to lease their assets to a TRS, rather than some third-party or captive lessee. TRS that are of a lodging REIT will not be permitted to manage any property. As such, the hotels would still need to be managed by either third party management company. Additionally, no gambling can occur at the leased hotels. Many hotel companies have already stated that they will be setting up TRS structures and recapture their leases.

RMA allows changes to the payout requirement of REITs from the current 95% of income to 90% of income, beginning in the year 2001. This will allow hotel REITs to be able to retain more income for capital improvements. Also, the lower payout requirement will give hotel REITs more flexibility.

Finally, RMA designation will allow hotels to pursue different types of business that they were permitted under the old law. However, under the RMA, REITs will be prohibited from having more than 20% of gross assets (combined equity and debt) as investment in their TRS.

HVS

CHAPTER 16

# Capital Sources and Financing


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## » 16.01 INTRODUCTION

The hotel industry has recovered almost completely from the time in the early 1990s when obtaining any type of financing was difficult. With the renewed success of the hotel industry, lenders are more willing to loan to valid hotel projects. This chapter explores the various financing techniques and sources of capital commonly used in the hotel industry. In addition, this chapter discusses the mortgage loan process and what the hotel developer should consider when obtaining a mortgage.

Exhibit 16-1 indicates the breakdown between various financial institutions that lend to the hotel industry.

**Exhibit 16-1 Who Provides Hotel Financing**

*Source: PKF Consulting. Hospitality Investment Survey (1996)*

**Other sources included investment banks, SBA loans, mortgage funds, conduits, and private equity.*

| Source | Percentage |
|---|---|
| Bank | 58.0% |
| Other Source* | 36.0 |
| Seller | 24.0 |
| Insurance Company | 24.0 |
| Pension Fund | 18.9 |
| Savings & Loan | 3.4 |

This chapter divides equity and debt sources into the following two categories:

1. Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:

   —Commercial banks;

   —Life insurance companies;

   —Private credit companies; and

   —Pension funds.
2. Investment conduits, which are primarily entities that invest in hotel real estate mortgages and passthrough income and gain to investors (both private individuals and institutions), including:

   —Real estate limited partnerships (RELPs);

   —Real estate investment trusts (REITs); and

   —Commercial mortgage-backed securities (CMBS).
3. Mortgage financing, which is how most hotels are financed. Topics covered include:

   —Types of mortgage loans; and

   —Obtaining a hotel mortgage.

## » 16.02 COMMERCIAL BANKS

Commercial banks have historically played the most significant role in providing financing for the hotel industry. However, they have been hurt by the real estate collapse of hotels during the early 1990s. Commercial banks sold off distressed and foreclosed loans and limited new lending to only the most healthy of hotel developers.

A significant new restraint on future hotel lending by commercial banks and by savings institutions is the Uniform Rule on Real Estate Lending established by the four banking agencies (the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision). The Uniform Rule, issued on December 31, 1992, requires every lender to adopt a written policy establishing appropriate limits and standards for granting real estate loans. Such loans are those secured by mortgages, as well as loans made for financing permanent improvements, whether secured or not.

As a supplement to the Uniform Rule, the agencies simultaneously promulgated a set of guidelines that establish the specific factors banks are expected to consider in establishing real estate (including hotel development) lending policies. Although the guidelines are not mandatory, a lender failing to comply with them invites extra scrutiny from regulators.

A crucial component of the guidelines is the loan-to-value (LTV) limits on real estate loans. The LTV ratio is based not only on the value of the property securing the loan but on the value of any acceptable collateral in addition to the real estate. The guidelines set supervisory LTV limits for various categories of loans as follows:

- For raw land, 65 percent
- For land development loans, 75 percent
- For commercial construction loans, 80 percent
- For improved property, 85 percent

The mere fact that a loan is made within the supervisory LTV limits does not mean it will automatically be deemed sound by a bank examiner. The lending institution must evaluate other credit factors as well, including:

- The capacity of the borrower or the sufficiency of income from the property to service the debt;
- The overall creditworthiness of the borrower;
- The amount of equity invested by the borrower; and
- Any forms of credit enhancement, including guaranties, mortgages, insurance, and additional collateral.

The guidelines also recognize that "exception loans" (those exceeding the supervisory LTV limits) may be appropriate if the credit factors justify the loan. Banks must identify these loans in their records and report all significant exception loans quarterly to their board of directors. As an upper limit, the aggregate amount of all exception loans for commercial loans, agricultural, multifamily, or other residential property (other than one- to four-family homes) may not exceed 30 percent of a bank's total capital.

Several types of loans are excluded from the supervisory LTV limits. These include:

1. Loans renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs) or in connection with a workout, with or without the advancement of new funds, if the restructuring is consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery of the loan;
2. Loans that facilitate the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith;
3. Loans to be sold promptly after origination, without recourse, to a financially responsible third party; and
4. Loans guaranteed or insured by federal, state, or local governments and a wide range of traditional corporate and business loans not considered true real estate lending, even though such loans might involve real estate collateral or improvements.

## » 16.03 LIFE INSURANCE COMPANIES

Life insurance companies have played an important and varied role in hotel development, from providing direct loans for development to participating as equity partners in the ownership of the hotels. Life insurance companies are among the largest financial institutions in the world. Their primary function is to provide financial security to policyholders through life insurance. The premiums collected by the companies are used largely to maintain reserves from which benefits are paid; these reserves constitute enormous capital pools that must be invested for long periods. Because the inflow of funds from premium payments can be predicted with great accuracy, and because fund outflows (upon the death of individual policyholders) can also be estimated with great accuracy, insurance companies are in a position to commit several years in advance to providing loan funds to borrowers and to make long-term commitments of capital.

Because an insurance company's obligations usually are measured in fixed dollars (e.g., the face amount of a life insurance policy), in theory it need not be overly concerned with the depreciation of the dollar through inflation. As a result, insurance companies always have been a major source of fixed-interest mortgages for hotel developers. However, during the period of high inflation that began during the Vietnam War and lasted throughout the 1980s, insurance companies found it necessary to offer a variety of indexed or variable insurance and annuity plans that gave insured persons some hope of hedging against the continued erosion of the dollar. Thus, insurance companies themselves were forced to seek an inflation hedge, resorting to financing techniques such as variable interest rates, equity participation, and other formulas.

Because of their volume of lending and the fact that they are subject to much less regulation than commercial bands and savings institutions, insurance companies have been responsible for many of the creative financing techniques that have surfaced during the past quarter century. Indeed, some insurance companies in the 1980s became virtual partners with developers or property owners by entering into joint ventures and participating loan arrangements that enabled the insurance company to share in any future growth of the property. This trend has all but disappeared following the real estate crash that began in the hotel business in 1987.

Insurance companies are still a significant financing source for the hotel industry. However, they have been reluctant to originate new mortgage money for hotels because of the serious overbuilding that occurred in the early 1990s. With occupancy rates increasing in both 1995 and 1996, it remains to be seen whether insurance companies will once again take the lead in financing of hotel projects.

Insurance companies along with commercial banks are turning with increasing frequency to the purchase of real estate securities rather than whole mortgages.

## » 16.04 PRIVATE CREDIT COMPANIES

In the early 1990s, when the traditional financing sources—commercial banks, savings institutions, and insurance companies—were unwilling or unable to provide real estate capital, private credit companies sought to expand their normally small share of the market. Credit companies, often called "lenders of last resort" because of their typically high interest rates and arduous terms, are usually real estate subsidiaries of large industrial companies. They generally peg their lending rates as a float over prime or at a comparable spread. Although credit from these lenders is generally expensive, they have become especially useful in providing the funds needed to acquire underutilized hotel property with appreciation potential.

At the height of real estate financing in the late 1980s, twenty-one major credit companies offered funding programs. The most prominent companies included European, Japanese, and American corporate loan subsidiaries. By the mid-1990s, the picture was quite different. Only a few major credit companies remained active; although they had an abundant supply of funds, they were highly selective. Nevertheless, they were prepared to extend their lending capabilities to a wide range of underwriting alternatives, as is discussed subsequently.

1. *Permanent loans.* Credit companies invade life insurance company and pension fund territory by structuring fixed-rate permanent mortgages, junior debt, and participating debt/equity deals. Unlike other permanent lending sources that loan for ten years or more, credit companies typically structure loans on a shorter term of three to seven years. Credit companies match their yields to their own commercial paper offerings, which are short-term obligations.
2. *Construction loans.* Credit companies are formidable competitors for the banking industry. Although both credit companies and banks use short-term capital that is suitable for funding construction and variable rate loans, credit companies are not governed by federal, state, and local banking regulations. Credit companies are more flexible while having the same financial understanding as banks because of their asset-based lending experience, including corporate lending and paper financing.
3. *Other types of financing.* Although credit companies are known for funding highly aggressive risk-oriented projects, the real estate credit crunch created excellent opportunities for them in conservatively underwritten real estate transactions. For example, credit companies frequently charge rates of as much as 1 and 2 percent of the total transaction amount per year for funding a standby commitment.

Credit companies also fund standby transactions with the expectation of taking a short-term ownership position in the property until the project has an opportunity to stabilize cash flow in a tough market condition. Of course, under all such conditions, credit company pricing reflects risk and reward return.

The credit company's biggest funding advantage over its competitors is its ability to provide commitments for financing on projects before or during cash flow stabilization. Although such lending underwriting involves higher risk, credit companies use a variety of deal structures that enhance the quality and reduce the risk of the total financing package.

Credit companies have been highly selected in financing hotel projects. They often demand that the investment returns exceed 20 percent. Hotels require significantly higher debt coverage ratios, often one-and-one half times the debt-service payment. Although they are rare, LTV ratios of as high as 85 percent are available. The higher-risk hotel deals require the borrower to give the lender a significant equity position (often as much as 50 percent or more).

Credit companies are a creative and active force in the real estate market. They have a direct link to the capital markets by their ability to raise capital through selling and guaranteeing commercial paper. As a result, credit companies may capture a larger market share from traditional lending sources in the future years.

## » 16.05 PENSION FUNDS

Pension funds are tax-exempt capital funds held by corporations or labor unions (private pension funds) or state and local governments (public pension funds). Their

purpose is to pay retirement benefits to employees or union members. They represent the fastest growing pool of capital in the United States, and they undoubtedly will play a major role in hotel real estate financing in the future.

Only a small percentage of pension fund assets are invested in real estate mortgages or real estate equity. The percentage seems certain to rise, possibly to as much as 10 percent of total assets. The asset and liability structure of pension funds is somewhat similar than that of life insurance companies in that the inflow of funds is continuous and stable and payment obligations are actuarially determinable (i.e., accurate predictions can be made of the payments that must be made in future years). Consequently, pension funds would seem to be a logical source of long-term real estate loans.

However, just when pension funds started to invest significantly in the real estate market, the market crashed in the period between 1987 and 1993. Many pension funds had invested in real estate funds as part of their investment strategy. These funds for the most part were closed-end funds, from which capital could be withdrawn only in limited amounts and at specified times. When real estate values began to decline sharply, the funds had to wait for a considerable period to close their accounts, at which point they suffered significant losses. As a result of these experiences, pension funds are now turning more and more to direct investment in mortgages and real estate equities. The trend to mortgage securitization offers pension funds an easy way to invest in commercial mortgages, while the resurgence of REITSs and the easing of tax limitations on pension fund investment in REITs are making the REITs an ideal intermediary for equity investment.

## » 16.06 REAL ESTATE LIMITED PARTNERSHIPS (SYNDICATION)

The limited partnership as a form of ownership of real estate is discussed in Chapter 15. In this chapter, the RELP is viewed as a source of real estate capital because of its primary role in the process known as syndication. In its broadest sense, a syndicate is a group of investors who pool their capital for investment in real estate. A syndicate may be any form of business entity, but by far the most popular format has been the limited partnership, because it represents the best combination of tax benefits and business efficiency.

Real estate syndicates experienced a sustained boom in the years prior to enactment of the Tax Reform Act of 1986 (TRA 1986). However, the TRA 1986, whose fundamental thrust was to minimize the role of taxes in investment decision making, had a major impact on hotel real estate syndication. The use of a RELP to pass losses directly through to investors was reduced almost to the vanishing point by the limitations placed by TRA 1986 on the deductibility of passive losses and the extended recovery (depreciation) period for real estate. The result has been that tax shelter-oriented real estate syndications have essentially been eliminated since passage of TRA 1986. Real estate syndication will remain an important part of the investment scene, but primarily in private rather than in public markets.

### [1] Basic Syndication Structures

In a typical real estate syndicate, the investors constitute a single class, with each receiving a pro rata ownership interest in the syndicate for a one-time investment in cash. New investors are not admitted once the syndicate has been formed, and no provision is made for redeeming syndicate interest during the life of the syndicate.

This basic pattern is subject to a number of variations. Perhaps the most common is to create a multiclass syndicate in order to broaden the market for syndicate shares. A multiclass syndication has more than one class of investors, with each class entitled to different investment returns. The idea is to offer investors a range of choices, similar to the choices available to purchasers of securities, who may choose, for example, between bonds, common stock, and preferred stock.

At least three different approaches to the multiclass syndicate can be distinguished; (1) different classes of interest within the same syndicate; (2) land/building split; and (3) equity/loan split.

### [2] Specified-Property or Blind-Pool Syndicates

In a specified-property syndicate, the particular property or properties to be acquired is identified in the offering statement and can be evaluated by the investor before he puts up his money. A blind-pool syndicate raises its capital before it has acquired any or less than all of the properties it will eventually own. A single-property syndicate almost always specifies the property to be acquired, although this is not necessarily the case. On the other hand, a multiple-property syndicate may or may not be a blind-pool syndicate, although it usually is.

### [3] Master Limited Partnerships

Master limited partnerships (MLPs) are large limited partnerships whose interests are publicly traded, either on a stock exchange or in the over-the-counter market. They are designed to combine the investment advantages of partnerships with the liquidity of corporate stock. The high liquidity of MLP units is achieved through the issuance of depository receipts that can be traded freely.

In most cases, a real estate MLP uses a two-tier arrangement in order to simplify ownership of the underlying real estate assets. The MLP (the investment vehicle) has outside investors as its limited partners and the sponsor as its general partner. The MLP itself becomes a limited partner in a second (operating) partnership that owns the real estate and for which the sponsor also acts as general partner. The TRA 1986 sharply reduced the attractiveness of MLPs for real estate by limiting the use of tax losses from properties to shelter income from active sources. As a result, the MLP has been largely replaced by the real estate investment trust (see IT 16.07). However, some MLPs continue to be traded in the public securities markets, and it is possible that they may come back into favor once again.

## » 16.07 REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REITs) as a form of real estate business structure are discussed in Chapter 15. In this chapter the emphasis is on REITs as a source of capital. REITs are playing an important role in the development of hotel property, especially since 1990. The resurgence of REITs can be traced to a number of causes:

1. *High yields.* As a result of the real estate collapse following the passage of TRA 1986, hotel properties suffered price declines ranging from 25 percent to 40 percent in most parts of the country. Many investors began to perceive hotel properties as a much more attractive income vehicle than common

stocks or bonds, which generally were becoming quite expensive. In addition, with interest rates having declined sharply, investors holding funds in money market accounts or CDs were seeing their income return decline sharply.

2. *Institutional demand.* A significant source of new investment in REITs has come from such institutional investors as common stock mutual funds, pension funds, and yield-seeking institutional investors.
3. *Financing source.* In the early 1990s, the traditional sources of real estate financing (thrift institutions, commercial banks, and insurance companies) sharply reduced their lending because of the high volume of distressed and foreclosed loans in their portfolios. Hotel developers, managers, and owners saw REITs as a means of raising new capital from the general market to pay down debt and grow their asset bases. Learning the lesson of previous REIT excesses, the new REIT sponsors structured their offerings on a much more conservative basis.

The resurgence of REITs in the early 1990s largely reflected the public's view of REITs as investments capable of generating high current yields as well as moderate appreciation in value over a period of years. Investors came to understand that cash flow was a more appropriate measure of a REIT's income than the "net income" measure used by business corporations. Cash flow (now known as funds from operations or FFO) disregards the paper write-offs for depreciation and amortization but reflects interest and amortization costs associated with debt financing.

One concern about REITs is whether high yields can be sustained if cash flow declines on underlying hotel assets. This could happen as a result of competition by the many new REITs to acquire desirable properties. The answer to this concern is that REITs can use two types of leverage to maintain or even increase yields: debt leverage and equity leverage.

## [1] Debt Leverage

Leveraging yields with debt encompasses traditional mortgage financing as well as various corporate financing techniques. Mortgage financing, while not easily avoidable in the early 1990s, undoubtedly will make a comeback as the hotel market improves and valuations become more stable. A REIT generally must meet the underwriting standards for mortgage financing as a non-REIT borrower of equivalent credit standing and with an equivalent asset portfolio.

REITs do have an advantage over non-REIT borrowers in that their large diversified portfolios enable them to use non-real estate financing techniques as well. For example, a REIT may issue long-term debt in the form of a bond or note that may be sold either to the general public or to private institutional investors. As long as the cost of such debt capital is below the free-and-clear return from the real estate portfolio, the REIT achieves positive (upside) leverage.

Another approach is to issue commercial paper or to use a bank credit. Commercial paper consists of corporate notes having maturities from 5 days to 270 days. The notes can be sold directly by the REIT to the customer-buyer or through a dealer. A bank line of credit will carry a floating rate of interest over prime and may require a compensating balance to be maintained whether the credit is used or not. In both cases, the short-term nature of the borrowing means that interest rates paid by the REIT are likely to be very volatile. This may affect the stability of the yield, an important consideration for public investors.

## [2] Equity Leverage

Equity leverage is the process of selling new equity at a premium over the book value (original issue price) of existing equity. To illustrate, assume that a single share issued by a REIT for $10 earns 10 percent ($1 per share) on its original cost. Assume further that investors now are willing to buy this stock at a price-earnings ratio of 20, to yield 5 percent. The result is a market value of $20 per share.

If a second share of stock is then issued by the REIT, it can invest a total of $30 (the initial $10 plus the new $20) and the same 10 percent yield will then earn $3 (or $1.50 per share). The trust has increased earnings per share by 50 percent but also the market value per share by the same amount.

Thus, equity leverage may be undertaken at any time at which the market value of a trust's stock commands a premium over original issue price. (If the stock is at a discount from that price, however, the issuance of new stock at that level will *dilute* the original issue price per share owned by existing stockholders.) It follows that the higher a trust's return on book value (original issue price), the greater is its capacity for growth.

Note that the use of debt leverage can achieve the same result as that just described. Suppose the REIT, instead of issuing another share of stock at $20, borrows $25 at 8 percent interest. If the REIT can maintain this 200 basis point (2 percent) spread between its free-and-clear return on assets and the loan interest rate, it will achieve the same 50 percent increase in earnings per share from $1 to $1.50; with the same market yield requirements, its stock will increase from $20 to $30 per share.

## » 16.08 COMMERCIAL MORTGAGE-BACKED SECURITIES

Commercial mortgage-backed securities (CMBS) are a major source of debt capital for commercial real estate and the hotel industry in particular. This section provides a brief historical overview of CMBS, which shows why securitization has become a favored method of financing for hotel owner/operators and other commercial property borrowers. It then explains the different roles that investment banks may play in the securitization process, outlines the steps involved in the underwriting and rating processes, and concludes with a focus on recent economic trends in the hotel industry and how these changes influence the industry's relationship with CMBS as an ongoing provider of debt funding.

## [1] The Evolution of CMBS

Commercial mortgage-backed securities are bonds or other debt instruments collateralized by loans secured by commercial real estate. CMBS are created by combining loans into pools of $100 million or more and depositing them into a trust that then produces fixed-income securities sold to institutional investors.

Mortgage-backed securities (MBS) have a longer history as a source of debt financing for single-family housing. CMBS evolved from this residential market and arose as a thriving source of debt capital for income-producing property during the real estate recession and savings and loan (S&L) collapse of the early 1990s. (A major difference between MBS and CMBS involves prepayment provisions. Whereas MBS loans are prepayable, mortgages in CMBS are generally locked out from prepayment; consequently, the investor does not have reinvestment exposure.)

The collapse in commercial real estate values triggered a major recapitalization beginning in 1989, when the Resolution Trust Corporation (RTC) was appointed chief

liquidator of S&L loans and real estate owned (REO) properties. The tidal wave of RTC offerings that followed during the next several years created a need to tap into the securities market to bring liquidity to commercial real estate. Investment banks were hired as loan sale advisors, and they consequently beefed up their commercial mortgage departments with real estate professionals who helped underwrite and dispose of the RTC offerings, incorporating mortgage securities structuring technology learned from the residential mortgage arena. Independent rating agencies at the same time increased their commitment to this emerging market by standardizing the underwriting criteria by property type, which was incorporated into the sizing of debt proceeds and the structuring of the underlying CMBS pools. This RTC-driven market was mainly functioning as an agency, or "best efforts" business, yet a small group of investors were earning an arbitrage by acting as a principal, purchasing RTC loans and selling them as rated and non-rated securities independently.

By the end of 1992, the RTC had disposed of approximately $11.6 billion of commercial real estate assets financed by CMBS, while the industry's traditional lenders (S&Ls, commercial banks, and life insurance companies) were experiencing unprecedented loan losses. This prompted these conventional lenders to move away from direct lending on commercial real estate. Instead, they bought long-term Treasury securities, enjoying a favorable spread between short-term and long-term rates (the Federal Reserve lowered short-term Treasury securities 200 basis points during this period).

Concurrently, stricter commercial real estate lending regulations were imposed by the Federal government. These restrictions led to larger loan loss reserve requirements and provided another impetus for traditional lenders to shift capital away from direct lending to buying CMBS—a natural for life companies that were already familiar with commercial real estate as collateral.

A dramatic transformation of commercial real estate finance was in full swing in 1993. In addition to the change in the role of traditional lenders—who were quickly becoming the largest buyers of CMBS—property owners were also changing the ways in which they raised equity, forming real estate investment trusts (REITs) and other capital markets vehicles to recapitalize their portfolios while issuing CMBS for leverage. Many borrowers looked to Wall Street to provide debt capital and issue single-borrower, multi-class transactions using sophisticated underwriting and structuring techniques.

By mid-year 1993, the RTC had securitized nearly $14 billion in performing commercial mortgages. This liquidation forced the markets to confront the issues of securitization. The establishment of underwriting standards, rating criteria, valuation techniques, and more standardized structures paved the way for further growth in CMBS and allowed the private sector to take the helm from the RTC and become the dominant issuer of CMBS.

Since that pivotal year, CMBS issuance has grown to reach approximately the $100 billion mark for total issuance. As the market matures, it has encompassed a broader group of both issuers and property types. In a 1994 study on income property securitization, Kenneth Leventhal & Co. pointed out that the market will continue to be influenced by interest rate fluctuations, competition from other lending sources, underlying real estate market conditions, regulatory changes, and information technology developments.

Despite such variables, the CMBS market has nonetheless witnessed increased efficiencies, including better availability and analysis of information to investors, improved reporting from servicers, better performance monitoring by rating agencies, and further standardization of transactions. All of these are becoming more uniform in terms of both structure and collateral, according to Duff & Phelps, a rating agency, which reported in early 1996 that such increased consistency translates into lower capital costs for borrowers. Another sign of the CMBS market's underlying strength

was that in 1995, CMBS substantially outperformed corporate bonds at a time when spreads were largely unchanged.

## [2] Roles of Investment Banks in CMBS

Investment banks that represent borrowers in a CMBS transaction act in either a best efforts or a principal capacity. This distinction has important implications for borrowers in terms of allocation of risks.

Some securities firms do not commit capital to transactions, but rather act in a financial advisory and/or brokerage capacity to borrowers and investors. Such firms are said to act on a "best efforts" basis. They assist in structuring the transaction and brokering the rated certificate classes to investors. After the certificates have been rated and sold, the borrower is funded from the proceeds of the sale. In such a best efforts transaction, the borrower does not know the rate or amount of debt proceeds to be received until the securities have been sold, and the borrower assumes all of the risks involved in the transaction, including:

- The risk that the transaction can be rated.
- The risk of what rating each class of certificates will be assigned (i.e., the amount of certificates that receive high ratings versus those that receive low ratings).
- The risk that the certificate classes, including the unrated classes, can be sold, and assuming that the classes can be sold, the risk of at what spread to Treasuries (i.e., price) each class of certificates can be sold.
- The risk regarding how long a period of time it will take to consummate the transaction. (The pricing and funding of a principal transaction typically takes between 60 and 90 days, while a best efforts placement can be expected to take between seven months and one year.)
- The risk that interest rates will increase during the processing period for the transaction. (In a best efforts placement, since there is uncertainty as to whether and when the transaction will close, it is not possible for the borrower to effectively hedge this risk.)
- The risk of assuming all costs of the transaction, regardless of whether it is consummated.

While a best efforts transaction may result in lower costs to the borrower, the foregoing risks make it clear that any savings over a principal transaction can be lost by interest rate movements and unfavorable rating agency treatment during the securitization process.

In a principal transaction, the investment bank/lender makes a permanent mortgage loan to the borrower, who is funded at the inception of the transaction. The aforementioned risks involved in a best efforts placement are assumed by the lender, who shepherds the loan through the rating and securitization process.

This distinction was particularly important from 1993 to 1995, when traditional lenders (who had always provided certainty of funding) remained on the sidelines. At that time, investment banks such as Bear Steams, CS First Boston, Lehman Brothers, and Morgan Stanley were accustomed to acting as an agent on CMBS because of their experience at working with the RTC, but they were reluctant to risk their own capital. As conventional lenders returned to aggressive lending again in 1995, more Wall Street firms did begin to act as principal.

## [3] Underwriting Criteria for Hotel Property Loans

Despite their better economic performance after the early 1990s, hotels did not derive any immediate capital benefit from CMBS, because rating agencies and bond buyers (many of which were former hotel lenders with unpleasant memories) were hesitant to put capital back into the sector. Gradually, though, CMBS investors have developed greater comfort with hotel collateral.

Each segment of the hotel industry—resort, full-service, limited service, or extended stay—has its own unique characteristics that need to be examined in the context of underwriting. What follows is an overview of general underwriting criteria for the structuring of securitizable hotel loans.

In general, hotels are underwritten to ascertain a stabilized net operating income (N01) from a trailing twelve-month cash flow to determine supportable debt proceeds at different debt service coverage ratios (DSCRs). N01 equals the actual net income of the properties before interest, depreciation and income taxes for the trailing twelvemonth period adjusted if necessary to cap the growth of departmental profit and occupancy. In addition, N01 takes into account all of the various operating expense line items to make sure they are consistent with historical and market performance. The underwriter evaluates the performance of the property over the previous five years to look for consistency while researching demand and supply characteristics of the market to essentially "mark the property to market." After a stabilized N01 has been determined, debt proceeds and pricing can be determined by applying a pricing matrix based on DSCRs at various proceeds levels with different amortization schedules. The price of a hotel loan or the all-in rate is based on a spread over the yield on the ten-year or fifteen-year Treasury security. Pricing varies by the quality of the collateral, but the most favorable pricing is generally given to loans with the highest DSCR.

## [4] Role of the Rating Agencies in CMBS

Independent rating agencies (i.e., Standard & Poor's Corporation, Moody's Investors Service, Inc., Fitch Investors Service Inc., Duff & Phelps, and others) assign ratings on debt and other securitized transactions with regard to the capacity of an issuer to meet its debt obligations in a variety of economic circumstances. Higher ratings come from the issuer's ability to make interest and principal payments under severe economic conditions.

The four highest ratings categories—Triple A, Double A, Single A, and Triple B— represent what is referred to as "investment grade" CMBS. A typical CMBS issue is divided into several classes by payment priority with each class receiving a separate rating.

The rating agencies have been careful to establish very conservative criteria for rating CMBS—in most cases, the result of in-depth studies of historical loan performance data (e.g., American Council of Life Insurance (ACLI) loan performance data and the Russell-NCREIF property performance indices). Through such studies, the agencies have sought to identify loan characteristics that influence performance and to establish reasonable assumptions regarding defaults and losses resulting from foreclosures. While such studies provide the basic framework for the rating process, the agencies adjust their expectations according to the unique characteristics of each transaction, especially those that most influence real estate performance.

Rating agencies review the economics for the property type that collateralizes the loans in a CMBS pool the same way that they consider the economics of the industry in which a borrowing company belongs when rating a corporate debt transaction.

Hotels are generally considered to be the most risky type of commercial property—clearly different from other sectors in that they provide services to short-term guests with revenues coming largely from room rents as well as such extras as restau-

rants and meeting rooms, especially at luxury hotels. Small increases in occupancy rates or room prices go a long way toward improving profitability because of considerable fixed costs. Yet unlike other income-producing properties, hotels do have increased expenses as occupancy increases; therefore, maximizing occupancy does not always equal maximizing long-term profits.

Because the performance of hotels depends largely on the active management of operations, the rating agencies place particular emphasis on the quality of property management teams. Well-managed properties with competitive positions in their regions present attractive collateral for commercial mortgages.

## [5] Outlook for the Hotel industry as a Component of CMBS

Smith Travel Research reported that 1995 was the most profitable year in the lodging industry, and as of mid-year 1996, hotel fundamentals remain strong. Industry occupancies for 1995 were at a 10-year high, averaging 65.5%, and room rate increases continued to outpace inflation in 1996, leading to further improvement in industry profits and operating margins. Revenue is expected to grow at slightly under 7 percent, with an operating leverage of 67 percent, meaning that 67 cents of every dollar earned is profit.

As profits continue to rise substantially, the hotel investment market is witnessing accelerated activity. Although this has fueled a rise in hotel values, it is still less expensive to buy rather than build, although the margin continues to narrow. In 1996, hotels in most segments could be purchased for approximately 80 percent of replacement costs, up from 1995 levels of 50 to 70 percent, according to HVS International.

Combine that with forecasts of historically high hotel profits in the next two years, and it is obvious why the industry is in an expansion mode. Construction starts are up, concentrated mostly in the limited service sectors, such as extended stay hotels. Many hoteliers have recently announced plans to expand their sets of offerings and markets, and some industry experts report expectations of overbuilding in the economy segment within the next few years. This may cause some concern that the hotel market is once again heading toward an overbuilt bust reminiscent of the 1980s. The pessimism may be largely unfounded, however, as several basic market characteristics are, thankfully, very different now. Some examples:

- Demographics are heading in the right direction for continued hotel demand. A robust level of business travel as well as a steady growth in leisure travel are both expected to continue as baby boomers reach middle age.
- Most new hotel construction is concentrated in the budget and extended-stay segments, which has been undersupplied and should be able to accommodate new supply in balance with rapidly growing demands. Meanwhile, the full-service sector has the advantage of essentially no new supply coming on board.
- The possibility of some oversupply on the horizon is offset by lower leverage ratios and, inherent in the CMBS process, the stricter underwriting criteria that come from rating agency review—a marked difference from the lending attributes of past periods of excess.

The health of the hotel industry at large combined with the ability of the CMBS market to better scrutinize funding requests and make more rational lending decisions should ensure that CMBS lenders remain committed to providing hotels with a viable borrowing option. This will allow hotel owner/operators to continue to take advantage of reasonable acquisition and expansion opportunities and eliminate overleveraging in their existing debt, which in many cases is based on higher interest rates or overinflated values of the past.

## » 16.09 MORTGAGE FINANCING

Hotel owners use a wide variety of mortgage loans to structure a financing package that meets their objectives. The following sections discuss the various types of loans typically employed in hotel financing.

### [1] Construction Loans

A construction loan is a short-term loan made during the period in which a project is under construction. The moneys from a construction loan are disbursed over the development period for amounts determined by the actual progress of construction. Interest is typically tied to a floating rate (usually prime), exceeding this rate by one to three points. Most construction loans call for interest only. Personal guarantees, as well as completion bonds, are normally required by construction lenders. Construction loans are paid off when the project is completed and the hotel opens. The lender that provides the permanent financing after the construction loan has been paid off is called the take-out lender.

### [2] Construction and Mini-Permanent Loans

When a lender provides both the construction financing and a short-term permanent loan (two to five years), the arrangement is called a construction and mini-permanent loan. The terms of the construction segment of the loan are similar to those of normal construction loans. The mini-perm often has a fixed interest rate rather than a floating rate, and it may have an amortization. The advantage of construction and mini-perm financing is that the borrower does not have to find a permanent take-out lender, which can be difficult to locate for a new hotel without an operating history. Once the hotel has been operating for two to four years and has an established track record, the borrower is better able to attract a long-term permanent lender at more favorable terms.

### [3] Permanent Loans

A permanent loan is obtained after the term of a construction or mini-permanent loan that are used to pay off the previous lender. Sometimes sufficient funds remain to allow the equity investors to remove some capital. The permanent loan carries either a fixed or floating interest rate and amortization over a twenty- to thirty-year term. The length of the loan typically extends for five to twenty years, depending on the lender. Most permanent loans made on stable hotels with established earnings do not require personal guarantees. If they do, the borrower can generally negotiate removal of the guarantee when a certain debt coverage has been achieved.

### [4] Term or Bullet Loans

If a construction lender does not want to provide a mini-permanent loan after the construction has been completed, the borrower can line up a term or bullet loan as the take-out. By using this type of loan until the property establishes a track record, the borrower is better able to obtain more favorable terms on a long-term permanent loan.

The terms of a bullet loan are similar to construction financing—it carries a floating interest rate of one to three points over prime, has little or no amortization, and personal guarantees are sometimes required.

### [5] Accrual and Zero Coupon Financing

An accrual loan is a mortgage where all or part of the interest accrues and is not paid until some point in the future—sometimes at the maturity of the loan. This structure reduces the amount of the debt service that has to be paid and assist hotels during initial start-up years when there is usually insufficient cash flow to cover debt service.

## » 16.10 OBTAINING A HOTEL MORTGAGE

Obtaining mortgage financing for a hotel venture is probably the most critical step in both the hotel development and the acquisition process. Since mortgage debt generally represents the largest source of cash invested in a hotel transaction, finding a mortgage lender is a make-or-break issue. Without a lender, the contemplated transaction will usually die.

Lenders, realizing this great power, are often difficult to approach. Coupled with the fact that most mortgage lenders do not make hotel loans, finding suitable financing can be difficult.

The key to obtaining hotel financing is to put together a transaction that clearly shows excellent financial potential and low investment risk. It must be presented to the lender in a highly professional manner so that the opportunity stands out from all the other submissions.

The following steps are involved in obtaining a hotel mortgage:

1. Determine how to approach the lender.
2. Put together a mortgage submission.
3. Negotiate the important terms.
4. Submit an application.
5. Obtain a commitment.
6. Fulfill the terms of the commitment.
7. Close the loan.

### [1] Approaching the Lender

The first step in obtaining a hotel mortgage is to determine whether to retain the services of a mortgage broker or to attempt the process alone. A mortgage broker's services can cost between 1 percent and 3 percent of the amount borrowed. While this might seem expensive, it may be worth the expense, since the transaction cannot be completed unless sufficient financing is secured. For new hotel owners without a lengthy track record of successful projects, the services of a hotel mortgage broker can be invaluable. Owners with extensive experience in the hotel industry and good financing contacts are better able to successfully complete the process without a broker. In any event, contacts are vitally important, and the proper introduction to the right person and the right lenders will give a project the necessary initial attention.

## [2] Compiling a Mortgage Submission

A mortgage submission is a package of information that describes the hotel investment, the financing requirement, and the structure of the contemplated transaction. It should provide the lender with sufficient information to generate interest in pursuing the mortgage. As with the overall process, the mortgage submission should be complete and have a professional appearance. The information a lender looks for in a mortgage submission includes the following:

- Description of the hotel project and contemplated transaction.
- Description of loan and requested terms.
- Resumes and financial statements of owners.
- Economic market study and appraisal.
- Owner's projection of income and expense.
- Description of management company experience and operating ability.
- Operator's projection of income and expense.
- Rendering or photograph of the property, including an aerial photo of the site with appropriate maps, plans, and legal description.
- Architectural plans and specifications.
- Estimate of all project costs—particularly if the hotel is to be constructed or will undergo a major renovation.
- Identification of project team, including architect, interior designer, and contractor.
- Copies of all major contracts—management contract, franchise agreement, ground lease, and tenant leases.

## [3] Negotiating the Terms

Once the lender shows interest in the contemplated project, the important mortgage terms are negotiated, including the following:

- Interest—rate, fixed or floating
- Term
- Amortization schedule
- Prepayment
- Personal guarantees
- Accrual facility
- Commitment and closing fees
- Timing

## [4] Submitting a Mortgage Application

When the borrower and the lender have agreed on the terms of the loan, a mortgage application is submitted. A mortgage application formalizes the information generally provided in the mortgage submission.

## [5] Obtaining a Mortgage Commitment

Once the loan has been approved by the lender, the lender issues a mortgage commitment, which describes the loan and its terms. The commitment may also contain a request for additional information as well as contingencies. Normal contingencies in a mortgage commitment include (1) an appraisal showing that all the property has a specified minimum value; (2) a satisfactory title report; (3) a survey guaranteed to the lender; (5) an engineering report showing a sound structure and equipment; and (6) satisfactory credit reports for the principals.

The borrower is usually required to sign the commitment letter and return it to the lender with a nonrefundable commitment fee of between 1.5 percent and 3 percent of the amount borrowed.

## [6] Fulfilling the Terms of the Commitment

The bank's commitment letter generally states that the borrower must provide additional information (e.g., appraisals, studies, and certified financial statements) and fulfill certain obligations (e.g., subordinating the management contract, obtaining rights under the franchise, and transferring the liquor license). These must be completed before a specified date or prior to closing the loan.

## [7] Closing the Loan

When the borrower has complied with all the provisions of the commitment and the transaction has reached its culmination, the loan is ready to close. At this point the borrower and the lender (and the seller if appropriate) meet and exchange and sign the necessary documents, and the moneys borrowed are exchanged.

CHAPTER 17

# Buying, Selling, and Exchanging Hotel Properties

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## » 17.01 PURCHASE OR SALE OF HOTEL PROPERTIES

Because the purchase or sale of a hotel property is basically the opposite sides of the same coin, when discussing purchases or sales, investors should realize that the motivation for one party will usually be a factor for the other party as well. There are no easy answers when a hotel owner should sell a property. Many factors play into the decision to sell a property. What will the future hold? Is the market expanding or contracting? How much competition is coming on line in the next few years? Will supply be expanding or contracting? All these questions need to be guessed at as best as the seller can in making his determination to sell or not. Of course the buyer is doing the same type of analyzing and is hoping that he may be able to buy at an opportune time and thus increase his overall value.

The seller motivation is always on the mind of the buyer. Some of the more common reasons for selling a hotel property include:

1. *Change of corporate policy.* Many large conglomerates may feel a particular hotel chain or group of hotels no longer fit within their corporate strategy.
2. *Need the money.* Many property owners borrowed so much money on the hotel's value that the property has a difficult time servicing the debt load. Of course this puts the buyer who has this information in a very strong position. For example, the Asian crisis has forced many foreign-owned hotels to be put up for sale because the corporate owners are in need of capital.
3. *Changes in perceived future market values.* Many hotel owners wish to get out because they see a peak in values that they feel will not be duplicated again in the near future.
4. *Retirement of key personnel.* Many hotel owners simply wish to get out of the business because there is no one to take over the business.
5. *Declining depreciation and other tax shelter aspects of the property which results in more taxable income being attributable to the owner.* The owner may wish to capitalize on lower capital gains rates.
6. *Changing neighborhood.* The owner may realize that new competition is coming into town and may wish to sell out before the information is generally known or that a key reason for travelers to visit the location is in jeopardy of leaving.

These are just some of the more common methods that motivate an owner. The buyer needs to beware of any or all possible motives for the sale of the properties. This is why an indispensable part of any purchase is for the buyer to ascertain as realistic as possible the true value of the hotel that he is about to purchase.

### [1] General Legal Requirements to a Real Estate Contract

When a hotel is purchased, the key instrument in the purchase is the sales contract or agreement of sale. This document spells out in great detail the rights and obligations of the parties during the contract period. It also will detail the manner in which the party will eventually be transferred.

Since real estate contracts need to be in writing in order to be enforceable, the sales contract is the essential agreement of exchange of promises which makes the sales transaction enforceable under law. Once the document has been signed, it is enforceable on both parties unless both parties assent to the changes. Throughout our legal history it has been well established that contracts must contain certain provisions in order to be enforceable.

◦ *Mutual agreement.* A basic requirement of any contract is that the parties have a "meeting of the minds." Mutual agreement is met when one party makes an offer and the other party accepts that offer.

• Any offer must meet certain well-accepted rules in order to be considered a valid offer. The offer must (1) be definite and certain; (2) define the precise subject matter of the proposed contract; and (3) be communicated by the one making the offer to the recipient of the offer.

• Once the recipient receives the offer it remains open and capable of being accepted until (1) it expires by its own terms; (2) the recipient rejects the offer;

or (3) the person making the offer revokes it before the recipient accepts. The offer is also canceled by the destruction of the hotel property or by circumstances that make the contract illegal.

• The recipient accepts the offer only when his deed or words clearly indicate acceptance of the terms of the offer. An acceptance must (1) be positive and unequivocal; (2) conform precisely to the terms of the offer; and (3) be communicated to the person making the offer within the permissible time period.

• Any counteroffer is considered a new offer and the above-mentioned criteria then is applied as if the contract is being offered for the first time. The parties may go through several counteroffers until final acceptance or rejection has taken place.

◦ *Reality of assent.* The assent of a party is real when it is given freely and with full knowledge of the circumstance affecting the agreement. When assent is not freely given, the contract may not be valid depending on the cause. The four such causes are fraud, mistake, duress, and undue influence.

• Fraud is the intentional misrepresentation of a material fact in order to induce another to part with something of value. It clearly indicates there must be a misrepresentation of a fact, not merely an opinion. The misrepresentation also must be significant and substantial, and it must be made with the intention that the other party rely on it to his detriment.

• Mistake is a difficult concept to apply to invalidate a contract. Generally, only mistakes of fact can invalidate a contract, and only if the mistake is material and the other party should have realized a mistake was being made.

• Duress occurs when one of the parties uses threats or coercion to obtain consent.

• Undue influence is when a party in a confidential relationship uses improper or excessive persuasion to obtain a consent.

◦ *Legal capacity to contract.* Each party must have the legal capacity to enter into valid legal contract. Legal capacity means the ability to reason and understand the significance of an agreement.

• Minors (children under the age of 18 or 21, depending upon the particular state) lack legal capacity to enter into a contract for the purchase of real estate. Any contract that the minor should make on real estate can be disaffirmed on reaching the age of majority. This type of contract is called voidable because it is considered to be valid until the minor takes steps to disaffirm his obligations.

- Persons found to be insane, incompetent, and at times, intoxicated at the time the contract was entered into may be held to lack the legal capacity to contract.

° *Consideration.* Contracts cannot be enforced unless consideration has passed between the parties. This is a fundamental requirement of all contracts. Consideration includes promises and actions that can include anything that constitutes a benefit to the promisor (the one whom makes the promise) or detriment to the promisee (the one to whom the promise is made). The law does not look at the adequacy of the consideration but merely whether consideration was actually bargained for.

° *Legality of the transaction.* A contract will be enforceable only if the purpose of the contract is legal. A contract to buy or sell a hotel property for an illegal purpose (e.g., gambling in a state that bars this activity) would be void and unenforceable.

° *Contract in writing.* Finally, real estate contracts must be in writing in order to be enforceable. This requirement originally was imposed by an English statute, the Statute of Frauds, enacted in 1677. Its purpose was to prevent many fraudulent claims that were based on alleged oral promises or agreements. All states recognize the writing requirement and apply them to all transactions involving the sale and purchase of real estate and all leases of real property that exceed a specified time period (usually one year).

The Statute of Frauds will be satisfied so long as the person against whom the contract is sought to be enforced has signed it. It is not necessary that the person seeking to enforce the contract has signed it. Generally, the writing must contain the following information:

1. The identity of the parties
2. The identification of the property of the contract
3. The consideration

The writing need not be designated a contract. Any written memorandum will suffice to satisfy the statute, provided it contains the requisite information.

Appendix 2, Sample Clauses for Hotel Purchase and Sale Agreement, contains an excellent checklist of what is included in most hotel sale agreements. Below is a summary of that checklist and some considerations that the buyer and seller may want to ensure are included in the contract.

## [2] General Provisions of a Sales Contract

### [a] Real and Personal Property Being Sold

A contract for the purchase and sale of a hotel should accurately describe the property to be conveyed and also the personal property to be included in the conveyance. The description may be by street address, full legal description, or reference to a public map; by plat attached to documents or schedules; or by some combination of these. Regardless of the method used, however, unless the description burnishes

the means of determining with reasonable certainty the property intended to be conveyed, the contract is unenforceable.

Sources for the description of the hotel would include current surveys, copies of the seller's warranty deed or title policy, and current title reports or binders. If a current, accurate description is not available or if the parties contemplate that a survey will be made before the closing, it is advisable to provide that the description that will be used at the closing be based on the survey.

All descriptions of property should be independently verified by the purchaser. Also, if rights of access or other rights affecting adjoining property are important to the use and enjoyment of the property being purchased, those rights should be specifically included. Where appropriate, clauses may be included to cover such items as air rights, rights in adjoining streets, easements, and leaseholds.

### [b] Business Assets Being Sold

Some of the most important assets of the hotel will be the right to operate the property through various government permits. If a government license or permit has already been issued for the property, the seller will want assurances that the seller will transfer these valuable rights. Success in obtaining a license (e.g., gaming license) or in obtaining the transfer of an existing license may be essential to the right of the purchaser to conduct or continue the conduct of the hospitality business located thereon. For this reason, contracts for the sale of hotel properties frequently contain provisions concerning the seller's duty to keep necessary licenses or permits (e.g., liquor license) in force and cooperate with the purchaser in obtaining the transfer of a license or permit to him.

### [c] Closing

The closing is the final meeting of the parties at which the instruments necessary for conveying title to the premises and to the personal property from the seller to the purchaser occur. It is also when the consideration from the purchaser to the seller takes place. Also at the closing, the final documents are signed and delivered, expenses are apportioned, income from the property is prorated, and all closing adjustments are made.

### [d] Purchase Price

The purchase price for the hotel must be readily ascertained from the sales contract or be calculated with a degree of certainty. Often, the contract will provide certain clauses that make the final purchase price unknown, but the price will be able to be ascertained by closing, thus meeting the requirement of certainty.

The contract should specify how payment of the purchase price shall be made; any down payments or earnest money payments that are required; and the method, medium, and time of payment.

[i] **Adjustment of purchase price.** Often the total purchase price will only be determined after a final audit of the property. The contract should specifically spell out what items will be used in adjusting the purchase price. For instance, liquor inventory at the time of closing would be an adjustment to the final purchase price.

[ii] **Allocation of price among different assets.** Although not required by law, the parties should consider allocating the purchase price of the hotel among the various assets. The reasonable allocation of purchase price among assets is an excellent method of avoiding trouble with the IRS over the value placed on personal property vs. real property. Of course, the seller would like as much as is reasonable, allocation of purchase price to real property for capital gain treatment and less to personal property, which would be taxed as ordinary income. The buyer has the opposite needs and wants, and therefore a goodfaith allocation is usually acceptable to the IRS.

[iii] **Allocation of price between land and buildings.** In order to maximize depreciation deductions, purchase price needs to be allocated to the building as opposed to land which is not a depreciable asset.

The Treasury regulations require that when nondepreciable and depreciable properties, such as land and building or improvements, are acquired together for lump sum, the acquisition cost must be allocated on the basis of the respective values of the land and the building or other improvements on the land. The Treasury regulations do not state how the respective values are to be ascertained. One way is to use a professional appraisal; other ways are to base the allocation on the relative values placed on the land and building by the local tax assessor or on the buyer's own information resulting from his personal familiarity with the area in which the property is located. Still another method is for the buyer to evaluate the buildings situated on the land from the investment point of view by capitalizing its cash flow. This may produce a particularly favorable allocation in the case of a hotel which is old is a very profitable one.

## [e] Earnest Money

Almost all major hotel sales require that the buyer put a substantial down payment or earnest deposit to show good faith in the purchase of the property. This good-faith deposit will be held in escrow during the period between the signing of the sales contract and the closing on the property (transfer or title). Also, in complex hotel sales there may be substantial performance clauses in which the buyer or seller may place funds in an escrow, in which case the escrow deposit is used as a security for the performance under the agreement.

An escrow deposit may be in cash, securities, promissory notes, letter of credit, or such other device that the parties agree will suffice as to proper value. Cash deposit is the most common method for securing a down payment. The cash deposit will be credited against the purchase price of the hotel and paid over to the seller at the closing, unless the purchaser has committed a breach of contract. Often the deposit is returned to the buyer if the sale is not consummated due to some other reason than a breach of contract.

Most escrow agents in the sale of hotel properties are brokers, attorneys, title companies, financial institutions, or escrow companies. The escrow agent by law must follow the specific instructions agreed to by the parties concerning his custody and disposition of the funds entrusted to his care. The law puts an escrow agent in a fiduciary bound duty to act according to the dictates of the escrow agreement. His duties should be strictly ministered, limited to the safekeeping of the funds in a separate, properly identified, interest-bearing account, and paying over the funds at the proper time and place to the proper person when required to do so under the terms of the escrow arrangement.

Often when the contract for sale requires the purchaser to make the deposit as security for his performance, the seller may insist on a provision declaring that the sum placed in escrow shall constitute liquidated damages if the purchaser subsequently defaults or breaches the contract. The purchaser, on the other hand, may in-

sist on placing provisions in the sales contract that if certain contingencies are not met or that if the seller defaults in his performance, the escrow deposit is to be returned to him.

## [f] Due Diligence

Usually in the purchase of a hotel property a prudent purchaser will insist that the seller expressly warrant the condition of the property, but also insist in the sales contract to the right to physically inspect the hotel and its record prior to closing. The purchaser should place in the sales contract a provision that if the condition of the hotel proves to be unsatisfactory or not as warranted or represented by the seller, the purchaser has the right to rescind or cancel the contract.

The purchaser will also want to insist that all existing leases and tenancies be disclosed in the contract. The purchaser will also want to put in the contract that the seller continue to perform any service and repair arrangements with the tenants until title passes to the purchaser.

Anytime that the purchaser is given the right to enter upon the premises and inspect the property before title is transferred to him, the seller should insist on the right to be indemnified or held harmless by the purchaser against any and all losses, damages, or claims arising out the purchaser's entry and activities on the premises. The seller should also require that the tests the purchaser conducts in the course of the inspection are at the purchaser's sole cost and expense.

If there are major physical problems with the hotel, the seller could be held liable to third parties after the sale of the property unless the purchaser hides and/or fails to disclose the dangerous or defective condition to the seller. Therefore, the purchaser should require provisions in the contract offering him protection against defective conditions existing at the hotel.

The purchaser's protective provisions may take several different forms. For instance, he may require the seller to fix the problems before closing will take place. The buyer could insist that the seller place in escrow sufficient funds as security against his performance of the necessary work within a specified time after closing.

The seller may want the contract to afford him the option to cancel the contract and return the purchaser's earnest money if the cost of remedying the offending conditions or securing the violations exceeds a specified amount.

## [g] Terms of Purchase Financing

[i] **Third-party financing.** Most hotels usually involve some type of mortgage financing in order for the purchaser to buy the hotel. Because the loan authorization process is often a very lengthy affair, the sales contract is made contingent on, or subject to the purchaser's procurement of a mortgage loan commitment meeting specified requirements. Some of the more common requirements for a loan include interest rate, amount, and duration.

Another important clause in the sales contract is the amount of time that the purchaser will have in order apply for and to procure a loan commitment. The parties may agree that the purchaser's procurement of the loan commitment within the required time and containing the required terms shall be a condition precedent to the obligation of either party to perform, or that the purchaser's failure to obtain the required mortgage loan commitment within the allotted time may be grounds for rescission or cancellation of the contract.

The sales contract should provide for a refund to the purchaser of the sums paid by him to the seller where the contract is canceled for failure to obtain the necessary

financing within the required time; if the seller is entitled to his costs, the contract should clearly state exactly what he is entitled to.

[ii] **Purchase-money financing.** Often the seller will be willing to help finance in whole, or in part, the purchase price of the hotel property by extending a purchase-money loan to the buyer secured by a mortgage, land contract, or deed in trust on the property sold. The most frequent use of the purchase-money loan will be as a second mortgage on the hotel property. Under these conditions, the purchase-money loan will be used to fill the gap between the purchase price of the property and the aggregate of the purchaser's cash investment and the proceeds of the existing outside-mortgage loan.

Sellers frequently enter purchase-money financing arrangements with their buyers on smaller hotel properties where financing of any kind is difficult to obtain or in times of high interest rates, which make the purchase of a hotel prohibitively expensive. Many sellers may prefer to enter into purchase-money financing because it will . generate interest income for the seller.

It is important that any purchase-money mortgage loan arrangement be reflected in the sales contract and the material details of the mortgage, land contract, or deed of trust including the property that secures the obligation. Some of the more important details include the amount of the loan, the loan term, the debt service payments, and the interest rate.

If the purchase-money mortgage is to be junior to an existing mortgage on the property, the contract should so state; and if it is to be subordinate to a new mortgage on the hotel property in favor of an outside lender, the contract should clearly state that fact. Finally, the sales contract should state whether the purchase-money loan is to be a recourse or a nonrecourse obligation; that is, whether the purchaser is to be personally liable for the loan or whether the seller's sole remedy in case of default is to proceed against the property.

[iii] **Existing mortgage.** Often there is an existing mortgage that is in existence at the sale of hotel property. The contract should spell out whether the hotel is to be purchased subject to an existing mortgage. If the buyer takes the property subject to an existing mortgage, the parties understand that the mortgage will not be satisfied by the seller by the time the title is transferred to the seller (closing). Instead, the purchaser will be responsible after the closing to make the mortgage payments under the original terms of the mortgage document.

Of course, any purchaser who takes subject to an existing mortgage should realize that the financial institution still maintains a lien on the hotel property and can foreclose and sell the property if the purchaser defaults on future mortgage payments. However, because he is not personally liable for the mortgage obligation, he cannot be held personally liable for the deficiency if the proceeds of the foreclosure sale are not sufficient to satisfy the balance due under the mortgage obligation plus intuits and costs. Instead, the mortgage holder (mortgagee) must look to the original seller (mortgagor) to recoup the deficiency, assuming that the mortgage obligation is a recourse obligation.

Another type of existing mortgage arrangement is when the purchaser assumes an existing mortgage. Rather than merely taking the title subject to the mortgage where the purchaser assumes a mortgage on the property, he undertakes personal liability for payment of the existing mortgage indebtedness. If the seller was personally liable to the mortgagee or the mortgage obligation before the sale, he remains personally liable after the sale even though the purchaser assumes the mortgage, unless the assumption of the mortgage obligations by purchaser is accompanied by a novation (new contract). Thus, if the holder of the mortgage agrees to substitute the personal liability of the purchaser for that of the seller (in other words, if the mortgage holder agrees to a novation), the seller remains personally liable and, in most juris-

dictions, the purchaser is also personally liable to the mortgage holder. If the seller becomes liable to pay any part of the mortgage debt, he is entitled to reimbursement from the purchaser since, as between them, the purchaser is primarily liable.

Today, however, many mortgage agreements carry a due-on-sale clause under which the mortgagee may accelerate the mortgage debt so that it becomes immediately payable in the event that the property is sold by the mortgagor. If such payment is forthcoming and the sale takes place, the mortgagee may proceed to its remedies under the mortgage. That is to force the payoff of the mortgage and force the purchaser to secure a second mortgage at supposedly a higher interest rate.

Finally, if there is a mortgage on the property, the purchaser should request before purchasing the hotel a duly executed estoppel certificate, statement, or letter from the mortgagee that states all the current particulars with respect to the mortgage, including the interest rate, balance due, and that there has been no default under the mortgage. The party executing the estoppel certificate cannot later claim that the facts stated are different, since the statement was issued with intention that it be relied on by the purchaser, and the purchaser bought the property with reliance on it.

### [h] Title Commitment and Survey

It is very important that the seller be able to convey title to the purchaser. If the seller can not convey good title, he will want provisions in their agreement so as not to be liable to the purchaser or to cure the defects of title regardless of the cost to him. The purchaser, for his part, will want assurance that the seller will be obligated to convey a good title when the closing date arrives. Within this framework, the parties may agree that the purchaser shall either accept, without abatement of the purchase price, such title as the seller can convey, or terminate the agreement and receive a refund of his earnest money deposit. Another option is to require the seller to remove, at his own expense, any and all defects of title that are subject to removal regardless of cost.

A contract that specifies that a marketable title is required refers to a title that (1) is free from liens or encumbrances except those specifically set forth in the contract; (2) discloses no serious defects; (3) does not depend for its validity on doubtful questions of law or fact; and (4) will not expose the purchaser to the hazard of litigation. In addition, the title should be such that a reasonable, well-informed, and prudent person acting on business principles with full knowledge of the facts and their legal significance would be willing to accept with the assurance that he, in turn, will be able to sell or mortgage the property at fair value.

The following examples have been ruled to render title unmarketable:

- A reasonable hazard of litigation
- Title acquired by adverse possession
- An outstanding right in a third person that interferes with the use or transfer of the property or subjects the property to an obligation, leases, liens of any tax assessment, or water charge
- Debts of decedents or a reasonable possibility of their existence
- Easements
- Outstanding mineral and oil rights

Regardless of the agreement reached by the parties, with respect to defects of title, the purchaser will want to include a provision that if the sellers inability to convey good title results from his own acts or omissions, he will be considered to be in default under the contract and will continue to be liable to the purchaser for any damages resulting therefrom.

One way to avoid many problems with title questions is for the purchaser to acquire a title insurance policy. The purchaser will still insist that the seller fix defects of title where the condition of the title is unsatisfactory, and that if title defects are not rectified, the purchaser should have the right or option to terminate the contract.

Although the title insurance does not cure a defective title, it does, however, protect the buyer against loss as a result of defects and encumbrances that are not specifically expected from the insurance coverage. In this regard, it is important for the purchaser to understand the legal implications of the endorsements to the title insurance policy and the exception contained therein.

A title insurance policy ensures against loss or damage to the insured by reason or defects, liens, or other encumbrances on his title that are not specifically excepted from, or excluded by, the policy. The policy does not cure a defective title; if the defect is such as to render the title unmarketable, title insurance will not render the title marketable.

In most jurisdictions, all title policies cover losses or costs arising from defects disclosed by the pubic records; defects not disclosed by the public records; the costs of defending title, whether justified or not; and mistakes of the title examiner, whether errors, omissions, or mistakes or judgment.

The purchaser will also insist that within a given number of days after the signing of the sales contract, a current survey of the property be prepared by a licensed surveyor.

Surveys, on the other hand, give the purchaser a description of the property by describing the property by metes and bounds and show the gross number of acres as well as the number of "net acres." The survey will also show all existing easements, rights-of-way, alleys, streets, and roads, and any encroachments upon the property.

## [i] Seller's Representations and Warranties

A warranty may be distinguished from a representation in that a warranty is a promise that is given contemporaneously with, and as part of, the contract, while a representation is of an existing fact and usually precedes and induces the contract. All hotel sales unless prearranged sales between related parties should have warranties as part of the sales contract. In the case of a breach of warranty, the contract remains binding, but the opposite party may sue for damages by reason of the breach. On a false material representation, however, the opposite party may elect to avoid the contract and recover the entire price paid or he may affirm the contract and sue for damages.

Representations and warranties may be expressed or implied. For this reason, the contract may include provisions that the seller makes no representations or warranties, whether express or implied, and that the purchaser is not relying on any representation or warranties made by the seller. Alternatively, the contract may state that no representations or warranties should be made or relied on other than those expressly stated in the contract as being made.

The specific representations and warranties that the parties will want to insist on depend on the situation of the parties and the nature of the transaction and the property. However, basic representations and warranties such as marketability of title or that no condemnation proceeding is pending, should be considered to be fundamental in any contract for the sale of the real estate.

[i] **Building and zoning regulations.** Of critical importance to the purchaser is that any use of the hotel property comply with proper building and zoning ordinances. It is important for the purchaser to make sure that he puts in the right protective language in the contract even if he is accepting the hotel "as is." The purchaser's worse nightmare is to purchase a hotel property that he cannot use or develop for the purposes or in the manner contemplated.

In order to protect himself, the purchaser should place a clause which makes the sale conditional on obtaining the required zoning change or accommodation. A contract so conditioned should clearly state who will be responsible for the approval and expenses of any zoning changes or accommodations required. As a general rule, the purchaser will want the option to rescind the contract and have the down payment or earnest deposit returned to him if the zoning change or accommodation cannot be obtained.

The purchaser should also be concerned about building violations such as violations of regulations adopted by local or state governmental entities concerning the construction, design, quality, use, occupancy, and maintenance of the hotel.

The purchaser should be assured that an existing hotel structure meets all the current government building codes and regulations. Depending on the severity of the violations, the parties can most likely negotiate any compliance measures needed to bring the hotel up to code.

[ii] **Franchise agreements.** Any franchise agreements need to be examined; generally, approval is needed to transfer to a new owner. See Chapter 18, Hotel Franchises, for a complete discussion of the hotel franchise process.

## [j] Closing Documents and Procedure

[i] **Title deeds.** A deed to real property is a written instrument by which title to the property is conveyed by the owner (grantor) to the buyer (the grantee). A deed is not valid as between the grantor and the grantee unless it is delivered to and accepted by or on behalf of the grantee and it also meets the following requirements.

° Each grantor must be identified and he must be a competent adult. While there must be a valid consideration that is set forth in the deed, the actual consideration need not be set forth and nominal consideration may be stated.

° A deed must contain language (e.g., "grant and convey") that shows that the property is being conveyed and the property conveyed must be sufficiently described to identify it.

° A deed must be signed by the grantor, and under the statutes of some states, the signature must be witnessed and/or notarized. Generally, a deed must be delivered by the grantor to the grantee and, unless delivered, it is invalid and ineffective to transfer title. The grantee must be in existence at the time the deed is delivered.

Deeds are of several different types; the key distinction among them is related to the precise responsibilities that the grantor assumes in connection with the conveyance. These responsibilities are called warranties, A warranty combines a representation that a certain state of facts is true and the responsibility to make good any damages if the facts turn out to be otherwise.

° *General warranty deed.* This deed includes the broadest warranties by the grantor and so would be most preferred by the grantee. In fact, it is the most common method of transferring title in this country. A warranty deed usually contains four basic covenants:

1. The covenant of seisen, by which the grantor represents that he in fact owns the property
2. The covenant of the right to convey

3. The covenant against encumbrances, that is, a representation that no claims exist against the property other than those specified in the deed or contract
4. The covenant of quiet enjoyment, by which the grantor represent that no person with superior right to the property can interfere with the grantee's use or possession of the property

° *Special warranty deed.* This is exactly the same as a general warranty deed with one important distinction. The grantor will be liable for the breach of his warranty only if the cause arose through the grantor's own act or during his period of ownership. The grantor thus disclaims any responsibility for defects that arose before he became the owner.

° *Bargin or sale deed.* This type of deed conveys title to property just as effectively as either kind of warranty deed but contains no covenants. Thus, it is also known as a deed without convenants.

° *Quitclaim deed.* While this deed, too, can effectively convey title, it is normally used as a means of surrendering a claim to property that may or may not be valid. In effect, the grantor under a quitclaim deed says "I don't know if I own this property, but if I do, I convey to you whatever rights I may have." This type of deed often is used to correct an error made in an earlier conveyance.

[ii] **Closings.** At the time of the closing, the seller will bring all the necessary documents necessary for the title to pass. This should include the deed to the property, and any documentary stamps that may be required will be attached to the deed at that time or immediately before recordation. The seller will also have with him any leases that pertain to the property. He will also bring the insurance policies covering the property (e.g., fire and extended coverage), certificates of occupancy, and all required government inspection documents.

The seller will also bring with him receipted bills for real estate taxes, water and sewer charges, and any other items as to which adjustments will be made at the closing. He may also bring a contract with the labor union representing the hotel workers.

In addition, the seller will have a bill of sale covering personalty ready for delivery to the buyer.

At the closing, the buyer will be ready to deliver a certified check for the approximate amount that will be due from him. While the adjustments are often approximated in advance of closing, they are computed accurately and finally, and often paid by check executed at the closing. The seller will want to obtain an owner's estoppel certificate from the purchaser if a purchase-money mortgage or deed of trust is to be assigned at the time title closes.

As already indicated, the adjustments are made at the closing, and the deed, any mortgages, release of mortgages, or other liens, the check or checks for the purchase price and the adjustments, and other documents are turned over to the attorneys for the parties or the title insurance company to be held until the deed and other documents are recorded. Recordation normally takes place as soon as possible after the closing.

## [k] Brokerage Commissions

Most hotel sales will involve a broker who brought the parties together. The sales contract should identify the broker; the party who is responsible for the payment of the brokerage commission; and the amount, time, and manner in which payment is to be made.

Generally, the seller will be responsible for payment of the brokerage commissions although the parties can agree otherwise. Assuming the seller is responsible for the brokerage commission, he will want to provide that the commission will not be payable unless and until the contract is closed and that it will not be payable if certain circumstances prevent the contract from being closed (e.g., purchaser unable to obtain financing). The brokerage contract is an important document in a hotel transaction and should be analyzed carefully before signing.

### [I] Miscellaneous Provisions

Although the discussion of the sales contract has been extensive, there are still many areas that the parties need to be aware exist although their discussion in detail is beyond the scope of this text.

1. Eminent domain and risk of loss
2. Assignment, successors, and heirs
3. Binding arbitration and other legal means of settling disputes
4. Controlling law

## » 17.02 HOTEL BROKERS

This section discusses the importance of hiring a professional broker when selling a hotel.

### [1] Creating a Story

Two of the most important factors in achieving the optimum price for a hotel are creating a competitive environment for that hotel and creating a "story." Every hotel has a story that describes its upside potential and opportunities for improvement. The better the hotel's upside potential, the greater the price the market will be willing to pay. Determining and understanding a hotel's highest and best use is the foundation of that hotel's story.

A hotel achieving only an 80 percent RevPAR penetration for its market may or may not be performing at its optimum potential; a hotel achieving a 130 percent RevPAR penetration, however, may or may not be achieving its RevPAR potential. No two hotels are the same physically or financially; none have identical market-demand generators or barriers to entry. Being able to reconcile all of the foregoing variables and accurately determine the weight that should be given to each is the difference between selling a hotel below market or selling a hotel above market. A professional hotel broker with an extensive transaction track record should provide great insight in sorting out the variables.

The story must be credible and intellectually defensible. If it consists of only "pie in the sky" projections, it will do more damage than good. A credible story, by contrast, places the foregoing variables in their proper perspective and can mean the difference of several million dollars in value. For example, consider a 300-room commercial hotel that recently sold at an enhanced price because of a competitive market. This hotel was in a city that had experienced the shutdown of a large military base, which had been the largest single provider of room nights to the city. The ini-

tial response of many to this loss of a major room-night generator was that it would hurt the hotel's future performance. However, it did not work out that way.

The military is lower-rated business than other commercial or leisure segments. This particular city ran a high annual city-wide occupancy. There were many days throughout the year in which tourist or commercial travelers who wanted to visit the city were unable to because of the lack of available rooms. With the absence of the military business, this city now can accommodate this latent or unaccommodated demand. As a result, occupancies remain the same as before the base closing, but average rates have grown significantly. Because the creators of the story of this hotel understood that the loss of the military base would ultimately be to the hotel's benefit, the price was enhanced.

## [2] Negotiating From Strength

A strong negotiating position is critical if a seller is to achieve the optimum proceeds from a hotel sale. The seller can lose proceeds from a sale in two ways if he attempts to market the hotel himself. First, purchasers discount the valid strong points made by a seller. If the seller describes the demand generators for a hotel as growing significantly over the next several years, a buyer will not only disregard this potential, but will argue, convincing himself, that the hotel's price should be based solely on the hotel's historic performance.

The second risk the seller runs by marketing a hotel himself is that the buyer will detect any weakness in the seller's position. When a seller pushes a buyer for a decision, the purchaser often perceives this as anxiety and may negotiate a lower price than the purchaser was willing to pay. On the contrary, if a professional hotel broker pushes a purchaser for a decision, the purchaser may perceive the time being of the essence in order to beat the market. This perception and concern on the part of the purchaser may yield a price higher than the purchaser wanted to pay.

## [3] Capital

Another method a professional hotel broker uses to achieve the highest possible price is to be a steady source of capital. An intermediary should be in constant contact with the lowest-cost capital sources and the most creative financing techniques. Consider the following example, wherein the capital helps achieve a higher price.

A buyer perceives that a hotel will produce a $5,300,000 net operating income during its first year of ownership. This purchaser has a source of financing for 70 percent of the acquisition price at an interest rate of 9 percent and an amortization schedule of twenty years, and the purchaser is seeking a 12 percent first-year return on equity. The buyer determines that it can pay a purchase price of $47,500,000 for this hotel. A 70 percent loan is equal to $33,250,000 and the equity required is $14,215,000. Using the foregoing interest rate and amortization schedule, the annual debt service is $3,589,907. The resulting cash flow after debt service is $1,710,093. If the $1,710,093 is divided into the equity investment of $14,215,000, the resulting cash-on-cash return is 12 percent.

If the professional hotel broker is able to source a 70 percent first mortgage at an 8 percent interest rate for 70 percent of the purchase price, the purchaser can then pay $50,000,000 for the same hotel, producing the same income stream and still yielding a 12 percent return on capital.

Mezzanine financing is another case in which the capital can create value, giving the seller a higher price and the purchaser a higher return. This form of debt is

subordinate to first-mortgage financing. It may or may not be secured by a second mortgage on the real estate. The cost of mezzanine financing is significantly higher than first-mortgage financing because of its higher-risk position; however, the cost is lower than market equity returns and occupies a priority position ahead of the purchaser's equity.

Assume that a purchaser is acquiring a hotel that is a turnaround opportunity. Although the hotel is currently producing a $500,000 net operating income, the purchaser believes that if the hotel had $5,000,000 invested in renovation and the franchise were changed, the stabilized cash flow of the hotel would be $2,000,000. The purchaser wants a 20 percent cash-on-cash return on his equity. Assume that the first mortgage is 70 percent of loan-to-cost at a debt constant of 10 percent. On the basis of a $2,000,000 stabilized net operating income, the purchaser could pay a purchase price of $10,384,615. That price plus the $5,000,000 renovation makes the total investment $15,384,615. The first mortgage is 70 percent of the total investment— $10,769,231. With a 10 percent debt constant, the annual interest payments on the first mortgage are $1,076,923. The equity, 30 percent of the total investment, is $4,615,385. Subtracting the annual debt service of $1,076,923 from the $2,000,000 net operating income yields a total of $923,077, which is a 20 percent return on the purchaser's equity.

If, instead of the purchaser making a 30-percent equity investment, a mezzanine lender invests half of the equity capital, a higher price can be paid for the hotel. Again, assuming that the purchaser's goal is a 20 percent cash-on-cash return on the stabilized year in which this hotel produces a $2,000,000 net operating income, the use of mezzanine financing can allow the purchaser to be more aggressive against the market and pay $11,326,531 for the hotel—a 9.1 percent increase. In this structure, the first-mortgage lender again makes a 70 percent loan to the total development cost. The purchase price is $11,326,531 plus the $5,000,000 renovation, making the total investment $16,326,531. The 70-percent first mortgage is now $11,428,571, and the annual debt service is $1,142,857. The mezzanine lender in this scenario has a 10 percent interest-only rate and participates in 20 percent of the resulting cash flow. The total debt service of the first-mortgage mezzanine lender is $244,898, resulting in a cash flow after debt of $612,245. Twenty percent of this cash flow is paid to the mezzanine investor and 80 percent is paid to the purchaser. Because the mezzanine lender put up half of the equity, the purchaser has invested only $2,448,980. After the debt service has been paid and 20 percent of cash flow is paid to the mezzanine investor, the cash flow available to the purchaser is $489,796, which is a 20 percent cash-on-cash return to the purchaser.

Obviously, if the purchaser were able to acquire this hotel at the original price of $10,384,615 and use the mezzanine structure, the purchaser's cash-on-cash returns would increase dramatically. In this example, the returns would be $553,846, which is a cash-on-cash return of 24 percent.

## [4] Marketing a Hotel

A professionally assembled marketing package requires 150 to 200 work-hours. Because the marketing package should be designed to convince a purchaser to part with millions of dollars to own a hotel, it must be more than an accumulation of facts. Some packages contain volumes of information but are uninteresting and unpersuasive. A marketing package should succinctly describe a hotel's potential for future cash flow and capital gain increases. An accurate and effective description of this potential can justify a higher price than a review of a hotel's historical performance.

Consider two properties—Property A, a hotel at a 12 percent capitalization rate

with a cash flow that will remain steady for the next five years, and Property *B,* a hotel at a 9 percent capitalization rate, the cash flow of which will grow at 15 percent per year. Assuming that both hotels originally produce $1,000,000 in cash flow, their purchase prices would be $8,333,333 or $11,111,111, respectively. Property A's cash flow five years from now is still $1,000,000. Assuming that this hotel sells at a capitalization rate of 12 percent, the unleveraged internal rate of return is 12 percent. With Property *B's* cash flow increasing at a compounding annual rate of 15 percent, at the end of five years, its cash flow is $1,749,006. Assuming it sells at the same 12 percent capitalization rate, its unleveraged internal rate of return is 18.6 percent.

Realistically, Property *B's* historic rate of growth will allow it to sell at a lower capitalization rate than Property *A,* increasing the already-higher return. An effective marketing package should effectively explain the hotel's growth potential to justify a greater than a "back of the napkin" value calculation.

To market a hotel, significant work-hours are required to make successful sales presentations to purchasers. All information in a presentation should be provided to a prospective purchaser in the context of what that purchaser wants. In other words, each presentation must be custom-made for each prospective purchaser. This can be done only in a one-on-one, give-and-take presentation, and a substantial number of work-hours per presentation is required.

First, a prospective purchaser's existing business and its wants and desires must be understood. This requires an interview. An in-person, face-to-face interview is more effective than one conducted by telephone. To arrange a face-to-face meeting, one to two hours are required. If the prospect is in a different city, an entire day is required to accomplish the interview. Because other work can be done during travel, five hours is a fair estimate of the amount of time needed to accomplish the interview. One hour is required either by telephone or in person to present a hotel's full potential and two hours of follow-up per prospect are required, on average, to determine its interest. To generate ten interested prospective purchasers, at least 100 presentations must be made. This means that, at an average work-hour requirement of 10 hours per presentation, 1,000 work-hours are required to effectively market a hotel. This does not include negotiating the transaction, purchaser's due diligence, purchase and sale agreement negotiation, or the closing process. If performed by one person on a fifty-hour work week who exclusively markets that hotel, forty weeks would be required to perform the marketing function alone. This length in chronological sequence required would prevent a competitive market from being achieved. A prospect whose interest was generated during the first month would most likely not be willing to wait for the marketer to complete the comprehensive process through the tenth month. Negotiations in a vacuum—with only one prospective purchaser at a time— are likely to result. This takes the competitive environment out of the process and, most likely, will result in a lower transaction price.

Only a professional hotel brokerage organization can provide the required work-hours in a rapid and efficient manner. First, a professional brokerage firm with a long history in the industry has already performed the interview step before even taking the assignment to market a hotel, cutting the required work-hours in half. Second, if the brokerage firm has a multi-person sales force, multiple presentations can be made simultaneously. This can reduce a nine- to ten-month marketing process to a matter of weeks. Additionally, showings can occur back-to-back when a firm has a multi-person sales force.

It is an often-stated truism that "time kills all deals." The professional hotel brokerage firm should greatly increase an owner's closing percentage.

## [5] Preventing Disruptions

All sellers must take measures to prevent disruptions at their hotels. If, for example, the direct management and leadership of a hotel becomes disgruntled or discouraged, the hotel's performance could decline. A negative trend in business could affect the price or derail a closing process.

The hotel brokerage professional can assist in minimizing disruption to the hotel's operations, and the owner can take several steps as well. First, the general manager of the hotel should be informed of the owner's intention to sell and should be made a part of the process. Obviously, the general manager can be quite apprehensive. An owner should structure a bonus for the general manager if the hotel is sold. This bonus should be significant and should be paid regardless of whether the general manager remains at the hotel to work for the new owner.

One potential cause of disruption is the presence of prospective purchasers at the hotel prior to the sale. Understandably, the purchasers will want to spend time at the hotel before buying it to learn as much as possible about it. Unfortunately, their presence could serve to disrupt or otherwise affect the direct management of the hotel. The hotel broker can alleviate this potential problem by providing comprehensive information to a prospective purchaser prior to the purchaser's ever inspecting the hotel. If the broker has diligently provided this information, inspection time at the hotel can be minimized.

## » 17.03 LIKE-KIND EXCHANGES

Today's competitive business environment has forced many changes within the hospitality industry as well as the constant restructuring of hotel properties. In many cases, financing new hotel properties has also become increasingly difficult. Thus, it is more important than ever that hospitality business owners be creative wherever possible in developing cost-saving strategies to achieve their goals.

One strategy often overlooked by hospitality owners is the use of like-kind exchanges to acquire property. The following discussion reviews some alternative methods of like-kind exchanges, which may provide new business opportunities for the hospitality owner as well as lucrative tax benefits.

## [1] Advantages

An exchange of hotels, or an exchange of business property for a desired hotel property, represents one creative means of acquiring a new property. This method can offer unique planning opportunities for the hospitality or business owner who wishes to relocate to another market. It can also provide significant tax savings for a new owner, because appreciated property can be exchanged without incurring any tax on the appreciated gain. The deferral of the gain is what makes like-kind exchanges such a valuable tool for hotel owners.

Consider the following example: a hotel owner in New York wishes to retire to Florida but remain active in the business. The individual might be able to find a property suitable to his needs in Florida, one that has an ambitious young owner anxious to relocate to a potentially faster growing market in New York. The two get together, simply exchange properties, and completely avoid tax liability on the appreciated gains of the two hotels. Other valid reasons for engaging in a like-kind exchange might be to reposition one's property into a different market, obtain property that will allow for expansion, allow investors into the hotel business with the exchange of dif-

ferent property; or to allow a hotel owner to leave the hospitality business and obtain other business property without paying any capital gains tax.

Business owners may also have non-business reasons for exchanging property under IRS like-kind exchange rules. It is a commonly used strategy in estate planning to defer taxes on appreciated property. For example, an owner would be required to pay substantial capital gains tax in an out-and-out sale of property that had significantly appreciated in value over the years. If the owner exchanges the property for property at another desirable location, however, all capital gains taxes are deferred until the property is eventually sold. In some cases, in fact, the gain on the property may never be taxed if the owner dies before it is sold and the property is passed on to the heirs.

IRS stepped-up basis rules essentially allow heirs to inherit property at the fair market value of the property at the time of the owner's death. This applies even if the deceased owner had very little basis left in the property. Thus, if the heirs sell the property at fair market value shortly after the owner's death, there is no gain to report. In this case, the basis equals the value of the property. This is known as receiving property that has been "stepped-up" to its fair market value at the time of death. Of course, estate taxation is a difficult, complex area of the law. A business owner getting on in years would be wise to talk to his tax adviser on whether the use of like-kind exchange as an estate planning tool would be advantageous or not in his or her specific circumstance.

There are several important reasons why the hotel industry is ideal for using business options such as like-kind exchanges. For one, the hotel industry is considered a specialized component of real estate and it is treated very favorably under like-kind rules. Second, the hotel industry is subject to market saturation. Therefore, there are a great many excellent hospitality properties operating in the market, providing a multitude of possibilities for an owner wishing to exchange properties to enter a desired market or better fit his or her strategic goals.

## [2] General Requirements

A like-kind exchange is a reciprocal transfer of property, as distinguished from a transfer of property for money only. But an exchange can occur even where cash (boot) is part of the consideration, if the transaction otherwise qualifies as a like-kind exchange. Like-kind property must be both given up and received in the exchange in order to satisfy the "exchange" requirements.

There are several requirements that must be met for a taxpayer to take advantage of a like-kind exchange. The exchanged property must be:

1. Held for the productive use in a trade or business, or for investment; and
2. Exchanged solely for property of a like kind, which is to be held for either productive use in a trade or business, or for investment.

If a taxpayer has a qualified like-kind exchange transaction in any given year, he or she is required to file the transaction on IRS Form 8824 along with his or her regular tax return.

## [3] Real Estate Qualifications

Whenever making business decisions in accordance with the Internal Revenue Code it is imperative to look closely at the language to determine the exact meaning of the

statutes. For example, "like-kind" as used in this chapter means "alike in terms of nature or character of the property." It does not refer to its grade or quality. Thus, one class of property cannot be exchanged for another class.

This means that real estate can not be exchanged for personal property. However, when real property is exchanged for real property, it does not matter whether the property is similar, or even whether one of the properties is unimproved. Thus, the exchange of vacant land for a hotel would qualify under the like-kind exchange rules. The existence or lack of improvements merely affects its grade or quality, not its class.

The following examples of exchanges have been held to qualify as like-kind transactions:

- Rental housing for farm property.
- A commercial building for a condominium interest in a newly constructed commercial building.
- Real property subject to a lease for real property not subject to a lease. The existence of the lease affects the grade and quality of the property, rather than its nature and character.

Consequently, a hotel could be exchanged for a different type of business real estate and be within the like-kind exchange guidelines. For example, a hotel owner could exchange his property for a bowling establishment. The transaction would still qualify under the like-kind exchange rules, because both the properties are classified as real estate.

There are certain properties that do not qualify for tax-free exchange (e.g., inventory stocks, bonds, and partnership interests). The property for exchange must be similar in nature or character to the transferred property, notwithstanding differences in grade or quality as shown in the preceding examples.

However, there are cases in which real estate exchanges are not considered as like-kind exchanges. Listed below are some circumstances under which a real estate transaction will fail to qualify under the like-kind exchange rules:

1. *Foreign property.* This is never considered like-kind property under the like-kind exchange rules.
2. *Sale of an apartment building in which the taxpayer used the proceeds from the sale and other property to acquire a like-kind property.* The fact that the taxpayer first sold the property invalidated any exchange opportunities.

It is important to keep in mind, however, that the IRS rules regarding property exchange transactions are mandatory, not optional. In a transaction structured as an exchange, all gain must be deferred on the property. Although this is generally good strategy, there are times when this should not be done. These occasions are discussed subsequently in this chapter.

## [4] Utilizing Deferred Exchanges

One of the biggest controversies involving like-kind exchanges occurs when exchanges are deferred, or do not take place at the same time. Because the Supreme Court stated in the now famous *Starker* case that exchanges do not have to occur at the same time to qualify as like-kind, Congress acted in 1984 to stipulate exchange time limits. It was not until 1991, however, that the IRS finally got around to issuing regulations that provided rules for complying with the deferred like-kind exchange requirements.

A deferred exchange is defined as an exchange in which, under the terms of the agreement, the taxpayer transfers qualified property (relinquished) and after the transfer, receives qualified property (replacement property).

Strict requirements have been established concerning when exchanged property must be identified and accepted in the exchange for the "like-kind" aspect to qualify the exchange as tax free. The property will not qualify as like-kind property if:

1. The replacement property is not identified as property to be received in the exchange within forty-five days after the date on which the transferor transfers the old property (the identification period requirement); or
2. The replacement property is not received by the earlier of 180 days after the date on which the transferor relinquishes the old property, or by the due date (including extensions) for the transferor's tax return for the taxable year in which the old property is transferred (the exchange period requirement).

An example how of the deferred exchange rule might work is as follows: On May 17, pursuant to a deferred exchange agreement, hotel owner Astor transfers his 100 room hotel property with a fair market value of $200,000 to Baker for a hotel property to be identified later. On or before July 1, (the end of the 45-day identification period), Astor is required to identify the like-kind replacement property to be received from Baker. Astor must then receive from Baker on or before November 13 (180-day receipt requirement) the property identified as the like-kind replacement property.

Neither party can extend the foregoing limitation periods for any reason. Therefore, if a hotel owner fails to identify replacement property or take possession of the replacement within the required time limit, the transaction will not be treated as a like-kind exchange. The gain on the transaction would thus be taxable.

For a hotel owner to properly identify any replacement property, he or she must send a description of the property in writing to the qualified parties before the end of the forty-fifth day. If the replacement property is transferred to the hotel owner before the forty-fifth day, the identification requirement is satisfied.

The hotel owner can identify more than one property when using the deferred exchange method. A hotel owner can, subject to the "three-property" and "200%" rules (explanation to follow), identify more than one replacement property regardless of the number of properties he has relinquished in the same exchange. Under the three-property rule, a hotel owner can select up to three properties without regard to their aggregate fair market value. Alternatively, a hotel owner, under the 200% rule, can select any number of properties as long as their aggregate fair market value does not exceed 200% of the aggregate fair market value of all the relinquished properties.

Using the preceding example, Astor on May 17 transfers his 100-room hotel valued at $200,000 to Baker. On or before July 1, Astor is required to formally recognize the like-kind replacement property. Astor identifies three potential hotel replacement properties (Properties 1, 2, and 3) in a written document that he signs and personally delivers to Baker on June 28. The written designation also provides that Astor will orally inform Baker by Aug. 1 which of the three identified hotel properties he wants to receive. Since Astor did not choose more than three properties, all three have been properly identified before the end of the identification period. It does not matter whether the aggregate fair market value (i.e. $500,000) exceeds 200% of the fair market value of the relinquished property ($400,000).

## [5] Related Party Transfers

There are specific rules covering transfers among family members. There is a special two-year holding period requirement for exchanges between related parties. This rule requires the hotel owner to report to the IRS on the property in the sale year of the like-kind transaction and again at the end of the two-year holding period. The related party rule does not bar like-kind exchanges between related partners; it merely imposes a two-year holding period.

Related parties for purposes of this rule include most family members and corporations in which the party holds more than 50 percent ownership. Special rules also govern transactions between partnerships and their partners.

There are three exceptions to the two-year waiting rule, permitting a holder to claim a nonrecognition provision for the like-kind exchange:

1. Any disposition of the property after the death of either the taxpayer or the related person.
2. Any disposition that is caused outside the control of the taxpayer, such as an involuntary conversion.
3. Any disposition to the satisfaction of the IRS that the main purpose was not to avoid income tax on the transaction.

Any taxpayer who feels that he or she may qualify for an exception to the general rule must attach an explanation to his or her tax return explaining the qualifying exception.

## [6] Determining Basis

Generally, the basis of property acquired in a like-kind exchange is the same as the basis of the property transferred. There is an exception, however, if money (called "boot" by accountants) or certain debt is involved.

Many times in a like-kind exchange, the properties will not be equal. The taxpayer may receive or give money, or other property, to equalize the transaction. As previously stated, the basis of property received in a like-kind exchange is the same as that of the property given up.

If money or other property not of a like-kind (boot) is received in the exchange, gain is recognized, but only to the extent of the money or boot received. If a party to the exchange assumes debt on the property, or acquires property from the taxpayer subject to a liability, then the debt assumption will be treated as boot.

It is important to remember that even if the taxpayer receives boot and shows a loss, the loss is not recognized under like-kind exchanges. Therefore, the taxpayer needs to be careful to analyze the transaction in terms of the possibility of realizing a loss. If a loss is probable, the trade must be structured so that the transaction does not qualify as a like-kind exchange. The same rules apply to recipients who receive money or property not qualifying as like-kind exchange property in a deferred exchange.

When a person gives boot instead of receiving boot, the non-recognition rules still apply to the person giving the boot. However, a taxpayer could recognize gain if certain nonqualified property is given as boot in the exchange.

A common practice is to give and receive property subject to a mortgage. The assumption of a liability or a transfer subject to a liability is treated as boot. The taxpayer who assumes a liability or accepts property subject to a liability receives boot.

If each party to an exchange assumes the liability of the other party, the liabili-

ties assumed by one party are offset against those assumed by the other. Only the excess is treated as part of the boot given or received. The following example will help explain how debt exchanges work.

*Example:* Hotel owner A in New England owns a property that has an adjusted basis of $80,000. It is subject to a $70,000 mortgage. He makes an exchange with hotel owner *B* for realty on another hotel in Florida worth $120,000, which is subject to a $50,000 mortgage. In addition, owner A receives $10,000 in cash. The gain A recognizes on the exchange is $30,000, computed as follows:

**TABLE 17-1**

| | | |
|---|---|---|
| **Hotel owner *A* received:** | | |
| Property worth | $120,000 | |
| Cash | 10,000 | |
| Mortgage on hotel given in exchange (treated as cash received): | 70,000 | |
| Total consideration: | | $200,000 |
| **Hotel owner *A* gave in exchange:** | | |
| Hotel at its adjusted basis | $80,000 | |
| Mortgage on Property received (treated as cash paid): | 50,000 | |
| Total given: | | $130,000 |
| Maximum recognizable gain to *A*: | | $ 70,000 |

In this scenario, however, the amount of gain recognized is limited to the net cash received by hotel owner A. If the mortgage on the property given is counted as cash received and the mortgage on the property received as cash paid, or $30,000, it computes as follows:

**TABLE 17-2**

Mortgage on property given up by hotel owner *A* [$70,000] -
Mortgage on property received by hotel owner B {50,000) =
Net reduction of hotel [$20,000]

Owner *A's* indebtedness [$20,000] +
Cash paid to hotel owner *A* [10,000] =
Gain recognized by hotel owner *A* [$30,000]

The final calculation a hotel owner needs to make in analyzing a like-kind exchange is to determine the tax basis for the properties. The tax basis is the value that the IRS recognizes when and if a property is sold. Generally speaking, the basis of the new property is the same as the property exchanged. However, if boot was given or received in the exchange, the basis on the new property could be affected.

If any gain is recognized because of receipt of money or other boot, the basis of all the property received is adjusted to include the old property, increased by the gain recognized and decreased by the money received.

If a loss is realized, but not recognized in an exchange in which a taxpayer receives money or other boot, the basis of all the property received is the adjusted basis of the old property, decreased by the money received.

The following is a simple formula for determining basis of property acquired in a like-kind exchange:

**TABLE 17-3**

| | |
|---|---|
| Adjusted basis of old property | $ ...... |
| Add: | |
| Cash or value of non–like-kind property given | $ ...... |
| Gain recognized | $ ...... |
| Subtract from this total: | |
| Cash or non–like-kind property received | $ ...... |
| Loss recognized on non–like-kind property given (excess of adjusted basis over trade-in allowance) | $ ...... |
| The resulting total is the basis of the new property. | |

Finally, a hotel owner must carefully examine his basis to determine whether property transferred will actually result in the deferral of a gain, and not a loss. This is an important concept to remember, because there are situations when it might be more beneficial for a business owner to structure such a transaction so that it is taxable. In this case the hotel owner will want to intentionally avoid meeting the like-kind exchange requirements, because the rules are not optional.

For example, a hotel owner may want to recognize gain, because he or she has just recently experienced a loss, which could be offset by a gain on the trade. This results in the hotel owner's getting a higher basis for the property received, which in turn, results in larger depreciation deductions.

The like-kind exchange rules are a valuable planning tool often overlooked by hospitality owners. Like-kind exchanges allow property relocation without recognizing any taxable gain on appreciated real estate. Like-kind exchanges can also be used as a strategy for family members wishing to exchange properties to better position family holdings. Finally, the like-kind exchange can be a valuable estate planning tool. Since step-up rules regarding estates value inherited property at fair market value at the time of an owner's death, taxes on his or her deferred gain may never be realized. Although like-kind tax rules appear complicated, the opposite can be true. The rules actually allow considerable flexibility in choosing properties to exchange. In addition, since any recognizable gains are usually very minor, compared with deferred gain on appreciated property, the tax benefits could be substantial.

# CASE STUDY: >> 17.04 How Investor Raised Cash To Acquire A Profitable Hotel

Mr. Comer Mann, an experienced hotel investor, wanted to acquire a going hotel that produces an annual operating profit of $1.68 million. The hotel has been doing well for several years, and its profits show an upward trend, as can be seen from the following table:

| Year | Gross Income From Operations | Net Profit From Operations |
|---|---|---|
| 1992 | $ 8,200,000 | $1,300,000 |
| 1993 | 9,000,000 | 1,425,000 |
| 1994 | 10,100,000 | 1,680,000 |

The owner, recognizing the earnings trend, insisted on a total price of $22 million for the hotel, This price covered the land, building, and the supplies, furnishings, and equipment, In addition, he wanted it all in cash.

The hotel was owned free and clear of any mortgages or other liens or encumbrances. It is 40 years old; it has 635 guest rooms and meeting rooms, and has a small ballroom that can accommodate 200 people. The hotel also has a food and beverage operation that accounts for almost 30 percent of its gross revenues.

Mr. Mann believed that if he acquired the property he could increase its operating profits within three years to as much as $2.3 million annually, because the hotel business is booming and the present owner has become less attentive to controlling operating expenses. However, he could not acquire the property unless he found some way that made its acquisition feasible for him. Whatever financing plan he came up with would, or course, have to take into account his front-end fees, expenses, and some immediate profit, He expected these "add-ons" would amount to some $500,000 as follows:

Legal fees $ 75,000 Accounting fees
25,000 Commissions and finder's fees 150,000
Promoter's profit 250,000

The total required was $22.5 million.

**[1] METHODS CONSIDERED BY INVESTOR**

Mr. Mann's task was to figure how approximately $1,680,000 of annual cash flow could service $22,5 million of financing. He began to think of the prices he would have to pay to attract various sources of investment funds.

**[a] Why $22.5 Million Could Not Be Raised From Tax-Shelter Investors**

The lowest price would be demanded by individual investors seeking a tax shelter in the form of large passive losses. If the reportable annual tax losses from the investment could be sufficiently high, these investors would be willing to invest with either no cash return or a cash return ranging up to 7 percent a year. But, there were two problems,

First, even though this was an older hotel with a lot of personal property which had short depreciable lives, not enough annual depreciation deductions could be generated during each of the first five years to satisfy an investor,

Second, a 100 percent equity investment can never be an attractive tax-shelter investment. The reportable annual losses can never be stretched to amount to a significant percentage of the capital contribution. For those investors who want to obtain reportable losses in the first five to eight years in an amount that is greater than their capital investment, their capital investment cannot represent a large proportion of the total cost of acquiring the depreciable assets.

**[b] Why a Tax-Exempt Bond Issue Was Not Available to Investor**

Mr. Mann knew that the next cheapest money would be municipal bond money, i.e., the proceeds from the sale of tax-exempt bonds issued by states, cities, and certain governmental authorities. Such investors require a return of 7 to 7.5 percent a year if the bond is issued by a creditworthy issuer and the annual interest payments are tax-exempt. Such financing may be available for the construction of new housing or industrial properties or for the rehabilitation of existing housing, but it is not available for the simple acquisition of an existing commercial hotel whose function will not be changed.

### [c] Other Sources of Funds

Among the other possibilities that occurred to Mr. Mann were:

1. Selling off the land to an investor who wanted a very safe investment and did not need any reportable losses. If the land was not worth more than about 25 percent of the total value of the land and building, the safety of the investment would be so great as to warrant paying a price as low as 7.5 percent per year for the money.
2. Finding equity investors who wanted an annual cash return but did not seek large amounts of tax shelter. Mr. Mann knew that if there was no significant amount of tax shelter to offer, equity investors could be found but would require at least a 9 percent cash return. They would have to be convinced that, in the long run, they could do better investing in this property than in making long-term savings bank deposits, which would pay them 6 percent or so, and would be much less illiquid than a real estate investment. Mr. Mann believed that investors could be found who would put up part of the money he needed, but he did not believe he could raise the full $22.5 million solely from this source,
3. Conventional first mortgage lenders. This source used to be the obvious first choice for financing an acquisition. However, Mr. Mann realized that if he sought even a 70 percent mortgage, that is, a first mortgage of $15.75 million, he would probably have to pay a constant of about 11 percent, or $1,732,500, which would leave him no cash flow available to service the remaining $6.75 million which had to be raised.
4. Financing with first and second mortgages was obviously impossible in this transaction, because second mortgage money, even if it was available, would cost Mr. Mann between 3 percent and 8 percent per year more than first mortgage money. The property simply did not earn enough to carry such a debt structure.

Mr. Mann knew that he would have to break up the investment into a number of different positions that would offer different attractions for investors pursuing a range of different objectives. This is what he did.

### [2] Investor Created a Ground Lease and a Leasehold Mortgage

Mr. Mann was able to arrange for the sale of the land, without the building or improvements, to a pension trust for the sum of $5 million; simultaneously, he leased the land back from the trust under a long-term net ground lease calling for a basic annual rent of $375,000. The ground lease was to run for an initial term of 25 years and figured to provide an annual return of 7,5 percent to the trust. The lease gave the lessee several options to renew for additional terms totaling 80 years. It also called for reappraisals of the land at the end of the first 15 years and thereafter at intervals of 10 years. The rent, on each reappraisal, will be fixed for the next 10 years at the higher of (1) the ground rent during the lease period then ending or (2) 7.5 percent of the fair market value of the land alone if the land was devoted solely to hotel uses.

Mr. Mann, having created the long-term ground lease, then obtained a leasehold and building mortgage loan of $9 million which was to run for a term of 15 years and bear interest at 9,5 percent. The annual debt service came to $945,000, or a 10,5 percent constant, When it matured at the end of 15 years, there would be a balloon of about $6 million,

The leasehold mortgage lender was a large savings bank. The mortgage covered both the lessee' interest in the ground lease and the fee title to the building. The mortgage was subordinate to the fee interest. Because of this, it was not necessary to obtain the consent of the pension trust, as owner of the land, to the terms of the leasehold mortgage. The lender agreed to this because it had appraised the entire property at $23 million, and regarded the land rent as representing only about 22 percent of the value or earnings. If the mortgagor defaulted under the mortgage, the lender could not foreclose the pension trust's fee interest, but could only become the lessee under the ground lease and the owner of the improvements.

### [3] How Investor Then Syndicated the Enterprise and Created a Subleasehold Operating Position

Mr. Mann then decided he could raise the remaining $8.5 million by organizing a limited partnership to own the leasehold estate and the building, and selling (syndicating) $8,5 million of limited partnership shares to passive investors, Because the leasehold mortgage was a nonrecourse mortgage,

Mr. Mann was able to offer his investors tax deductions and no risk of personal liability.

At the same time, he chose to create an operating position in a Hotel Operating Company (HOCO), a separate partnership composed of himself and five of his business associates. HOCO sublet the entire property from the partnership under a long-term net sublease which ran from the partnership, as sublessor, to HOCO, as sublessee. This net lease was also for an initial term of 25 years and gave HOCO options to renew for additional terms aggregating 80 years. The basic annual rent HOCO would pay under the sublease came to $1,745,000. This sum was arrived at as follows:

1. $375,000 (annual ground rent to the fee owner) plus

2. $945,000 (annual debt service under leasehold mortgage), plus

3. $425,000 (representing a 5 percent annual cash return before taxes to the syndicate investors), plus- a participation in future profits.

This basic rent was somewhat higher than the earnings produced by the hotel at that time. However, the pattern of increasing earnings made it reasonable for Mr. Mann to undertake the risk. What's more, the sublease gave the sublessee the option to walk away from the deal at any time after the first three years without the landlord's consent, and upon an assignment HOCO would have no further liability

The sublease also contained a profit-sharing formula. HOCO, the sublessee, could retain the first $155,000 of profits after paying $1,745,000 of basic rent annually. If profits exceeded $155,000, HOCO could keep one-half of the excess and pay the other half as coverage rent to the sublessor.

Mr. Mann could have used a general partnership as the legal vehicle for the syndication group. By creating an independent operating sublessee, he removed the risk of any of the investors being liable for the operation expenses of the property. However, he chose to use a limited partnership as the legal form because many investors have become accustomed to it. (They have some hesitancy about entering a general partnership even if they know they have been legally and totally separated from the conduct of the activities that could result in liability)

Mr. Mann had considered taking a limited partnership interest along with the investors, instead of creating the net sublease, The cash investors would have been entitled to the first available distributions up to $425,000 in each year. Then Mr. Mann's limited partnership interest would have received the next $155,000 of each year's distributable operating profits. If the annual operations produced more than $580,000 of distributable cash (after payment of ground rent and leasehold mortgage debt service), the excess would be divided half to Mr. Mann and half to the other investors. He decided against this course because he preferred to have the sublease, which was a separate, salable asset.

In addition to their 5 percent cash return, Mr. Mann could offer his syndicate investors the benefit of annual depreciation deductions of approximately $959,000 in the first five years of their investment as follows:

| Asset | Basis | Recovery Period | Annual Depreciation |
|---|---|---|---|
| Building | $14,000,000 | 39 years | $359,000 |
| Equipment, furnishings, & supplies | $3,000,000 | 5 years (average) | $600,000 |

After the fifth year of their investment, the syndicate investors would no longer receive depreciation deductions for the furnishings and equipment because their replacements would be paid for by the sublessee. At that point, however, they had the expectation of an increased cash flow, most or all of which would be tax-sheltered.

**Exhibit 17-1 Contract of Sale—Hotel or Motel With All Personal Property**

Agreement made _____*[Date],* between _____, of_____ *[address],* ______ *[city],* _____ County, _____ *[state],* referred to as seller, and
_____, of _____ *[address],* _____ ["O']) _____ County, _____
*[state],* referred to as buyer.

**SECTION ONE**

**SALE OF BUSINESS**

Seller agrees to sell and buyer agrees to purchase _____ *[name of hotel or motel],* located at ____ *[address],* ____ *[city],* ____ County, _____ *[state],* more particularly described as follows: _____ *[set forth legal description],* referred to as _____ *[hotel or motel],* together with all right, title, and interest of seller in the furniture, furnishings, apparatus, linens, fixtures, and other equipment situated in or on the premises, as specified in Exhibit _____, which is attached and incorporated by reference.

**SECTION TWO**

**PURCHASE PRICE**

As full payment for the transfer of the above-described _____ *[hotel or motel]* and listed assets by seller to buyer, buyer shall pay to seller the sum of _____ Dollars ($_____). The purchase price shall be allocated among the assets as follows: _____ *[list categories and amounts as appropriate].*

**SECTION THREE**

**CONDITIONS OF PURCHASE**

The purchase is subject to the following conditions:

(a) The customary objections contained in the certificate of title issued by _____ *[title company]* or any other title company the seller may designate;

(b) Special assessments and special taxes, if any, not confirmed by a court of record or confirmed after the date of the recording of the deed executed and delivered by seller, and as provided in this agreement, and all special assessments and special taxes thereon due after _____ [year];

(c) Zoning and building laws and ordinances and governmental rules and regulations;

*(d)* General taxes for the year _____ and subsequent years;

(e) Building lines, building and liquor restrictions of record, if any;

(/) Party wall rights or agreements, if any; and,

*(g)* All liens or encumbrances and things created, placed, or suffered to accrue, by buyer.

## SECTION FOUR

## EARNEST MONEY

Buyer has deposited with seller _____ Dollars ($_____), as earnest money, to be applied on the purchase when and if consummated, and buyer shall pay the balance of _____ Dollars ($_____) within the time and in the manner provided by this agreement.

## SECTION FIVE

## ESCROW

The closing of title shall be consummated through an escrow agreement, as provided by this agreement, with _____ *[escrow company], of* _____ *[address},* _____ *[city],* _____ County, _____ *[state]*. The charges of the escrow fee shall be _____ *[divided equally between seller and buyer or as the case may be}.*

## SECTION SIX

## DEPOSITS BY BUYER IN ESCROW

Within _____ days after this agreement is signed by both parties, buyer shall deposit with escrow the full purchase price of _____ Dollars ($_____).

## SECTION SEVEN

## DEPOSITS BY SELLER IN ESCROW

Contemporaneously with deposits by buyer in escrow, seller shall deposit with the escrow agent the following:

*(a)* A _____ *[warranty}* deed from seller conveying the above-described premises to buyer;

(ft) A bill of sale in customary form of all right, title, and interest of seller in all personal property located in or on the above-described real estate;

(c) All instruments necessary to enable the escrow agent, on payment of the unpaid balance of the purchase price, to procure the release of the present _____ *[mortgage or deed of trust]* held on the property, which, together with the
indebtedness secured thereby, are held by _____ *[bank] of* _______ *[address],*
_____ *[city],* _______ County, _____ [state]; and,

*(d)* Assignments of all leases with respect to the _____ *[hotel or motel}* and the originals of the leases so assigned.

## SECTION EIGHT

## RECORDING OF DEED

The escrow agent shall be directed to record the deed from seller to buyer on the deposit by buyer of _____ Dollars ($_____) and to secure the customary
preliminary report of title of ______ *[title company}* covering the date of the deed
and showing title in the grantee of the deed to the hotel property, subject only to the matters set forth in Section Three above, together with:

(a) Rights of parties in possession not shown of record;

(b) Mechanics' liens, if any, where notice of such liens appears of record.

**SECTION NINE**

**DEFECTS OF TITLE**

If the report of title of _____ *[title company]* discloses any defects in title other than the matters stated in this agreement, seller shall have _____ days from the date of receipt of the report from the escrow agent within which to cure the defects in a manner satisfactory to the purchasers. In case the defects in title should not be cured within _____ days, buyer may elect to grant to seller, by notice in writing, an additional _____ days in which to cure the defects in a manner satisfactory to buyer, or may terminate this contract, or may elect to take title as it then is, on giving to seller notice of the election and tendering performance on buyer's part.

**SECTION TEN**

**INABILITY TO CURE DEFECTS OF TITLE**

In the event that buyer withdraws from this agreement, buyer shall forfeit _____ Dollars ($_____) to seller, which sum escrow is authorized to pay out of the fund deposited by buyer in escrow. Seller shall accept the above sum in full payment of all claims, and the parties shall have no further liability to one another.

**SECTION ELEVEN**

**CLOSE OF ESCROW**

The date occurring _____ days after the date of notice in writing from the escrow agent to seller and buyer of the willingness of ______ *[title company]* to issue its certificate of title in its usual form, guaranteeing the grantee in the deed against any loss or damage to the extent of the purchase price by reason of any defects in the grantee's title to the above-described real estate, subject only to the matters and things set forth in Section Nine of this agreement, shall be the date of the actual closing. However, the apportionment of all prorations in connection with this agreement shall be as of the date of the deposit of the balance of the purchase price as provided in this agreement.

**SECTION TWELVE**

**PRORATIONS**

Rents, general real estate and personal property taxes, insurance premiums, and other like charges, if any, together with such other items as are usually prorated, shall be adjusted pro rata as of the date provided in Section Eleven, and all accounts receivable accruing from and after that date shall become the property of buyer, and all accounts payable from and after that date shall be assumed and paid for by buyer.

**SECTION THIRTEEN**

**ACCOUNTS RECEIVABLE**

Buyer agrees to make reasonable efforts to collect all accounts receivable and rents due and remaining uncollected up to _____ *[time],* _____ *[Date],* and pay them over to seller promptly when and as collected. Seller shall have the right to

audit buyer's records not more often than semi-monthly at a reasonable time during any business day until the accounts receivable and rents are fully liquidated. The provisions of this paragraph shall survive the delivery of the deed under this agreement.

Seller's accounts payable include goods delivered, services performed and work done through _____ *[Date]*. Buyer's accounts payable include all goods delivered, services performed and work done after _____ *[Date]*.

**SECTION FOURTEEN**

**ESCROW ADJUSTMENTS**

Adjustment shall be made at the office of the escrow agent on the date of closing. If the net amount of all the prorations shall show a balance in favor of seller, buyer will immediately deposit the amount of the balance with the escrow agent. If the net amount of all the prorations shall show a balance in favor of buyer, the balance shall be transferred from the purchase price.

**SECTION FIFTEEN**

**SATISFACTION OF CONDITIONS**

When all deposits have been made with the escrow agent, escrow shall be closed out in the customary manner pursuant to the escrow agreement to be agreed on between seller and buyer, it being understood that when the escrow has been closed, the property to be delivered to buyer will be subject only to items (a) through *(g)* specified in Section Three of this agreement, describing conditions of title.

**SECTION SIXTEEN**

**POSSESSION**

Provided all the deposits of buyer as required in this agreement have been made, buyer shall be entitled to take possession of the above-described premises and improvements on the date of the close of escrow, together with the personal property included in the sale.

**SECTION SEVENTEEN**

**DEED RECORDING**

Seller shall pay costs of the issuance of the certificate of a title, and buyer shall pay the costs of recording the deed.

**SECTION EIGHTEEN**

**BUYER'S _____ *[MORTGAGE or DEED OF TRUST]***

If buyer desires to place a _____ *[mortgage or deed of trust}* on the above-described real estate for the purpose of securing a loan for any portion of the purchase price, the above-described escrow agreement shall be drawn in such a way as to permit the _____ *[mortgagee or trustee}* to deposit in escrow the proceeds of the _____ *[mortgage or deed of trust}* loan, and shall contain mechanics with respect to disbursement of the loan, for nothing to be included in the escrow agreement shall impair the rights of seller to receive payment of the purchase price in accordance with the terms and provisions set forth above.

**SECTION NINETEEN**

**LIQUIDATED DAMAGES FOR BUYER'S DEFAULT**

If the purchase and sale of the _____ *[hotel or motel]* is consummated in accordance with the terms of this agreement, seller shall retain buyer's earnest money and buyer shall receive credit on the purchase price for the amount of the earnest money. If the purchase and sale of the _____ *[hotel or motel} is* not consummated pursuant to the terms of this agreement, seller shall return buyer's earnest money, unless the purchase and sale are not made by reason of the fault of buyer, in which event _____ Dollars ($_____) shall be retained by seller as liquidated damages in full satisfaction of the liability of buyer,

**SECTION TWENTY**

**LIQUIDATED DAMAGES FOR SELLER'S DEFAULT**

If the purchase and sale of the _____ *[hotel or motel}* contemplated by this agreement is consummated in accordance with the terms of this agreement, buyer shall return seller's earnest money. If the purchase and sale of the _____ *[hotel or motel]* is not consummated pursuant to the terms of this agreement, buyer shall return seller's earnest money, unless the purchase and sale are not made by reason of the fault of seller, in which event _____ Dollars ($_____) shall be retained by buyer as liquidated damages in full satisfaction of the liability of seller.

**SECTION TWENTY-ONE**

**RISK OF LOSS**

If, prior to transfer of legal title or possession of the above-described premises to buyer, the premises are fully or materially destroyed by fire or other casualty without fault of the buyer or taken by eminent domain, buyer may terminate this contract without liability and recover any portion of the price paid. _____ Dollars ($_____) damage shall be considered material destruction of the premises.

**SECTION TWENTY-TWO**

**NOTICE**

Any notice required or desired to be given under this agreement may be given by registered mail to seller at _____ *[address],* _____ *[city],* _____ County, _____ *[state],* and to buyer at _____ *[address],* _______ *[city],* _____ County, _____ [state], and notice so made shall, for all purposes, be as effective as though it was served on buyer and seller in person at the time of depositing the notice in the mail.

**SECTION TWENTY-THREE**

**REAL ESTATE BROKER'S COMMISSION**

It is expressly understood and agreed that the purchase price of _____ Dollars ($_____) is the net amount to be paid by buyer to seller in the event of the consummation of this sale. _____ *[Buyer or Seller]* shall pay the entire real estate brokerage commissions and charges of every kind that arise in connection with the sale of the property.

**SECTION TWENTY-FOUR**

**BINDING ON ASSIGNEES**

This agreement shall bind the parties and their respective heirs, representative, successors, and assigns.

The parties have executed this agreement at _____ *[designate place of execution]* on _____ *[Date],*

*[Signatures]*

*[Acknowledgments}*

## Exhibit 17-2 Contract of Sale—Hotel Furniture And Fixtures

Agreement made _____ [Date], between _____, of_____ *[address]*,_____ *[city]*, _____ County, _____ *[state]*, referred to as seller, and_____, of _____ *[address]*, _____ *\city*, ______ County, _____*[state]*, referred to as buyer.

**SECTION ONE**

**SALE OF FURNITURE AND FIXTURES**

Seller agrees to sell to buyer, who agrees to purchase at valuation and on terms mentioned below, all the stock, implements and utensils in trade, household furniture, fixtures, fittings and effects specified in the inventory, attached as Exhibit _____,
and incorporated by reference, now being in, on and about the _____ Hotel, its
cellars, stores, garage, outbuildings, yards and premises, which now are occupied by seller, situated at _____ *[address]*, _______ *[city]*, ______ County, _____
*[state]*.

**SECTION TWO**

**DATE OF VALUATION**

The valuation shall be made on or before _____ *[Date]*, up to which time all depletions in respect of the above-described hotel and business shall be defrayed by seller, when the amount of the valuation shall be paid to seller, who will then deliver to buyer, or buyer's agent, full and peaceable possession of the above-described personal property and fixtures.

**SECTION THREE**

**WHO SHALL MAKE VALUATION**

The valuation shall be made by two persons, one to be chosen by each party, or by an umpire to be chosen by the appraisers before entering on the valuation; and in case either party shall neglect or fail to make the appointment within _____ days from the date of this agreement, or if either of the appraisers or the umpire shall refuse or neglect to proceed and complete the appraisal within _____ days of their appointment, the appraiser of the other of them shall proceed alone, and the appraiser's valuation shall then be binding and conclusive on both parties,

**SECTION FOUR**

**DEFAULT; LIQUIDATED DAMAGES**

If buyer refuses or neglects to pay the amount of the valuation on _____ *[Date]*, or if seller, on an offer, in writing, of the purchase money, delivered, or left at the hotel, refuses or neglects to deliver possession of the above-mentioned personal property and fixtures, the defaulting party shall pay to the other of them _____ Dollars ($_____) for liquidated damages between them; and this agreement shall become void.

Each party to this agreement has caused it to be executed at _____ *[place of execution]* on the date indicated below.

*[Signatures and date(s) of signing]*

HVS

CHAPTER 18

# Hotel Franchises


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## » 18.01 INTRODUCTION

A hotel franchise is essentially an agreement between a hotel chain (franchisor) and a hotel owner (franchisee) wherein the hotel chain allows the owner to make use of the chain's name and services (e.g., a central reservation system and defined operational procedures) in return for which the hotel owner pays the hotel chain a franchise fee. Under such an agreement, the chain has no ownership or financial interest in the hotel and is not directly responsible for its economic success.

Hotel companies involved in franchising generally start off as small chains made up of company-owned properties. Over time, they develop a concept, image, and brand name that prove successful in attracting customers. Specific operational procedures (known as the mode of operation) are established that produce a profitable level of efficiency. When the lodging product thus developed becomes successful, and it can be demonstrated that hotel owners using the brand name and mode of operation of the company will also be successful, the hotel company is able to franchise its concept and procedures.

One of the first franchise agreements in the hotel industry occurred in 1907 when Caesar Ritz allowed his famous name to be used on hotels in New York City, Montreal, Boston, Lisbon, and Barcelona. Modern hotel franchising started during the 1950s, when hotel construction resumed after the end of World War II. Hotel chains, realizing that their name, image, goodwill, established patronage, mode of operations, and reservation system all had value, turned to franchising their brand names and modes of operation as a rapid, inexpensive, and profitable means of expanding their holdings. Hotel developers were drawn to this idea because it gave a new hotel an immediate identity and a set of established systems and procedures that provided both lenders and investors with confidence that the property would be financially successful.

Some of the hotel chains that first offered franchises were Holiday Inns of America, Inc.; Howard Johnson's Motor Lodges; and Ramada Inn Roadside Hotels. The first Holiday Inn was a company-owned motel that opened in Memphis, Tennessee in 1952. By 1954, Holiday Inns started to franchise, and within a few years, franchises represented the bulk of the properties with which the company was involved.

Howard Johnson, a successful restaurant company that was founded in 1925, started franchising motor lodges in 1954. These were generally rooms-only facilities constructed in conjunction with freestanding Howard Johnson restaurants. The motor lodges and restaurants were often separately owned and operated.

Ramada Inn started out as a chain called Flamingo Motor Hotels in 1952. The name was later changed to Ramada Inn Roadside Hotels in 1958 when the company started successfully franchising.

Hotel franchising flourished during the 1960s and 1970s when a building boom, fueled by financing made available through real estate investment trusts (REITs), spurred the development of thousands of new hotel rooms. When the benefits of a chain affiliation became apparent to sophisticated hotel investors, particularly mortgage lenders, either a franchise or a first-tier management contract became almost a standard requirement of any development or acquisition deal. At present, very few hotels are developed as independents.

## » 18.02 ADVANTAGES FOR FRANCHISORS

### [1] Inexpensive, Rapid Expansion

Hotel companies that seek to become major chains often use franchising as a growth vehicle, because doing so generally requires a relatively modest capital investment compared with developing or acquiring properties on their own. In addition, franchising does not require the extensive management structure that is needed to operate a hotel management company. Depending on the up-front cost of a central reservation system, the capital required to start a franchise chain can be as low as several hundred thousand dollars for legal expenses, promotional material, and start-up costs. The bulk of the expenses for a franchise company consists of the advertising and promotional efforts needed to sell franchises and obtain the critical mass of franchisees required in order to have an economically viable chain.

Another cost-saving aspect of a franchise system is that development responsibilities are shifted to individual property owners. Because these parties typically have first-hand knowledge of local real estate and business markets, they are usually in a better position than a franchisor to acquire the best sites and to handle the overall development process.

The capital that makes a franchise organization grow comes from the owners of the individual hotels in the form of fees. Franchisees assume the major portion of the financial risk associated with opening a new hotel, but in return receive most of the economic rewards.

### [2] Profitable Source of Revenue

The revenue generated by a hotel franchise chain typically starts with initial fees paid by franchisees when they join the franchise system, along with ongoing royalty fees. In addition, some franchisors require additional payments for services that they provide, such as marketing, advertising, reservations, frequent traveler programs, and training.

The expenses incurred by franchisors that are chargeable against these fees are generally for services provided by the franchisor and are usually minimal. Many of the services provided by franchisors generate fixed fees (e.g., centralized reservation systems, chain directories, and various administrative functions), so a franchise chain must have a sufficient number of properties under contract in order to be profitable. Once the number of franchisees reaches this level (the "critical mass"), the franchise company typically grows to become extremely profitable. Depending on the nature of the services provided by the franchisor and the fees charged the franchisees, this critical mass of properties can range in number from twenty to fifty.

Because many franchise companies also own hotels or operate properties under management contracts, franchising offers a means of spreading the fixed operating costs of the owned or managed facilities among franchised properties, thereby achieving the necessary critical mass in a shorter period of time.

## [3] Customer Recognition and Brand Loyalty

Customer recognition is an important attribute for a hotel chain. While recognition can be created through advertising and promotion, one of the best methods of developing a known hotel brand name is to have a product for people to see and use. Having hotels in both popular destinations and in the cities en route to the destinations (known as feeder cities) provides potential customers with the opportunity to see or hear about the chain before selecting their overnight accommodations. Most people are very particular in their choice of sleeping facilities; product knowledge (either first-hand or second-hand) is an important factor in the selection process.

The rapid growth potential offered by franchising accelerates the essential process of creating customer recognition. Once customers recognize a hotel product and have been satisfied after using it, brand loyalty develops, which results in repeat patronage along with positive word-of-mouth promotion.

## [4] Income From Brand Name, Trademarks, Image, and Goodwill

Most hotel companies that offer franchise affiliations started in the industry by developing or acquiring properties that they owned or managed. Over time they created a brand name and trademarks that in turn developed consumer image and goodwill. Further development of the companies included a mode of operation consisting of a home office management structure, operating systems and procedures, and in most instances, a central reservation system and marketing network.

This entire package, particularly the established consumer image and goodwill, has special value for an independent hotel in need of identity and image. Franchising converts this intrinsic value into income for the franchisor. There often is a direct relationship between a hotel chain's consumer image and goodwill and the volume of franchise fees generated on a per-property basis.

### » 18.03 DISADVANTAGES FOR FRANCHISORS

## [1] Loss of Operational Control

The operating responsibility for a franchised hotel lies with either the hotel's owner or the owner's agent (i.e., a management company). The franchisor exerts very little influence over the day-to-day operation of the property. Although franchise chains attempt to control the quality and image of each individual hotel through rules and regulations and periodic property inspections, the persistent fact that the franchisor does not really have basic control over an operation can sometimes result in lower standards of quality and service than the franchisor wishes to maintain. When this occurs, the guests who experience the substandard level of quality service form an incorrect image of the entire chain, which can easily have a detrimental effect on repeat patronage or word-of-mouth promotion.

For this reason, chains such as Hyatt and Westin did not franchise until just recently, citing for years their concern with the risk of losing the operational control of a hotel. Marriott has franchised for a number of years, but has attempted to maintain only a select few management companies that Marriott believed would maintain the levels of quality and service that it requires. Generally speaking, lodging chains associated with the higher classes of facilities are less likely to franchise than those that provide a lower level of service, because they are more concerned with the need to

maintain operational control. Two exceptions to this include Motel 6 and Red Roof Inns, although it appears that Motel 6 is anticipating offering franchises in the near future.

Franchise chains attempt to exert operational control by periodically inspecting each property to see that the facilities are well maintained and the hotel is operating at the prescribed standards. Backing up these inspections are extensive operating requirements contained in the franchise agreement. Objective standards set by franchisors, such as requirements that the hotel accept American Express credit cards, that the restaurant be open from 6 A.M. to 10 P.M., or that all guestrooms have a color television, are relatively simply enforced. Subjective standards are more difficult to evaluate and enforce. For example, determining whether an operator complies with regulations stating that a hotel must, at all times, be clean and well maintained or that an operation must be "first-class" can be difficult.

The ultimate penalty franchisors can wield in order to enforce their various regulations and standards is the termination of the franchise. Unfortunately, the time it takes to actually terminate a franchise, particularly if the franchisee is uncooperative, can range from several months to one or more years. The termination process becomes even more difficult if litigation is involved and the dispute involves a subjective regulation.

Perhaps the greatest loss of control for a hotel franchisor is the prevention of its expansion by franchisees concerned about the impact of new hotels being developed in their area that are affiliated with the same brand. For a hotel company that does not offer franchises, the decision to have multiple properties in a given market is made purely in-house on a corporate level. However, because the franchisee does not expect to compete either with the parent lodging company's own brand or with other brands that are owned by the company, franchisors must prove that such development would not impact the existing franchisee.

For these reasons, loss of operational control can be a significant deterrent for a hotel chain that is evaluating the potential of franchising. Not only is it difficult for a franchisor to enforce its standards, but the process of terminating a franchise can be time-consuming. The potential liability is a substandard hotel that could tarnish the image and goodwill of the entire chain.

## [2] Difficulties With Owners

A hotel franchise company generally has to work with many property owners and management companies. The hotel industry is largely ego-driven, so the chances are good that the objectives of a franchise company will not always mesh with the motivations and styles of all of the individuals with which it works. In fact, franchisees often band together and form a franchise association that represents their interests when disputes with their franchisor arise.

In any case, the end result of maintaining a number of business relationships is that hotel franchise companies often have to spend a considerable amount of time and money attending to their franchises in order to keep their system functioning in an efficient and orderly manner.

## [3] Liability Without Control

When a franchised hotel is involved in litigation, particularly in suits involving liability claims, the franchisor is often named as a defendant. Even though the hotel chain is often found to have no control over the incident and therefore to bear no

liability, the cost of legal defense can often be considerable. Occasionally, franchisors are found to be liable even though they do not have direct control over the operation of a hotel. This liability exposure can be and generally is limited through insurance, which in itself can represent a considerable expense.

## [4] Quality, Service, and Cleanliness Control Problems

As described earlier, controlling the level of quality, service, and cleanliness at individual properties is not easily accomplished by franchisors. Because these subjective elements are always open to different interpretations, property owners are sometimes able to get by with lower standards than those intended by the franchisor.

Periodic property inspections followed by counseling with on-site management are the usual steps taken by franchisors seeking control of a property. Some chains offer extensive training programs and operating manuals that describe the various operating procedures that must be used to maintain the standards that they set. In any event, maintaining acceptable levels in these areas can often involve a large amount of effort and expense on the part of a franchisor.

## [5] No Control Over Pricing

Another element beyond the control of a franchisor is the establishment of uniform room rates and pricing policies for individual franchisees. For some types of lodging chains, particularly those catering to price-sensitive travelers, a uniform pricing strategy is highly desirable. Uneven pricing from one hotel to another can confuse customers and adversely affect the image of the entire chain.

## [6] Costly Start-Up

When a hotel chain first begins franchising, the company generally experiences a negative cash flow until the number of its properties reaches the necessary critical mass. Cash flow should turn around when the critical mass is reached, but the franchisor must have sufficient funds set aside to provide the necessary services to the franchises it has on board during the build-up period.

## [7] Mandatory Disclosure Document

All forms of franchising are strictly regulated by both the federal government and certain state agencies. Aimed at protecting the small investor from risking life savings on fraudulent franchise schemes, these regulations require full disclosure of many of the important business aspects of a franchise investment. This level of disclosure eliminates the possibility of franchisors creating individual agreements for each potential franchisee and adjusting terms through negotiation. As a result, most terms of a franchise agreement are fixed and are not subject to alteration.

The Federal Trade Commission (FTC) is the primary governmental overseer of franchising in the United States. In order to offer (sell) a franchise, potential franchisors must first file with the FTC a disclosure document known as a Uniform Franchise Offering Circular (UFOC). While this document does not receive either an

approval or disapproval from the FTC, it must be accurate and current. The following list contains the major items that must be addressed in a UFOC.

1. *Introduction.* Brief introduction and warnings that the material should be read carefully and that a lawyer or an accountant should be consulted. Notice from the FTC that even though the offering circular has been filed with that agency, the agency has not checked it and does not know whether it is correct.
2. *The franchisor and any predecessor.* Description of the franchisor and the franchised business. Date when the franchisor started the business, its business address, any previous owners. An overview of the franchised business, its concept and strategy.
3. *Identity and business experience of the persons affiliated with the franchisor; franchise brokers.* Biographical sketches of the directors, principal officers, and other executives who have management responsibility in the franchisor's business.
4. *Litigation history.* Description of any past or present litigation involving the franchisor or the persons affiliated with the franchisor described in Item 2.
5. *Bankruptcy.* Fifteen-year bankruptcy history for the franchisor, its predecessor, or any of the persons affiliated with the franchisor described in Item 2.
6. *Franchisee's initial fee or other initial payment.* Description of the initial fee paid by franchisee to acquire the franchise. Description of the franchisor's expenses that are paid from the initial fee.
7. *Other fees and expenses.* Description of the other fees and expenses payable by the franchisee during the term of the franchise, which typically include royalty fees; accounting and auditing fees; advertising fees; expansion fees; initial leasehold construction fees; furniture, fixture, and equipment fees; insurance fees; ongoing maintenance fees; refurbishing fees; telephone reservation referral fees; transfer fees; and training fees. Statement of whether these charges and fees are to be paid to the franchisor, or expenses are to be paid to other parties (e.g., contractors, furniture and equipment dealers, and accountants).
8. *Franchisee's estimated initial expense,* A broad estimate of the major expense categories involved in developing and starting a lodging facility typical of what will be franchised.
9. *Obligations of the franchisee to purchase or lease from designated sources.* Terms of any requirement for franchisee to purchase or lease anything from either the franchisor or suppliers designated by the franchisor.
10. *Obligations of the franchisee to purchase or lease in accordance with specifications or from approved suppliers.* Terms of any requirement for franchisee to use either approved specifications or suppliers when purchasing.
11. *Financing arrangements.* Terms of any agreement by franchisor to provide any financing to the franchisee.
12. *Obligations of the franchisor.* Other supervision, assistance, or services. List of the services and obligations of the franchisor, which are generally subdivided into pre-opening obligations and continuing obligations.
13. *Exclusive area or territory.* Details of any exclusive areas or territories granted by the franchisor.

14. *Trademarks, service marks, trade names, logotypes, and commercial symbols.* Description of the various marks and trade names owned by the franchisor and available to the franchisee. Description of any known infringement or agreements limiting the use of these marks.
15. *Patents and copyrights.* Description of any patents and copyrights owned by the franchisor. Terms of issuing and maintaining operating manual supplied to franchisee, including any provisions regarding confidentiality.
16. *Obligations of the franchisee to participate in the actual operation of the franchised business.* Rules pertaining to whether the franchisee must actually operate the hotel or can hire a professional management company. Restrictions, if any, regarding the conduct of other hotel business activities and the diversion of business to other hotels are also described.
17. *Restrictions on goods and services offered by the franchisee.* Definition of what goods and services can be offered by the franchisee at the franchised premises.
18. *Renewal, termination, repurchase, modification, and assignment of the franchise agreement and related information.* Various aspects of the franchise terms including length of initial term and renewal term; termination by franchisee; termination by franchisor, with and without notice; obligations upon termination or expiration; franchisee's interest upon termination or non-renewal; transfer of interest by franchisor; transfer of interest by franchisee;
transfer upon death or mental incapacity; franchisee sale of its securities;
corporate transfers; non-waiver of claims; covenants not to compete; and modifications of agreement.
19. *Arrangements with public figures.* Description of any public figures involved with the franchise.
20. *Actual, average, projected, or forecasted franchise sales, profits, or earnings.* Any statement or projection of sales, profits, or earnings, made by the franchisor.
21. *Information regarding franchises of the franchisor.* Data relating to the number of franchises currently in existence and the projected franchise sales for one year.
22. *Financial statements.* Recent audited financial statements of the franchisor.
23. *Contracts.* Complete copy of franchise agreement and other contracts that must be executed by the franchisee.
24. *Statement of prospectus accuracy.* Representation by franchisor that prospectus is accurate.
25. *Acknowledgment of receipt by a prospective franchisee.* Statement by prospective franchisee noting the date of receipt of the UFOC.

The UFOC must be given to a prospective franchisee at the earlier of the first "personal meeting" or "the time for making disclosures." The FTC defines the "time for making disclosures" as ten business days prior to the earlier of (1) the execution by a prospective franchisee of any franchise agreement imposing a binding legal obligation or (2) the payment by a prospective franchisee of any consideration in connection with the sale or proposed sale of a franchise. In addition to the FTC disclosure requirements, several states impose additional franchise regulations, some of which are more stringent than the federal rules.

The ultimate effect of this level of disclosure is to establish uniformity in franchise structures, requirements, and fees, and thus eliminate any advantage a franchisor may have over a franchisee in terms of bargaining power.

## » 18.04 ADVANTAGES FOR FRANCHISEES

### [1] Instant Recognition and Shortened Start-Up Period

The primary benefit of a franchise affiliation for a hotel is the instant name recognition that it provides. Hotel patrons traveling to new destinations often look for a lodging facility with a recognizable name and image because they want to know that the quality of the accommodations and service at the hotel they choose will meet the expectations they have that are based on prior experience with (or recommendations of) the same product. Although an independent hotel without a chain identity may well develop its own reputation and patronage, the period of time needed to penetrate the market in this fashion may extend over many years. Another decided advantage for new hotels with a recognizable affiliation is that they generally experience a faster build-up of patronage. This shortens the normal start-up period, so that a hotel with a chain affiliation will reach a stabilized occupancy level more quickly than would a new, non-affiliated hotel.

### [2] Attraction of Different Market Segments to Different Franchises

Over time, hotel chains develop specific images in various market segments. For example, Marriott Hotels, Hyatt Hotels, Westin Hotels, Sheraton Hotels, and Hilton Hotels generally achieve high penetration in the meeting and convention market segment. Courtyard by Marriott, Embassy Suites, and Doubletree Hotels have a strong following in the commercial segment, while Holiday Inns, Hampton Inns, and Comfort Inns have strong followings in the leisure market. Residence Inn by Marriott, Homewood Suites, Villager Lodges, and Studio Plus Suites are oriented toward extended-stay guests.

The market strengths of each lodging chain can directly benefit the hotels that take on their franchises, so a hotel owner looking for a franchise affiliation should thus be aware of the market strengths of each available franchisor and determine which affiliation will make the best use of both the available market and the subject property's contemplated or existing facilities.

### [3] Proven Method of Operation and Product Merchandising

Successful, established hotel chains generally allow potential franchisees access to the manuals and training programs that they have developed as internal guidelines for their mode of operation and product merchandising. By reviewing these materials, a franchisee can be certain that the franchisor has tried and proven systems and procedures that will increase the chances of franchise success.

New franchise companies typically have several company-owned hotels that serve as laboratories for developing systems and procedures. Prospective franchisees, lenders, and investors look at the operating results of these properties and use them as a means of confirming the ability of the franchisor to run viable, profitable hotels.

## » 18.05 DISADVANTAGES FOR FRANCHISEES

### [1] Excessive Cost if Incorrect Franchise Is Chosen

The selection of a franchise is one of the most important decisions that a hotel owner must make. Choosing the wrong franchise almost always adversely affects operating results. For example, an affiliation with a luxury-quality, convention-oriented lodging chain will negatively affect a hotel that, based on local market conditions and characteristics, should be oriented toward the budget-rate, leisure market segment. Some of the costs that can result from selecting the incorrect franchise include:

- Operating losses during the period the ineffective affiliation is in use;
- Cost of acquiring a new franchise;
- Cost of purchasing new identity items such as signs, logos, and monogrammed items; and
- Operating losses during the initial occupancy build-up period under the new franchise.

### [2] No Guarantee of Success

Hotel franchisors typically have no financial interest in the properties they franchise and make no representation that a particular franchise will be an economic success. In fact, franchisors occasionally set operating standards that may in themselves be costly to the franchisee, such as requiring a hotel to upgrade its facilities even though such upgrades may not have a direct impact on the operating profitability of the hotel.

Even though franchise offerings are regulated by the FTC and some state agencies, franchise salespeople have occasionally resorted to unethical practices in order to sell new franchises. The compensation received by many of these salespeople is based on the number of franchises they sell, so without strict supervisory control, some salespeople may attempt to sell franchises either to unqualified owners or to projects that have no economic feasibility. Such conduct was partially responsible for the overbuilding that took place during the early 1970s.

As discussed previously, hotels spend anywhere from .75% to 9.34% of total revenues to affiliate with a national lodging franchise. This percentage is often the largest single expense incurred by a hotel after payroll and typically makes up the largest expense in the hotel's marketing budget. As with any substantial cost or investment, purchasers of a service like to see the benefit that they are receiving for their money.

With regard to the economic benefit of hotel franchise fees, we are provided only with the claims and promises provided by the franchisors themselves. Some franchise companies refuse to provide performance statistics of any kind, fearing that such claims would constitute guarantees which if not achieved would leave them open to ridicule and perhaps litigation. Other companies provide statistics such as system-wide reservation contributions, but these statistics are closely guarded and vary from chain to chain as to what is considered a reservation and/or denial. Furthermore, in comparing the gross delivery of reservations for a given period, many of which are composed of room-nights booked months and sometimes years in the future, against the actual occupied rooms in that period can be quite misleading.

Initiated by the University of Denver School of Hotel, Restaurant and Tourism Management, Richfield Hospitality, one of the largest independent hotel management companies, used this model as a basis to survey forty-three of its hotels, which oper-

ate under thirteen different franchises. The model attempted to quantify three areas of franchise performance:

1. The benefit of programs and services offered by the franchise;
2. The consumed reservation room night contribution of the reservation system; and
3. The drive-by value of the franchise name.

The findings enabled Richfield to rank the various franchises based on these three categories as shown in Exhibit 18-1.

**Exhibit 18-1 Franchise Rankings**

| Hotel Franchise Portfolio | Franchise Programs and Service | Reservation Contribution | Drive-by Value |
|---|---|---|---|
| A | 1.0 | 3.0 | 4.0 |
| B | 7.0 | 4.0 | 6.0 |
| C | 10.0 | 1.0 | 1.0 |
| D | 5.0 | 2.0 | 7.0 |
| E | 3.0 | 13.0 | 11.0 |
| F | 8.0 | 6.0 | 9.0 |
| G | 12.0 | 10.0 | 13.0 |
| H | 2.0 | 5.0 | 5.0 |
| I | 13.0 | 8.0 | 3.0 |
| J | 9.0 | 9.0 | 2.0 |
| K | 11.0 | 11.0 | 10.0 |
| L | 4.0 | 4.0 | 12.0 |
| M | 6.0 | 6.0 | 8.0 |

The franchises surveyed include Best Western, Clarion, Comfort Inn, Days Inn, Hilton, Holiday Inn, Howard Johnson's, Knights Inn, Quality Inn, Radisson, Ramada, Sheraton, and Travelodge. The survey results indicated that each franchise offered different benefits to the hotels that operate under their flag. Several of the best performing franchises in terms of their actual room night contribution were viewed by many general managers as not very effective in their programs and services provided. Similarly several franchises that did not contribute significantly to the hotel's occupied rooms through their reservation service were perceived by the general managers to provide strong benefit in terms of the flag's drive-by value.

Although it is not known whether the University of Denver model and the Rich-field study adequately quantified all of the aspects of return on investment, the relative rankings of the different chains provide insight into the substantial differences in performance that can be expected on the basis of property type and location relative to the particular affiliation. HVS is currently taking this study to the next level by rolling it out on a national basis.

The goal is to quantify the benefits offered by all the major national franchises and analyze the information to see how these benefits relate to the size, type, loca-

tion, and competitive situation of a particular hotel. The success of the survey is of course contingent on the contribution of the independent owners and management companies from which the survey information is polled. Although such information may be available from the franchises themselves, we believe that the owners and operators themselves will provide the most objective and pertinent information available. After all, it is not the value of a particular franchise to the franchise company itself that is being assessed; it is the value of the franchise to the franchisee that poses one of the biggest questions in the minds of hotel owners and operators in the lodging industry today.

## [3] Nontransferable Franchises

Some hotel franchisors do not allow existing owners to freely transfer a franchise to a new owner in the event of a sale. Some of the transfer restrictions typically imposed by franchisors include:

- Payment of a transfer fee;
- Approval of new owner by franchisor;
- Application for an entirely new franchise;
- Refurbishment of hotel to meet current franchise standards; and
- Right of first refusal on transfer.

Ultimately, the risk posed to the seller by these transfer restrictions is that the franchise may not be renewed or that it can be renewed only for a price. For example, a transfer may require spending hundreds of thousands of dollars in order to bring a hotel up to current standards. Anything that could inhibit the transfer of a valuable franchise could also adversely affect the market value of the property.

## [4] Short Term of Franchise

Franchisees and potential buyers face the risk that the reversionary value of an investment in a hotel will be discounted if its franchise cannot be renewed or extended. Since the economic lives of hotels generally span thirty to forty years, and franchise terms typically range from ten to twenty years, continuation of a favorable franchise affiliation is important, A change of name and image midway along a hotel's economic life can result in severe marketing and financial difficulties. For this reason, first-tier hotel management companies typically require contracts that extend beyond twenty years in order to preserve the name integrity of the chain.

## [5] Little Control Over Other Franchisor Affiliations

Most franchise agreements are not overly restrictive regarding the number of new hotels in the market area with which the franchisor can be affiliated. Occasionally, a franchise will grant a property owner an exclusive area for a specific period of time. In most cases, however, a franchisor is free to add a new product to a market whether it is another franchised hotel or a property managed or owned by the franchise company. With the recent trend in product segmentation, franchisors sometimes claim that adding a product to a market area that caters to a different market segment or price

classification will not adversely affect an existing franchisee. While this may have been true during the late 1980s, when demand for accommodations was extremely high, many hotels located in the same market area that formerly targeted different segments of the traveling public found themselves competing directly for business during the lean years of the early 1990s. Proliferation of new brands virtually stalled as new development of hotels became a nearly impossible task. However, with the strong operating performance of most hotels from 1994 through 1996, many new brands targeting specific segments are set to come on line during the latter half of the 1990s.

## [6] Adherence to Chainwide Standards

The various regulations and standards developed by franchisors are designed to cover all the hotels in the chain and ensure uniform mode of operation and image. Occasionally, these standards may be inappropriate for a specific property, or unsatisfactory to a particular owner, but franchisors generally do not allow any deviation from their system. The chainwide standards that can negatively affect individual hotels include:

- Required year-round operation;
- Set operating hours for restaurants, lounges, and room service;
- Minimum staffing level requirements, such as 24-hour door attendants and bell hops;
- Participation in chain advertising and frequent traveler programs; and
- Required amenities (e.g., a swimming pool, a restaurant, room service, a lounge, or free parking).

Property owners who would be adversely affected by these standards are sometimes able to work out exemptions with franchisors before signing an agreement.

## [7] Benefits Dependent on Number of Properties in Chain

Just as a franchise chain has a critical mass for the franchisor at which franchise revenues cover the costs of licensing and maintaining franchises, so too does a franchise chain have a critical mass for the franchisee, at which the economic benefits of the franchise affiliation exceed the cost of acquiring and maintaining it. The benefits of a franchise affiliation that are directly related to the number of properties in the chain include:

- Reservation referrals from other properties;
- Word-of-mouth referrals from patrons with favorable experiences;
- Advertising and marketing assistance;
- Additional chain services; and
- Sophisticated central reservation system.

A potential franchisee should evaluate the price/value relationship of joining a hotel chain, particularly in light of the fact that some new franchisors will reduce initial and continuing franchise fees during their start-up period to reflect the reduced level of benefits that they provide compared with an established chain.

## [8] Lack of Control Over Chain Quality and Image

Individual franchises have little control over any of the operating policies of the franchisor that adversely affect the overall quality and image of the franchise chain, and so are essentially at the financial mercy of the franchisor. An analysis of the hotel franchise organizations that started during the 1950s and the 1960s yields examples of chains that faded in popularity and others that increased in strength because of their ability or inability to maintain efficient operating policies. Necessary policies for a franchise company include:

- Mechanism for terminating franchises that do not maintain an appropriate level of quality and service.
- Mechanism for removing hotels from the system that are not functionally up-to-date.
- Periodic update of marketing strategies and chainwide customer image.
- Consistent product and unified image.

A twenty-year franchise commitment will typically expose the owner of the affiliated hotel to at least one complete turnover in the management of the franchise company. New policies and management outlook evolve on a continual basis, and this may or may not be a positive influence on the entire lodging chain.

## » 18.06 SERVICES OFFERED BY FRANCHISORS

Like any other long-term financial situation, a hotel franchise has certain risks and benefits. Hotel owners can minimize the possibility of an unpleasant experience by carefully reviewing the services offered by individual franchisors and dealing only with reputable franchise companies.

## [1] Site Selection and Market Analysis

Hotel franchise chains often help prospective franchisees to select a suitable hotel site and analyze the characteristics of the surrounding market area. In this regard, however, their assistance is reactionary in that franchise companies generally only comment on a potential site chosen by the franchisee; they do not actually seek out suitable locations.

Franchisors also typically recommend independent hotel appraisers who can perform market analyses for potential franchisees. Franchisors are also often able to assist appraisers by providing important data such as the room rates and occupancy levels of competitive lodging facilities, the number of fill nights at other chain properties in the market area, and reservation data regarding the amount of satisfied and unsatisfied lodging demand in the immediate area.

## [2] Provision of Plans and Specifications

Hotel chains that seek to have a uniform image or character for their properties generally provide prototypical architectural plans to the franchisee that can be modified and adjusted to fit a particular site. The benefit of these plans to the franchisee is two-

fold: they often reduce development cost, and they assure a well-conceived, functional property. Some franchisors also provide detailed specifications for construction and furnishings in order to maintain the quality standards of the chain. Potential hotel developers should realize that most hotel chains have strict guidelines concerning plans and specifications for constructing and furnishing their facilities. Consequently, developers should make no significant expenditures for architectural plans until a franchise has been selected and the required specifications have been obtained.

## [3] Development Assistance

Hotel franchisors are often able to provide assistance during the construction of a hotel. At the minimum, a hotel chain usually wants the opportunity to approve plans and specifications prior to construction and to inspect for compliance during development and after the project is completed. Some franchisors, however, have in-house development experts who will provide extensive support in all phases of the development process. The cost of these services is generally an additional charge over the normal franchise fees.

## [4] Assistance in Obtaining Financing

Franchisors generally do not secure financing for franchisees, but they do sometimes assist in assembling loan packages for lenders. A good hotel chain typically develops relationships with the various financial components necessary to obtain financing, which include firms that perform market studies and appraisals, mortgage bankers and brokers, construction lenders, permanent lenders, real estate investment trusts, mortage conduits, and investors. In addition, large hotel companies such as Marriott, Promus, Choice, and HFS offer potential franchisees direct financing of their own. This was a necessary vehicle created by these companies during a period in which the economics for expansion were present but the financial sources for hotel construction were not. As traditional third-party financing has returned to the market in recent years, these programs at the major hotel companies have been scaled back.

Because financing is an important aspect of a hotel development or acquisition, more franchisors can be expected to take an active role in obtaining funds in the future. A franchise package that offers not only the normal franchise benefits but some form of financing commitment is an unbeatable combination for attracting franchisees.

## [5] Publicity and Promotion Assistance

Generally, hotel chains that sell franchises have prepared professional advertising and promotional campaigns that include logos; trademarks; signs; property; billboards;
and print, radio, and television ads. Franchisees can usually obtain these advertisements and promotional materials from the franchisor and immediately use them in the proper media.

## [6] Centralized Purchasing

Many franchisors offer centralized purchasing services that are able to take advantage of quantity discounts available to large volume buyers, passing these savings on to

the individual franchisees. Not only can the financial benefits of centralized purchasing be substantial, but the ease of ordering, receiving, and accounting is often greatly simplified. Vendors, realizing the purchasing power of an entire organization, are also more likely to provide better service. Centralized purchasing not only reduces the cost of buying products such as furniture and operating supplies but decreases the price of such services as advertising, accounting, and legal counsel. Centralized purchasing is generally a voluntary service; in most instances, the franchisee is free to purchase supplies, furnishings, and equipment from any vendor in the market as long as the specifications of the item purchased meet the franchisor's approval.

Another advantage gained by the buying power of a lodging chain is that individual franchisees are able to receive reductions in credit card commissions.

## [7] Referrals Between Properties

One of the primary benefits of belonging to a lodging chain is the referral of business between the properties within the chain. In effect, each property in the chain functions as a marketing office that creates room-nights of demand for other hotels throughout the chain. For example, when a patron is checking out of one hotel, the front desk personnel should determine whether the traveler requires a reservation at the next destination. If so, a sale should occur, and a reservation should be made with another franchisee in the chain. Similarly, when meeting and convention groups have been satisfied with the service and accommodations they received by one hotel in a chain, they should be referred directly to other chain hotels for future meetings. Individual franchisees benefit by keeping hotel patrons "within the chain" through property level referrals.

Hotel owners who are prospective franchisees should investigate whether a franchisor actively encourages referral activity between properties, and if so, whether there is chain representation in the feeder cities where this type of reservation activity would originate.

## [8] Centralized Reservation System

Another major benefit of a franchise affiliation is the centralized reservation system that ties the entire chain together. Most hotel chains offer a reservation system consisting of a central reservation office with a toll-free telephone number. Staffed by trained personnel, the central reservation office takes all reservation requests and records the following information:

- The hotel within the chain that is the most convenient destination to the caller.
- The availability of accommodations at the requested hotel on the desired date(s).
- Available room rates.
- A reservation, if the caller so chooses.
- Guarantee of the reservation, if necessary.
- Any special request.
- Information about the caller (e.g., name, address, and telephone number).

This data is stored in the central reservation computer for future statistical analysis and, if necessary, is also transmitted to the property to confirm the reservation and identify the patron.

Hotel franchise reservation systems vary in sophistication. Potential franchisees should investigate the workings of each reservation system to determine which will work best for their particular operation. The aspects of the system that should be analyzed include the following;

- The number of reservations the central system actually generates for the properties within the chain. (The franchisee should trace this data to individual properties that have locations similar to the subject property, and then analyze the reservation data on both a monthly and weekly basis.)
- The number of reservations that represent actual room-nights and the number that result in no-shows.
- The number of reservations that are currently unaccommodated within the potential franchisee's market area, and to what properties unaccommodated reservations are currently referred.
- The identity of the properties in the chain from which the subject property can expect to receive reservation overflow. Reservation system computers are programmed to refer unaccommodatable reservations to another property within the chain, usually the closest based on travel time. This procedure should, however, be verified to ensure that the potential franchisee's hotel will receive its fair share of overflow reservations.
- The identification of the potential franchisee in the reservation system. For example, a hotel might be known as the Sleep-Inn Downtown or Sleep-Inn Convention Center or Sleep-Inn Airport or Sleep-Inn Interstate. Incorrect information conveyed by a name or description could divert reservations and patronage to other properties even if they are less well located to the traveler's final destination.

Hotel franchise companies with centralized reservation systems are generally able to provide franchisees with market analysis based on their reservation data. These reports can provide important market research information to the franchisee. The reports containing this research information that are usually available to franchisees include:

- *Reservation originations.* A listing of where reservations originate, categorized either by zip code or by telephone area code. This information is useful in planning future marketing programs.
- *Reservation denial report, A* listing of the number of potential patrons who attempted to make a reservation at a specific property but, because the property was fully booked, could not be accommodated. This information is important for quantifying unaccommodated demand, which provides an indication of the need to expand a property.
- *Occupancy comparisons. A* report showing how a specific property's occupancy percentage compares with other hotels of the same franchise in the property's market area, state, and region. This information is useful in evaluating operating performance.

A potential franchisee should request to see examples of the different reservation system reports offered by franchise chains in order to determine which offers the most useful information.

## [9] Proven Mode of Operation

A franchisor should provide the franchisee with a tried and proven mode of operation that includes all the systems and procedures that are necessary in order to operate the franchise efficiently. In most instances, the information regarding the implementation of the mode of operation is communicated either by training programs or by an operations manual offered by the franchisor.

Some chains offer extensive schools or seminar programs to familiarize management level personnel with the chain's mode of operation and general philosophies. Other franchisors have detailed operating manuals that provide recommended solutions to almost any problem that the management of the property may encounter. While the assistance provided by the franchisor will not substitute for actual hotel operating experience, it is important to use the experience of the hotel chain in order to reduce the number of operational errors and to conform with the chainwide image and mode of operation of the franchisor as well.

## [10] Marketing Offices

Most hotel chains, particularly those with a group marketing orientation, maintain national and regional marketing offices that generate meeting, convention, and group business. This service is particularly beneficial for those hotels that anticipate heavy usage in the meeting and convention segments. The time and effort required to establish the marketing infrastructure to effectively penetrate the meeting and convention segment can be overwhelming for an individual hotel; tapping into a chain's database of group business can offer a substantial advantage. The potential franchisee should verify that such information does exist and will ultimately produce meeting and convention room-nights for the subject property.

## [11] Property Inspection and Evaluation

Quality assurance is an important activity for franchisors. A hotel chain is only as good as its poorest hotel, so constant inspection and evaluation on the part of the franchisor is necessary to maintain a consistent level of physical and service quality.

Most hotel chains typically inspect their properties two to four times per year. A score is usually awarded based on a 1,000 point system. Franchisees that do not achieve a satisfactory score are usually provided with a set time frame to correct the issues that brought them below the given standard. The purpose of these inspections is to monitor quality standards and familiarize the on-site management with the techniques used to maintain the required level of quality. Because rigid enforcement of quality standards is extremely important for the success of a franchise system, the methods of regulating property level quality should be closely evaluated by potential franchisees.

## » 18.07 FRANCHISE FEES

When evaluating a possible hotel franchise, one of the most important economic considerations is the structure and amount of the franchise fee. Hotel franchise fees are the compensation paid to the franchisor for the use of the chain's name, logo, identity, image, goodwill, operating systems and procedures, marketing plans, and refer-

ral and reservation systems. Franchise fees are normally formulated using an initial fee paid upon applying for the franchise plus continuing fees paid periodically during the term of the franchise.

## [1] Initial Fee

The initial fee typically takes the form of a minimum dollar amount based on a hotel's room count. For example, the initial fee may be a minimum of $45,000 plus $300 per room for each room over 150. Therefore a hotel with 125 rooms would pay $45,000 and a hotel with 200 rooms would pay $60,000. The initial fee is paid upon submission of the franchise application. It covers the franchisor's cost of processing the application, reviewing the site and market potential, evaluating the plans or existing layout, inspecting the property during construction, and providing services over the pre-opening or conversion phases.

If the hotel is existing and the franchise represents a conversion, the initial fee structure is occasionally reduced. Some franchisors will return the initial fee if the franchise is not approved, while others will keep a portion (5% to 10%) to cover the cost of reviewing the application.

Other costs associated with the initial acquisition of a national franchise may include the cost of signage and any specialized computer software or hardware needed to interface with the franchisor's central reservation system. An existing hotel contemplating an affiliation also bears the possible burden of repurchasing towels, brochures, operating supplies, and paper items imprinted with the national franchisor's logos. It is also possible that the potential affiliate may have to undertake a property refurbishment or renovation (ranging from installing a higher grade of carpeting to enclosing a property's exterior corridors). These costs must be considered when measuring the cost/benefit of affiliation, and varies from hotel to hotel and between the various franchise organizations.

## [2] Continuing Fees

Payment of continuing franchise fees commences when the hotel assumes the new franchise affiliation; these fees are paid monthly over the term of the franchise agreement. Continuing fees generally include a royalty fee, an advertising or marketing contribution fee, and a reservation fee. In addition, continuing fees may include a frequent traveler program and other miscellaneous fees.

### [a] Royalty Fee

Almost all franchisors collect a royalty fee, which represents compensation for the use of the chain's trade name, service marks and associated logos, goodwill, and other franchise services. A significant profit is generally factored into the royalty.

### [b] Advertising or Marketing Fee

Chain-wide advertising and marketing consists of national or regional advertising in various media, the development and distribution of a chain directory, and marketing geared toward specific groups and segments. In many instances, the advertising or marketing fee goes into a fund that is administered by the franchisor on behalf of all members of the chain. In this situation, these dollars must be utilized for the purpose

of promoting the chain, and do not normally represent a source of profit to the franchisor.

### [c] Reservation Fee

If the franchise chain has a reservation system, the reservation fee supports the cost of operating and paying for the central office, telephones, computers, and reservation personnel. Like advertising or marketing fees, the reservation fee is designed to cover the cost of the reservation system, and generally provides little profit to the franchisor.

### [d] Frequent Traveler Program

Some franchisors maintain incentive programs that present awards to guests for frequent stays. The programs are designed to encourage loyalty to the affiliation.

### [e] Other Miscellaneous Fees

These fees may include fees payable to the franchisor for additional systems or procedures; they are generally minimal in cost and do not represent profit. In addition, those franchisors that provide extensive training programs for their franchisees levy training fees that cover the cost of the instructional programs.

Sometimes the franchisor offers additional services for a fee. These services include consulting, purchasing assistance, computer equipment or satellite communication equipment rental, optional training programs, on-site opening assistance, or additional advertising services. The fees for these services are typically not qualified in the disclosure documents.

## [3] Continuing Fee Assessment

Continuing franchise fees are assessed on the basis of several formulas. Royalty fees are generally based on a percentage of rooms revenue (which can vary as much as 1 percent to 6.5 percent). Advertising, marketing, and training fees are generally calculated on a percentage of rooms revenue (ranging from 1 percent to 4.5 percent), but sometimes are based on a dollar amount per available room per month. Reservation fees may also be based on either a percentage of rooms revenue (1 to 8 percent) or a dollar amount per available room per month ($2 to $6) but in some instances are assessed by an amount per reservation sent to the property through the central reservation system ($1 to $5.50). These various formulas may be used by themselves or they may be combined with each other. For example, the marketing fee for a franchise may be the greater of $2.00 per available room per day or 2 percent of rooms revenue. Many also have first-month contingency fees in lieu of recorded revenues (e.g., a royalty fee of $24.00 per room for the first month and then 5% of gross revenues in the ensuing months).

Each one of these fee structures offers advantages and disadvantages for the individual property. A fee based entirely on a percentage of rooms revenue is favorable for hotels that derive significant income from food and beverage sales. Fees based on an amount per available room are fixed, and tend to benefit hotels with high volumes and penalize properties with lower results. Paying a reservation fee based on the number of reservations received is fair, as long as the reservations equate to occupied room nights and not to no-shows.

Many franchisors are now requiring franchisees to bear their fair share of the costs associated with operating a frequent traveler program. Frequent traveler program assessments are typically based on a percentage of total or rooms-only revenues generated by a member of the program at a hotel (1.0% to 6.5%), or a fixed dollar amount per room occupied by a frequent traveler member ($1.60 to $5.00). Many programs also require hotels to contribute a one-time participation fee of $5.00 to $10.00 per guestroom, while others use a combination of all three methods.

The specific fee structures required by a franchise company must be disclosed in the UFOC that it must file with the FTC, so potential franchisees can evaluate the fee structure of prospective franchise companies and determine whether the price/value relationship warrants the acquisition of a particular franchise. Exhibits 18-3, 18-4, and 18-5, developed from information contained in UFOCs, provide comparisons of the fees charged by various franchise companies. Each table deals with a different class of lodging facility (i.e., economy, mid-rate, and first-class) and the data in them is derived from the operating information in Exhibit 18-2.

**Exhibit 18-2 Lodging Facility Class Distinctions**

| | Economy Hotel | Mid-Rate Hotel | First-Class Hotel |
|---|---|---|---|
| Room Count | 100 | 200 | 300 |
| Average Room Rate (Year 1) | $35.00 | $65.00 | $95.00 |
| Room Rate Growth | 5% per Year | 5% per Year | 5% per Year |
| Occupancy | | | |
| Year 1 | 60% | 60% | 60% |
| Year 2 | 70% | 70% | 70% |
| Year 3 | 75% | 75% | 75% |
| Projection Period | 10 years | 10 years | 10 years |
| Total Room Nights | 266,450 | 532,900 | 799,350 |
| Total Rooms Revenue During **10-Year Projection Period** | $11,794,243 | $43,798,356 | $96,027,117 |
| Total Food and Beverage Revenue During 10-Year Projection Period | N/A | N/A | $57,616,270 |
| Number of Reservations From Franchisor | 15% of occupied rooms | 15% of occupied rooms | 15% of occupied rooms |
| Percent of Rooms Occupied by Frequent Travelers | N/A | 8% of occupied rooms | 8% of occupied rooms |
| Percent of Rooms Occupied By Third Party Reservation Travelers | N/A | 5% of occupied rooms | 5% of occupied rooms |
| Average Length of Stay | 2 nights | 2 nights | 2 nights |

Our model assumes that each affiliation is capable of generating the same portion of occupancy from its reservation system. In truth, some affiliations generate more demand and some contribute less.

The following three exhibits summarize the franchise fee information relating to each franchise affiliation. The first column in each table identifies the name of the franchisor. The second column shows the amount of the initial fee based on the room

count assumed for each class of facility. The next five columns represent the continuing fees, which are subdivided into royalty, reservation, marketing, frequent traveler program, and miscellaneous cost. The continuing fees were calculated annually over the ten-year projection period and represent the total ten-year amount that would be paid by the franchisee. The next column represents the sum of the initial and continuing fees. The last column shows the percentage relationship of the total projected franchise fees to the total projected rooms revenue.

A total of fifty-seven franchise groups, in which twenty-six budget, eleven mid-rate, and twenty first-class franchisors participated, were included in the analysis. The trend toward continued franchise expansion and segmentation was exhibited by a 19 percent increase in the number of 1994 study participants.

The Budget Host organization lead the analysis, with only 0.75 percent of its projected ten-year revenue going toward expenses related to franchise fees. Other organizations achieving low percentages included Preferred Hotels at 1.49 percent, Best Western at 1.94 percent, Microtel at 2.70 percent, and Best Inns at 4.12 percent. The percent of rooms revenue figures ranged from 0.75 percent to 9.34 percent in the budget category, 1.94 percent to 8.99 percent in the mid-rate category, and 1,49 percent to 9.91 percent in the first-class category. Low percentage leaders in each category were Budget Host, Best Western, and Preferred Hotels, respectively. The overall range was a low of 0.75 percent to a high of 9.91 percent with a median of 6.57 percent.

Budget Host, Best Western and Preferred Hotels are, technically, not franchises, but rather associations or referral organizations. Because these groups are structured for the benefit of their member hotels, fees are oriented more toward covering operating costs rather than producing large profits. Their percentages are therefore somewhat representative of the actual cost of operating a franchise organization and provide an indication of the margin of profit realized by other chains.

A Marriott affiliation is still the most expensive; Marriott is currently the only franchisor whose continuing fees are based on a percentage of the combined rooms and food and beverage revenues. Marriott's frequent traveler award program also contributes to the above-average cost of this affiliation. However, few would argue with the success of Marriott's proven operating abilities, as well as its favorable customer image and good will. Often a direct relationship exists between a hotel's good will and its potential for asset value enhancement. Therefore, while affiliating with such a franchisor may well prove feasible and prudent, it will be comparatively costly.

As Exhibit 18-6 shows, the overall franchise class average showed steady growth over the past five years. The budget class maintained a three-study average of 5.7 percent, the mid-rate class carried a 6.7 percent average, and the first-class group had a three-study average of 6.4 percent. The budget group exhibited the lowest averages over the past five years, while the mid-rate group logged the highest.

Most hotel lenders believe that to be competitive in today's hotel market, a strong franchise affiliation is essential. Customers want to know the level of quality for which they are paying, and would rather not take the chance of having an unpleasant surprise from a "no-name" lodging facility. Hotel lenders also typically insist on a franchise affiliation of some type because it reduces the perceived investment risk. The big question is whether to opt for a Best Western affiliation at 1.94 percent of rooms revenue or for a Days Inn affiliation at 8.97 percent.

The selection of a chain affiliation should be evaluated carefully to determine when the price/value relationship is favorable to the hotel owner and when that relationship shows promise for long-term stability. One of the tools available to compare the relative cost of a franchise chain affiliation is the preceding analysis. Armed with this information, owners can address additional costs pertinent to their particular properties and determine the overall cost of affiliation.

Exhibit 18-3 Summary Table of Chain Franchise Fees—Budget Hotels

| Chain | Total Initial Cost | Total Royalty Costs | Total Reservation Cost | Total Marketing Cost | Total Frequent Traveler Cost | Total Misc. Cost | 1994 Total Ten-Year Cost | 1994 Total as a % Total Revenue |
|---|---|---|---|---|---|---|---|---|
| Americinn | $20,000 | $589,712 | — | $235,885 | — | — | $845,597 | 7.2% |
| Best Inns | 13,875 | 235,885 | $117,942 | 117,942 | — | — | 485,644 | 4.1 |
| Budget Host | 3,500 | 51,875 | 30,000 | — | — | $3,500 | 88,875 | 0.8 |
| Budgetel | 25,000 | 589,712 | 117,942 | 117,942 | — | 1,000 | 851,596 | 7.2 |
| Comfort Inn | 40,000 | 588,918 | 164,871 | 255,494 | — | 9,600 | 1,058,883 | 9.0 |
| Downtowner Inns | 10,000 | 471,770 | 24,000 | 117,942 | — | — | 623,712 | 5.3 |
| EconoLodge | 25,000 | 471,315 | 164,771 | 255,295 | — | 9,600 | 925,981 | 7.9 |
| Fairfield Inn by Marriott | 37,500 | 471,770 | 160,907 | 294,856 | — | 6,500 | 971,533 | 8.2 |
| Friendship Inn | 20,000 | 352,911 | 164.471 | 254,994 | — | 9,600 | 801.976 | 6.8 |
| Hampton Inn | 35,000 | 471,770 | — | 471,770 | — | 36,700 | 1,015,240 | 8.6 |
| Holiday Inn Express | 40,000 | 589,712 | 189,582 | 235.885 | 35,745 | 10,600 | 1,101,524 | 9.3 |
| Howard Johnson Inns | 35,000 | 471,770 | 294,856 | 235,885 | — | 6,650 | 1,044,161 | 8.9 |
| Master Host Inns & Resorts | 15,000 | 530,741 | 24,000 | 117,942 | — | — | 687,683 | 5.8 |
| Microtel | 25,000 | 294,856 | — | — | — | — | 319,856 | 2.7 |
| Nendels | 10,000 | 353,827 | 216,354 | 182,500 | — | — | 762,681 | 6.5 |
| Passport Inns | 10,000 | 412,799 | 24,000 | 117,942 | — | — | 564,741 | 4.8 |
| Red Carpet Inns | 15,000 | 471,770 | 24,000 | 117,942 | — | — | 628,712 | 5.3 |
| Rodeway Inns | 25,000 | 354,211 | 164,871 | 255,394 | — | 9,600 | 809,076 | 6.9 |
| Scottish Inns | 10,000 | 412,799 | 24,000 | 117,942 | — | — | 564,741 | 4.8 |
| Shoney's Inns | 25,000 | 412,799 | 117,942 | 117,942 | 55,000 | — | 728,683 | 6.2 |
| Signature Inns | 25,000 | 471,770 | 412,799 | — | — | — | 909,569 | 7.7 |
| Sleep Inn | 35,000 | 471,415 | 255,395 | 166,871 | — | 28,800 | 957,481 | 8.1 |
| Super 8 | 20,000 | 471,770 | — | 353,827 | — | — | 845,597 | 7.2 |
| Thriftlodge | 30,000 | 471,770 | — | 508,270 | — | — | 1,010.040 | 8.6 |
| Travelodge | 30,000 | 471,770 | — | 508,270 | — | — | 1,010,040 | 8.6 |
| Villager Lodge | 15,000 | 589,712 | 121,592 | 117,942 | — | — | 844,247 | 7.2 |

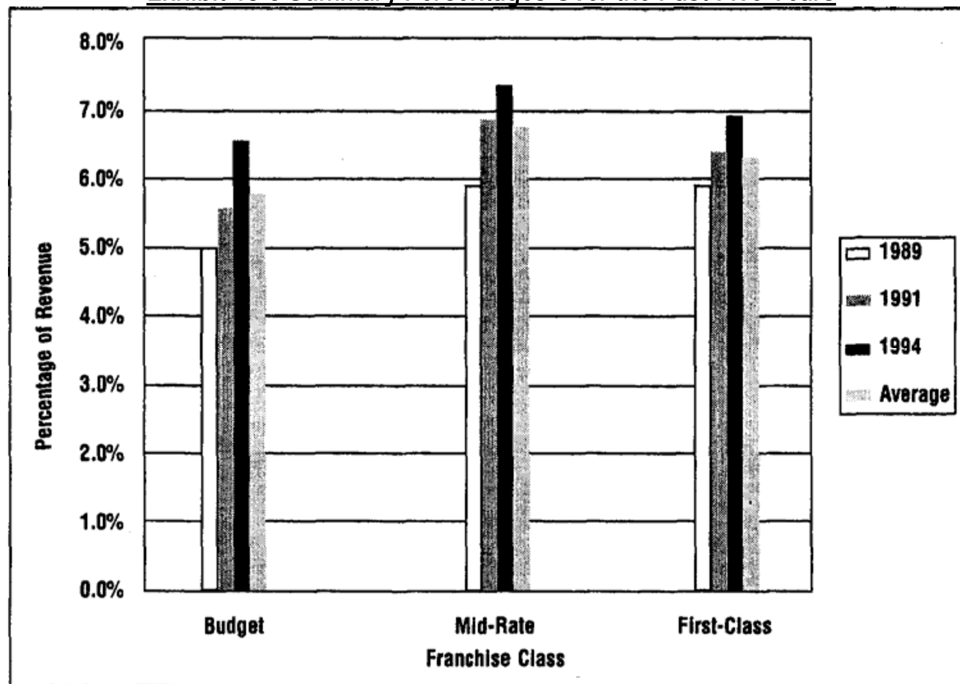
**Exhibit 18-4 Summary Table of Chain Franchise Fees—Mid-Rate Hotels**

| Chain | Total Initial Cost | Total Royalty Costs | Total Reservation Cost | Total Marketing Cost | Total Frequent Traveler Cost | Total Misc. Cost | 1994 Total Ten-Year Cost | 1994 Total Cost as a % of Total Room Revenue |
|---|---|---|---|---|---|---|---|---|
| Best Western | $42,000 | $ 46,160 | $311,593 | — | — | $449,865 | 849,618 | 1.9% |
| Comfort Suites | 60,000 | 1,751,934 | 523,746 | $772,294 | — | 9,600 | 3,117,574 | 7.1 |
| Country Lodging by Carlson | 20,000 | 1,268,043 | 439,643 | 2,144,010 | — | — | 3,871,696 | 8.8 |
| Courtyard by Marriott | 80,000 | 2,126,572 | 501,656 | 875,967 | — | 52,000 | 3,636,195 | 8.3 |
| Days Inn | 80,000 | 2,846,893 | 1,007,362 | — | — | 4,750 | 3,939,005 | 9.0 |
| Holiday Inn | 80,000 | 2,189,918 | 584,764 | 656,975 | $227,911 | 13,350 | 3,752,918 | 8.6 |
| Howard Johnson | 70,000 | 1,751,934 | 1,094,959 | 875,967 | — | 6,650 | 3,799,510 | 8.7 |
| Park Inn | 31,000 | 1,740,807 | 3,650 | 870,487 | — | — | 2,645,944 | 6.0 |
| Quality Inn | 60,000 | 1,757,734 | 523,946 | 772,694 | — | 9,600 | 3,123,974 | 7.1 |
| Quality Suites | 60,000 | 1,751,934 | 523,946 | 772,694 | — | 9,600 | 3,118,174 | 7.1 |
| Ramada | 70,000 | 1,751,934 | — | 1,970,926 | — | 6,650 | 3,799,510 | 8.7 |

**Exhibit 18-5 Summary Table of Chain Franchise Fees—First-Class Hotels**

| Chain | Total Initial Cost | Total Royalty Costs | Total Reservation Cost | Total Marketing Cost | Total Frequent Traveler Cost | Total Misc. Cost | 1994 Total Ten-Year Cost | 1994 Total Cost as a % of Total Room Revenue |
|---|---|---|---|---|---|---|---|---|
| Clarion | $90,000 | $2,866,409 | $1,084,972 | $1,552,090 | — | $9,600 | $5,603,073 | 5.8% |
| Doubletree | 30,000 | 2,880,814 | 3,360,949 | — | — | — | 6,271,763 | 6.5 |
| Doubletree Club | 30,000 | 2,880,814 | 3,360,949 | — | — | 60,000 | 6,331,763 | 6.6 |
| Doubletree Suites | 30,000 | 2,880,814 | 3,360,949 | — | — | — | 6,271,763 | 6.5 |
| Embassy Suites | 150,000 | 3,841,085 | 120,034 | 3,360,949 | — | — | 7,472,068 | 7.8 |
| Guest Quarters Suites | 30,000 | 2,880,814 | 3,360,949 | — | — | — | 6,271,763 | 6.5 |
| Hawthorn Suites | 120,000 | 3,841,085 | 2,400,678 | — | — | — | 6,361,763 | 6.6 |
| Hilton Garden Inn | 55,000 | 4,801,356 | 1,920,461 | 960,271 | 584,371 | — | 8,321,459 | 8.7 |
| Hilton Inn | 55,000 | 4,801,356 | 1,920,461 | — | 584,371 | — | 7,361,188 | 7.7 |
| Hilton Suites | 55,000 | 4,801,356 | 1,920,461 | 960,271 | 584,371 | — | 8,321,459 | 8.7 |
| Holiday Inn Crowne Plaza | 120,000 | 4,801,356 | 1,178,691 | 1,920,542 | 502,341 | 19,600 | 8,542,530 | 8.9 |
| Homewood Suites | 90,000 | 3,841,085 | — | 3,841,085 | — | 53,700 | 7,825,870 | 8.1 |
| Marriott | 90,000 | 7,487,115 | 359,708 | 960,271 | 614,574 | — | 9,511,667 | 9.9 |
| Omni | 50,000 | 2,880,814 | — | 3,360,949 | — | — | 6,291,763 | 6.6 |
| Preferred Hotels | 19,000 | 390,000 | 1,008,285 | — | — | 12,950 | 1,430,235 | 1.5 |
| Radisson | 45,000 | 3,841,085 | 419,659 | 3,760,624 | 389,683 | 139,886 | 8,595,937 | 9.0 |
| Sheraton | 60,000 | 4,801,356 | 1,199,519 | 960,271 | 385,599 | 284,768 | 7,691,514 | 8.0 |
| Sheraton Suites | 150,000 | 5,761,627 | 1,043,436 | 960,271 | 384,099 | 254,793 | 8,554,226 | 8.9 |
| Westin | 50,000 | 4,801,356 | 960,271 | 1,920,542 | 623,493 | 90,000 | 8,445,662 | 8.8 |

Exhibit 18-6 Summary Percentages Over the Past Five Years




## » 18.08 HOTEL FRANCHISE SELECTION PROCESS

The selection of an appropriate franchise affiliation is one of the most important decisions to be made during the entire hotel development or acquisition process. The chain affiliation of a hotel affects the property's image, market orientation, ability to benefit from referral business and a central reservation system, ability to compete in the local market, potential for future competition, and ability to generate profits. A poor choice of franchise can seriously affect the competitiveness of a hotel and its ultimate profitability and financial success.

### [1] Market Study and Appraisal

Selecting a hotel franchise is essentially a matter of first identifying what sort of hotel represents the highest and best use of a property and then determining which hotel chain affiliation would best complement the type of hotel chosen. The key to determining the highest and best use of a property is a thorough market study and appraisal. As described earlier, a market study and appraisal is an evaluation of the market potential of the subject area. Based on the locational and competitive factors determined to be influencing the subject property, recommendations are made in the study regarding market orientation, types of facilities required to cater to this orientation, and the appropriate class or level of quality for the facility. Once these characteristics have been determined and the highest and best use established, appropriate franchise affiliations can be investigated on the basis of their ability to complement and create demand for the subject property.

Developers should evaluate the important factors regarding franchises before proceeding to the next step in the selection process. The first factor that should be

considered is that a hotel chain will not consider granting a franchise that will be directly competitive with another lodging facility that it owns, manages, or has franchised in the same market area unless there is sufficient existing and unaccommodated room-night demand. The presence of a competitive property within the market should not deter a potential franchisee from investigating whether the franchisor will consider a franchise application. In some cases, a franchisor may be considering the termination of a franchise, which could mean an available opening for a new property. However, the presence of another property in the same market area should alert the hotel owner to research other franchise opportunities.

The second factor to be considered is whether or not a franchisor has any properties in the feeder cities to the subject's market area. It is important from a marketing point of view that a franchisor have representation in the cities that will provide demand to the subject property's market area. Familiarity with a product often influences the selection of a lodging facility.

## [2] Analysis of Suitable Franchise Affiliations

Once several suitable franchisors have been found, the prospective franchisee should contact the appropriate franchise salespeople and request a copy of their company's UFOC. This document will contain a wealth of information, but additional investigation will probably be necessary. The following checklist contains questions that the prospective franchisee should ask in order to properly evaluate a franchise affiliation and make a suitable selection.

- ☐ How long has the chain been in business?
- ☐ Is the chain growing?
- ☐ How many properties did it have five years ago?
- ☐ How many properties does it have at present?
- ☐ How many properties is it expected to have two, five, and ten years from now?
- ☐ How many properties are owned, managed, or franchised by the chain?
- ☐ Has the product or concept been market tested?
- ☐ How many franchises were terminated over the last five years?
- ☐ What were the reasons for terminating these franchises?
- ☐ What are the names, addresses, and phone numbers of franchisees that can be contacted for references?
- ☐ What percentage of the chain's properties are up-to-date in design, and what percentage are currently being refurbished?
- ☐ How many reservations per property does it produce, on an annual, monthly, and weekly basis?
- ☐ Does it tie into airline reservation systems?
- ☐ How effective is the reservation system for other properties in the market area? For similar properties outside the market area?
- ☐ What types of reservation reports are available?
- ☐ What is the typical percentage of no-shows from the reservation system?
- ☐ What is the operating performance of other chain hotels within or near the

subject's market area?

- ☐ What services are offered by the franchisor? Is there an additional charge for these services?
- ☐ What is the chain's reputation among travelers?
- ☐ Does the franchisor sell franchises only to individuals it considers qualified?

## [3] Negotiation of Final Terms

Because a franchisor is generally required to amend the UFOC whenever any important terms of a franchise agreement are changed, most hotel chains will not negotiate variances to their standard agreement. Occasionally, however, some additions and modifications such as the following can be obtained.

*Exclusive territory.* Sometimes franchisors will grant exclusive territories to franchisees who promise to develop a certain number of properties in the area within a specific period of time. Having franchise control over a geographic region often creates value for the holders of these exclusive territories, who can sometimes sell the franchise rights to others.

*Protected areas.* Franchisees are sometimes able to negotiate an agreement by which the franchisor cannot own, manage, or franchise another property within a specified geographic area for either a certain period of time or until a certain level of operating performance has been achieved at the franchisee's property (e.g., occupancy over 70 percent for two consecutive years). A protected area is an important benefit if it can be obtained from a franchisor.

In regard to the final selection of a franchise company, potential franchisees should strive to make their choice as early as possible in the development or acquisition process. Because most franchisors have specific requirements for layout, design, quality, and furnishings, it is advantageous to involve the franchisor before any architectural plans or specifications are made. The franchisee should always ask for an exclusive area, since this technique is an effective means of prohibiting new competition. If the franchise chain that is chosen is new, the franchisee should ask for reduced fees until the chain reaches a certain size. Finally, since the reservation system is one of the key elements to a franchise affiliation, the franchiser should try to obtain some guarantee that the system will be effective and generate actual room-nights for the facility.

## » 18.09 FRANCHISE AGREEMENTS

Once an offer to grant a franchise has been made by the franchisor and accepted by the franchisee, a contractual agreement is drawn up that details the responsibilities of the two parties. The general provisions of franchise agreements typically provide an overview that attempts to make the franchise system and concept appear to be unique so the franchisor can consider the license it grants (the franchise) to be proprietary. Most licenses for franchises are granted for a specific location, so the franchise agreement should include a description of the exact location of the hotel. If the franchisor allows a restricted area, the details of this area should be contained in the agreement.

## [1] Term of Agreement

Hotel franchise agreements typically range from ten to twenty years. Sometimes they provide extensions at the option of the licensee. Franchisees should seek a term for as many years as possible if they have the ability to freely terminate the franchise should the benefits it generates not measure up to expectations of the franchisee. If there is a cost associated with termination, the franchisee should ask for short terms with several options to extend. Most lenders want franchise terms to extend over the life of the mortgage on the property. In addition, lenders generally want the right to either terminate or take over the franchise for the remaining term in the event of a foreclosure. Mortgagee provisions of this kind are known as "comfort letters."

## [2] Proprietary Information

Most franchisors consider all of the publications and written material that they generate for the benefit of their franchise holders to be proprietary. These include operations and training manuals, educational material, conferences and seminars, methods, techniques, formats, specifications, procedures, architectural plans, and so forth. Franchise agreements generally stipulate that this information must be treated confidentially and that its disclosure must be limited.

## [3] Relationship of Parties

All parties to a franchise agreement are considered independent and are not able to bind each other. To limit liability, most franchisors stipulate in their franchise agreements that signs be posted at the front desk stating that the hotel is independently owned and operated under a license with the franchisor. Franchisors generally require indemnification from their franchisees for any claims or actions brought against them.

## [4] Hotel Image and Operating Standards

One of the most important sections of a franchise agreement is the one containing provisions regarding the maintenance of a hotel's image and general operating standards. These provisions relate to franchisor control over not only the physical quality of a lodging facility, but also the level of service and guest satisfaction. Franchisors generally require contract provisions that allow them to monitor the condition and appearance of the hotel and to establish standards for grading compliance. Some chains insist on requirements that hotels that hold their franchises be upgraded at regular intervals so that they remain in conformance with company standards. If alterations are to be undertaken or if the hotel must be rebuilt after a casualty or condemnation, the franchisor will generally want the right to approve plans and specifications. In order to control the quality of furnishings, equipment, and supplies, franchisors also often develop strict specifications that must be followed when purchasing, including the use of approved vendors. Operational procedures are controlled by setting forth requirements in the agreement that the franchisee follow the standards established in the operating manuals provided by the franchisor. Operating standards

also generally include restrictions regarding the franchisee's operating competing hotels, diverting business, employing company personnel, and working for another franchisor. Insurance coverage is another important operating standard for franchisors, so they include provisions related to the amount and types of insurance that must be carried by the franchisees in the agreement.

## [5] Training and Guidance

Hotel chains generally require some form of training or orientation for senior level management in order to familiarize personnel with the various systems, procedures, programs, and policies developed by the franchisor. The franchise agreement should specify the nature of this training, which can range from regular classes conducted by the franchisor at an educational facility to simple training manuals. A certain amount of ongoing guidance and consulting is also normally provided, but if the time involved in these activities becomes excessive, the franchisor will usually require a fee.

## [6] Reservation Systems and Advertising

Most franchised hotel chains offer some form of reservation or referral system that is paid for either by the continuing franchise (royalty) fee or by a separate reservation fee that is stipulated in the franchise agreement. A reservation fee can be assessed on the basis of a percentage of rooms revenue or on some other formula related to the number of reservations received. Some hotel chains establish advertising funds to be used for such activities as national or regional advertising and specialized marketing. Most of these funds are established and administered by the franchisor, but are funded by the individual hotels within the chain.

## [7] Fees

As noted previously, most franchises require prospective members to pay an initial license application fee. The amount and details of the fee should be set forth in the franchise agreement. The license application fee is generally payable upon application and is considered earned by the franchisor when the application is approved. The agreement should specify the procedure to be followed if the franchise is not approved. For example, a percentage of the fee may be retained by the franchisor to offset the cost involved in processing the application.

## [8] Reports, Inspections, and Audits

Most franchise agreements establish the right of the franchisor to inspect the books, records, and financial reports of the franchisee, particularly if the franchise fee is based on a formula tied to the financial operating results of the franchisee. Provisions relating to the types and timing of reports that must be submitted to the franchisor are set forth in this part of the agreement.

Franchisors periodically inspect the properties in their chains to determine whether the standards set forth in their franchise agreements are being maintained. If it is necessary to verify the accuracy of the financial data, a franchisor usually has the right to conduct an audit.

## [9] Assignment

A franchise can be assigned by either the franchisee or the franchisor, and while both parties will generally want the right to freely transfer the franchise, usually, only the franchisor has the ability to do so. The franchisee must request approval in accordance with the franchise agreement.

Naturally, the primary concern of the franchisor is to maintain the chain's level of quality, so a new franchisee must be closely reviewed. Franchise agreements generally set forth the basis for approving an assignment as well as the procedure for notification. Some franchisors require that a property be brought up to current standards before it can be assigned, which can entail a substantial expenditure and thus make the property more difficult to transfer. Most franchisors want the right of first refusal in the event they might desire to acquire the property upon a contemplated transfer.

## [10] Termination

Most franchise agreements do not permit the franchisee to terminate the agreement before the end of the term. If the agreement is terminated, the franchisee generally has to pay damages to the franchisor that usually amount to two to three times the franchise fee paid over the past year. Since the cost of terminating a franchise can be expensive, it is important for franchisees to make a good initial selection in order to reduce the chance of an early termination.

Most franchise agreements grant the franchisor extensive rights regarding franchise termination. Some of the more common termination provisions include failure to open the property; failure to operate the property; failure to have proper moral character; violation of a law or ordinance; bankruptcy; failure to maintain insurance;
failure to pay franchise fees; and failure to comply with franchisee agreement. In most instances, the franchisee has a right to cure the default before the franchise is terminated.

Franchise agreements generally establish certain obligations on the part of the franchisee in the event that the franchise is terminated or expires. Some of these obligations are: payment of all monies owed to the franchisor including liquidated damages, if appropriate, and removal of signs, systems, marks, and identity items. Some franchise agreements even require that the telephone number of the hotel be returned to the franchisor.

The selection of an appropriate franchise affiliation affects a property's ability to compete in the local market, generate profits, achieve a certain image or market orientation, and benefit from referral business. Because the success of a hotel is predominantly based on the cash flow it generates, owners and lenders must quantitatively measure the benefits and services of a national affiliation against the total cost of such a commitment.

Continued brand recognition, consistency, and franchisor staying power also are important factors in an owner's or lender's decision to add or change a franchise affiliation.

HVS

CHAPTER 19

# Property Management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## » 19.01 INDIVIDUAL MANAGERS VS. MANAGEMENT COMPANIES

The financial success of any lodging facility is largely dependent on the skill and ability of on-site management. Hotel operators face a number of unique problems, ranging from booking convention business to running a high-energy lounge to installing night audit financial controls. While the skills needed to handle such problems can be acquired through college-level training and operational experience, it is the type of system used by management that usually determines how successfully personnel can apply their skills.

Historically, hotel owners have either hired individual on-site managers to operate their properties or have engaged the services of professional hotel companies through hotel operating agreements such as property leases or management contracts.

The employment of individual managers is the less expensive approach, but there are serious drawbacks to such arrangements. In terms of supervision of staff, overall management skill, and effective operational methods, management companies are frequently superior to individual managers.

### [1] Supervision

All the employees of a lodging facility should be supervised to ensure that the integrity of the facility's financial control system is maintained. An individual general

manager often cannot provide the necessary level of direct supervision, whereas the structure of a hotel management company generally provides several layers of control over this aspect of the business. Furthermore, an individual general manager can be abruptly hired away by a competitor, or may quit because of a dispute. A hotel management company, on the other hand, can provide the back-up staff, logistical support, and uninterrupted supervision that is essential for a 24-hour-a-day, 365-day-a-year business. Unless ownership can assume total operational responsibility for the hotel on short notice and for extended periods, an individual general manager is often not a viable alternative for property management.

## [2] Expertise

Many professional hotel management companies offer a range of expertise and experience that individual general managers cannot match. Management companies can assist hotel owners with property development, acquisition, and operation by providing such services as national advertising and reservation systems, interior decorating, and property engineering. Management companies are often also able to provide counseling and representation for labor negotiations, permit and license applications, and zoning and property tax proceedings.

## [3] Verifiable Past Performance

A successful hotel management company should be able to document its past performance and provide references regarding its operations currently under contract. Verifiable information of this kind provides hotel operators with a basis for selecting a qualified operator. Individual managers, on the other hand, generally cannot document the effect of their management on a particular hotel. As a result, the selection of a qualified general manager usually must be made with very little assurance that the individual will be capable of successfully operating the property. At the least, poor selection results in confusion and loss of momentum until another manager is located and brought in to take over the operation. While vulnerable to the same problem, a management company is better able to handle a transition between general managers because it can provide trained interim personnel who can quickly assume necessary responsibilities within an established system, permitting continuous operation of all essential controls and procedures.

## [4] Established Methods and Procedures

The major advantage in hiring a management company is that it can provide established, functional methods and procedures that constitute a complete system capable of handling the complex job of operating a lodging facility. In instances in which a takeover must be made rapidly, established management companies can bring in top-level management staff from other properties to train local personnel and implement proper operating systems and controls. For new lodging facilities, management companies can often provide valuable advice in the layout and design of the physical plant, and once the facility is completed, can institute their mode of operation and quickly bring on-line a fully functioning lodging facility. This experience and expertise saves time and reduces costly mistakes.

Most hotel management companies have developed procedure manuals and

training programs that cover all of the aspects of lodging facility operations. When nothing is left to chance and set methods are established for handling all foreseeable problems, the element of human error is greatly reduced and hotel guests receive a consistently high level of service.

The benefits of retaining a professional hotel management company usually far outweigh the alternative of employing an individual general manager, particularly when a hotel owner does not have the ability or desire to provide a high level of supervision, As a result of many investors reaching this conclusion, the number of hotel properties managed by third-party operators has grown significantly over the past twenty-five years. This trend is further substantiated by hotel lenders, underwriters, and rating agencies, who typically require that a competent hotel company be included in the project team.

## » 19.02 TOTAL PROPERTY LEASES

The practice of using professional hotel companies to manage lodging facilities for property owners began in the early 1900s. During this period, hotels became larger and more complicated to operate and the benefit of chain identification became an important competitive factor as the general population gained mobility. Hotel chains such as Hilton, Statler, Manger, and Albert Pick began to expand throughout the United States, operating both their own properties and hotels owned by others.

At first, the most common method by which hotel companies furnished management services was through total property leases. Essentially, a total property lease is an agreement between a hotel company and a hotel property owner whereby the hotel company leases the hotel (land, improvements, and sometimes the furniture, fixtures, and equipment) from the property owner. The hotel company thus becomes the tenant and assumes all operating responsibilities, as well as the financial obligations of funding, working capital, operating expenses, and rent. The landlord-owner is passive with respect to all operating decisions and is not responsible for working capital or operating expenses. The hotel company receives the residual net income after all expenses, including rent, are paid.

Under a total property lease, the financial burden is placed on the hotel company, which enjoys some benefits if the property is successful, but suffers all of the losses when operating performance is not adequate. Because of the popularity of management contracts, hotel operating leases have all but disappeared. Only recently, with the resurgence of real estate investment trusts (REITs), have operating leases been reestablished.

## [1] Rental Formulas

Many types of rental formulas were devised for total property lease agreements. In a typical arrangement, known as a "25, 10, and 5 lease," the rent was based on the total of the percentages of various revenues realized by the property. See Exhibit 19-1.

Under such an arrangement, the landlord, as owner of the land and improvements, was responsible for payment of real estate taxes. The tenant owned the personal property and paid all of the operating expenses incurred by the hotel. Sometimes the rental agreement also provided the landlord with a minimum rent to cover the debt service on any mortgages on the property. If such was the case, the tenant paid the greater of the minimum rent amount or the rental formula, such as that for a 25, 10, and 5 lease.

**Exhibit 19-1 25, 10, and 5 Leases**

| | Percentage of Total |
|---|---|
| Rooms Revenue | 25 |
| Beverage Revenue | 10 |
| Food Revenue | 5 |
| Other Income | 20 |

## [2] REIT Structures

The use of real estate investment trusts (REITs) as an alternative for hotel acquisition, financing, and portfolio expansion has resulted in the increased popularity of hotel operating leases. To qualify for favorable REIT tax advantages, the owning company may not operate the properties—it must "lease" the hotels to an independent lessee. Typically, the lessee in turn contracts third-party management, in which management fees are subordinated to the minimum base fee paid to the company. Rents typically include a base and percentage fee or are the greater of the two. In these scenarios, the lessee assumes a majority of the downside risk and is often related to the chosen operator, effectively creating a total property lease.

As a result of REITs competing in the same arena as other fixed income securities, the life of a real estate investment trust fluctuates with the rise and fall of interest rates. For this reason, hotel operating leases may be limited to the few hotel-specific REITs created during periods of low interest rates.

## [3] Advantages and Disadvantages of Property Lease Agreements

A property lease agreement contains advantages and disadvantages for both parties. A property owner realizes the following advantages:

1. The owner retains title to the property, which provides possession and creates residual value when the term of the lease expires.
2. The financial risk to the owner is minimized, particularly if the hotel company is creditworthy and has guaranteed a minimum rent.
3. The owner has no operational responsibilities. The

property owner faces the following disadvantages:

1. The operator has little incentive to maintain the property in top condition as the lease term nears its expiration date. For this reason, many hotels are returned to the owners in poor physical condition, as well as with a tainted reputation. Furthermore, because much of the existing business is often diverted to other hotels managed by the operator, few reservations are on the books for the owner or new tenant.
2. A hotel lease places the owner in a passive position. Under such an agreement, the owner has no input in the operations of the hotel or control over the hotel management. Little can be done if the property is not operated

in a profitable and appropriate manner unless the terms of the lease are violated.

3. If the hotel is extremely successful, the property owner does not participate in the financial rewards to the extent of an owner/operator. Thus, the potential for profit is somewhat limited.
4. Leases are difficult to terminate. Unlike a management contract, which is an agency agreement, a lease creates an encumbrance on the real estate that gives the tenant specific rights of possession.

There are several advantages in a property lease agreement for the hotel operator:

1. The operator has total control of the hotel during the term of the lease with very few approvals required from ownership.
2. A profitable hotel creates a leasehold value that can sometimes be mortgaged by the operator. If the terms of the lease permit a transfer, the leasehold value can also be realized through a sale.
3. The upside profit created by a successful hotel will solely benefit the operator, who receives whatever money remains after operating expenses and lease rental have been paid.

The disadvantages for a hotel operator are as follows:

1. The hotel operator loses possession of the property when the lease term expires.
2. The leasehold loses its value as the term of the lease expires.
3. The financial risks of operating the hotel are borne by the hotel company, so the operator must have a net worth great enough to be able to incur the exposure.
4. Leasehold interests create contingent liabilities on corporate balance sheets that can adversely affect the value of stock in publicly traded companies. Of course, because of the requirements for real estate investment trusts, hotel operating leases are a necessity.

## » 19.03 DEVELOPMENT OF HOTEL MANAGEMENT CONTRACTS

Hotel management contracts came into use between 1950 and 1960. During that time, more and more Americans started traveling abroad, and foreign governments that were interested in attracting American tourists began encouraging U.S. hotel companies to develop hotels in their countries.

The concept of a worldwide lodging chain was appealing to a number of hotel companies, but many were reluctant to expose themselves to the development and operating risks associated with owning or leasing a hotel in a foreign country. Many factors, including governmental instability, fiscal uncertainty, and a lack of skilled labor led hotel companies to develop a replacement for the property lease that would shift the financial burden from the operator to the owner. The result of the hotel companies' efforts was the hotel management contract.

A management contract is essentially an agreement between a hotel management company and a hotel property owner whereby the management company takes on the responsibility of managing the hotel and its facilities. The owner, unless stipulated

otherwise, assumes a passive position with respect to operating decisions, while assuming responsibility for all working capital, operating expenses, and debt service. The management company is paid a fee for its services and the owner receives the residual net income after all expenses.

Unlike a property lease, the financial burden under a management contract is placed entirely on the owner, who enjoys the upside benefits of a successful property, but suffers the downside losses if the operation is not profitable. Under this arrangement, American hotel companies were eager to expand overseas because the foreign country assumed the financial risk for the benefit of developing tourism and the management company provided operational expertise and name recognition. Chains such as Hilton International, Hyatt, Sheraton, Western International (Westin), and Intercontinental were among the hotel companies that used management contracts to expand their bases of operations worldwide.

Once hotel companies discovered that they could make almost as much money with a management contract as with a property lease without assuming any of the financial risks, they started to change their modes of operation.

## » 19.04 PROPERTY LEASES VS. MANAGEMENT CONTRACTS

Exhibit 19-2 illustrates the shifting of financial risks between the property owner and the hotel operator, using both a property lease and management contract structure. Two scenarios are set forth for a proposed 300-room, first-class hotel: one assumes a new property (Hotel A) with a normal occupancy build-up and the other assumes a new property of the same description but with a lower starting occupancy and a longer and slower build-up (Hotel *B*).

**Exhibit 19-2 Assumed Occupancy and Average Room Rates**

| | Hotel *A* (Normal Occupancy Build-up) | | Hotel *B* (Low Occupancy Build-Up) | |
|---|---|---|---|---|
| **Year** | **Occupancy** | **Average Rate** | **Occupancy** | **Average Rate** |
| 1 | 58% | $95.00 | 45% | $95.00 |
| 2 | 65 | 101.65 | 48 | 101.65 |
| 3 | 70 | 107.75 | 50 | 107.75 |
| 4 | 73 | 113.14 | 52 | 113.14 |
| 5 | 73 | 117,66 | 53 | 117.66 |
| 6 | 73 | 122.37 | 54 | 122.37 |
| 7 | 73 | 127.26 | 55 | 127.26 |

As shown in Exhibit 19-2, Hotel *A* starts with a 58 percent occupancy in Year One and reaches a stabilized level of 73 percent in Year Four. Hotel *B* starts with an occupancy rate of 45 percent in Year One that grows slowly and stabilizes at 55 percent in Year Seven.

Seven-year projections of income and expense for each hotel based on these occupancy and average rate assumptions are shown in Exhibits 19-3 and 19-4. The data for operating ratios for controllable expenses have been adjusted to reflect differing levels of occupancy; fixed expenses such as property taxes and insurance have been

held constant except for inflationary increases. A basic management fee of 3.0 percent (based on total revenue) has been deducted as well as a 4.0 percent reserve for replacement (also based on total revenue) to provide a fund for the replacement of furniture, fixtures, and equipment.

A property lease and a management contract structure is assumed for each scenario in the Exhibits. The terms for these structures are based on typical provisions found in the marketplace. It should be noted that, beyond their use in REIT structures, hotel property leases are no longer common and therefore the assumed terms are based on the historic use of these instruments.

As stated previously, the rent paid under hotel property leases has typically been determined by the "25, 10 and 5" lease. The actual dollar amounts yielded by this formula for both hotels are shown in Exhibit 19-5.

Usually, under such an agreement the landlord owns the land and improvements and is responsible for the payment of real estate taxes. The tenant owns the personal property and pays all operating expenses.

Exhibit 19-6 shows how the net income realized by Hotel A is divided between the hotel company (tenant) and the property owner (landlord) under a property lease.

The net income realized by the tenant starts with the net income from the projection of income and expense. The landlord pays the real estate taxes out of the rent, so the amount deducted for real estate taxes can be added back to the net income. The rent is deducted from the net income and is calculated using the rental formula set forth above. The result of these calculations is the net to the tenant.

The net to the landlord is based on the previously calculated rent minus the property tax obligation. Because the tenant is assumed to own the furniture, fixtures, and equipment, a reserve for replacement has not been deducted from the net to the landlord.

The terms of the management contract assume a basic management fee of 3 percent of total revenue plus an incentive fee equal to 10 percent of house profit (income before fixed charges) after deducting the 3 percent base fee. Exhibit 19-7 shows how the net income for Hotel A is divided between the hotel company and the property owner under a management contract.

The net to the management company is the total of the basic management fee plus the incentive fee; the net to the owner is equal to the residual net income remaining after deducting the total management fee.

A comparison of each structure is made for Hotel A in Exhibit 19-8 by totaling the income to each party over a seven-year period assuming both a lease and management contract.

Hotel *B* has a lower starting occupancy and a longer and slower income buildup and as a consequence produces much different results from Hotel A. Exhibit 19-9 shows how the net income of Hotel *B* would be divided between the hotel company (tenant) and the property owner (landlord), assuming a property lease. As can be seen, the net income realized by the tenant is actually negative for the first four years, while the landlord, on the other hand, realizes a positive cash flow.

Exhibit 19-10 assumes a management contract structure for Hotel *B* and shows how the net income is shared between the hotel company and property owner. Exhibit 19-11 compares each structure by totaling the income to each party over the seven-year period.

In this scenario, the hotel company would want to operate the hotel with a management contract, while the property owner would realize more income from a lease. In fact, if the transaction were structured as a lease, the hotel company would have a cash flow shortfall of almost $4 million during the first seven years of operation. For many of the smaller hotel companies, this degree of exposure is not acceptable.

Comparing the economic benefits to the hotel company under a lease with those under a management contract, it becomes apparent that the potential upside benefit

## Exhibit 19-3 Hotel *A*—Projection of 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 | |
| **Days Open** | 365 | | 365 | | 365 | | 365 | | 365 | | 365 | | 365 | |
| **Occupied Rooms** | 63,510 | | 71,175 | | 76,650 | | 79,935 | | 79,935 | | 79,935 | | 79,935 | |
| | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** |
| **Revenue** | | | | | | | | | | | | | | |
| Rooms | 6,033 | 54.9 | 7,235 | 56.4 | 8,259 | 57.3 | 9,044 | 58.0 | 9,405 | 58.0 | 9,782 | 58.0 | 10,173 | 58.0 |
| Food | 3,212 | 29.2 | 3,624 | 28.3 | 3,980 | 27.7 | 4,271 | 27.3 | 4,442 | 27.3 | 4,620 | 27.3 | 4,804 | 27.3 |
| Beverage | 1,285 | 11.7 | 1,450 | 11.3 | 1,592 | 11.1 | 1,708 | 10.9 | 1,777 | 10.9 | 1,848 | 10.9 | 1,922 | 10.9 |
| Telephone | 248 | 2.3 | 285 | 2.2 | 316 | 2.2 | 342 | 2.2 | 355 | 2.2 | 370 | 2.2 | 384 | 2.2 |
| Other Income | 214 | 1.9 | 229 | 1.8 | 243 | 1.7 | 256 | 1.6 | 267 | 1.6 | 277 | 1.6 | 288 | 1.6 |
| Total | 10,992 | 100.0 | 12,823 | 100.0 | 14,390 | 100.0 | 15,621 | 100.0 | 16,897 | 100.0 | 17,571 | 100.0 | 17,571 | 100 |
| **Departmental Expenses** | | | | | | | | | | | | | | |
| Rooms | 1,505 | 24.9 | 1,631 | 22.5 | 1,745 | 21.1 | 1,845 | 20.4 | 1,919 | 20.4 | 1,996 | 20.4 | 2,075 | 20.4 |
| Food and Beverage | 3,562 | 79.2 | 3,833 | 75.5 | 4,082 | 73.3 | 4,305 | 72.0 | 4,478 | 72.0 | 4,657 | 72.0 | 4,843 | 72.0 |
| Telephone | 169 | 68.1 | 182 | 63.9 | 194 | 61.4 | 205 | 59.9 | 213 | 60.0 | 222 | 60.0 | 231 | 60.2 |
| Other Income | 134 | 62.6 | 141 | 61.6 | 147 | 60.5 | 154 | 60.2 | 160 | 59.9 | 166 | 59.9 | 173 | 60.1 |
| Total | 5,370 | 48.9 | 5,787 | 45.1 | 6,168 | 42.9 | 6,509 | 41.7 | 6,770 | 41.7 | 7,041 | 41.7 | 7,322 | 41.7 |
| **Departmental Income** | 5,622 | 51.1 | 7,036 | 54.9 | 8,222 | 57.1 | 9,112 | 58.3 | 9,476 | 58.3 | 9,856 | 58.3 | 10,249 | 58.3 |
| **Operating Expenses** | | | | | | | | | | | | | | |
| Administrative and General | 953 | 8.7 | 1,022 | 8.0 | 1,087 | 7.6 | 1,145 | 7.3 | 1,191 | 7.3 | 1,239 | 7.3 | 1,288 | 7.3 |
| Management Fee | 330 | 3.0 | 385 | 3.0 | 432 | 3.0 | 469 | 3.0 | 487 | 3.0 | 507 | 3.0 | 527 | 3.0 |
| Marketing | 572 | 5.2 | 613 | 4.8 | 652 | 4.5 | 687 | 4.4 | 715 | 4.4 | 743 | 4.4 | 773 | 4.4 |
| Franchise Fees | 241 | 2.2 | 289 | 2.3 | 330 | 2.3 | 362 | 2.3 | 376 | 2.3 | 391 | 2.3 | 407 | 2.3 |
| Property Operations and Maintenance | 623 | 5.7 | 668 | 5.2 | 710 | 4.9 | 748 | 4.8 | 778 | 4.8 | 809 | 4.8 | 842 | 4.8 |
| Energy | 554 | 5.0 | 582 | 4.5 | 610 | 4.2 | 637 | 4.1 | 663 | 4.1 | 689 | 4.1 | 717 | 4.1 |
| Total | 3,273 | 29.8 | 3,559 | 27.8 | 3,821 | 26.5 | 4,048 | 25.9 | 4,210 | 25.9 | 4,378 | 25.9 | 4,554 | 25.9 |
| **House Profit** | 2,349 | 21.3 | 3,477 | 27.1 | 4,401 | 30.6 | 5,064 | 32.4 | 5,266 | 32.4 | 5,478 | 32.4 | 5,695 | 32.4 |
| **Fixed Expenses** | | | | | | | | | | | | | | |
| Property Taxes | 349 | 3.2 | 363 | 2.8 | 378 | 2.6 | 393 | 2.5 | 409 | 2.5 | 425 | 2.5 | 442 | 2.5 |
| Insurance | 121 | 1.1 | 126 | 1.0 | 131 | 0.9 | 136 | 0.9 | 142 | 0.9 | 147 | 0.9 | 153 | 0.9 |
| Reserve for Replacement | 440 | 4.0 | 513 | 4.0 | 576 | 4.0 | 625 | 4.0 | 650 | 4.0 | 676 | 4.0 | 703 | 4.0 |
| Total | 910 | 8.3 | 1,002 | 7.8 | 1,085 | 7.5 | 1,154 | 7.4 | 1,201 | 7.4 | 1,248 | 7.4 | 1,298 | 7.4 |
| **Net Income** | 1,439 | 13.0 | 2,475 | 19.3 | 3,316 | 23.1 | 3,910 | 25.0 | 4,065 | 25.0 | 4,230 | 25.0 | 4,397 | 25.0 |

**Exhibit 19-4 Hotel *B*—Projection of 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% | | 52.00% | | 52.00% | | 52.00% | |
| **Average Rate** | $95.00 | | $101.65 | | $107.75 | | $113.14 | | $117.66 | | $122.37 | | $127.26 | |
| **Days Open** | 365 | | 365 | | 365 | | 365 | | 365 | | 365 | | 365 | |
| **Occupied Rooms** | 49,275 | | 52,560 | | 54,750 | | 56,940 | | 56,940 | | 56,940 | | 56,940 | |
| | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** | **Total $** | **% Gross** |
| **Revenue** | | | | | | | | | | | | | | |
| Rooms | 4,681 | 52.8 | 5,343 | 54.0 | 5,899 | 54.8 | 6,442 | 55.5 | 6,700 | 55.5 | 6,968 | 55.5 | 7,246 | 55.5 |
| Food | 2,705 | 30.5 | 2,935 | 29.7 | 3,136 | 29.2 | 3,350 | 28.8 | 3,484 | 28.8 | 3,623 | 28.8 | 3,768 | 28.8 |
| Beverage | 1,082 | 12.2 | 1,174 | 11.9 | 1,254 | 11.7 | 1,340 | 11.5 | 1,394 | 11.5 | 1,449 | 11.5 | 1,507 | 11.5 |
| Telephone | 199 | 2.2 | 219 | 2.2 | 235 | 2.2 | 253 | 2.2 | 263 | 2.2 | 274 | 2.2 | 285 | 2.2 |
| Other Income | 202 | 2.3 | 213 | 2.2 | 223 | 2.1 | 234 | 2.0 | 244 | 2.0 | 253 | 2.0 | 263 | 2.0 |
| Total | 8,869 | 100.0 | 9,884 | 100.0 | 10,747 | 100.0 | 11,619 | 100.0 | 12,085 | 100.0 | 12,567 | 100.0 | 13,069 | 100.0 |
| **Departmental Expenses** | | | | | | | | | | | | | | |
| Rooms | 1,389 | 29.7 | 1,472 | 27.6 | 1,551 | 26.3 | 1,633 | 25.3 | 1,698 | 25.3 | 1,766 | 25.3 | 1,837 | 25.4 |
| Food and Beverage | 3,332 | 88.0 | 3,521 | 85.7 | 3,699 | 84.3 | 3,887 | 82.9 | 4,043 | 82.9 | 4,204 | 82.9 | 4,373 | 82.9 |
| Telephone | 157 | 78.9 | 166 | 75.8 | 175 | 74.5 | 184 | 72.7 | 191 | 72.6 | 199 | 72.6 | 207 | 72.6 |
| Other Income | 132 | 65.3 | 138 | 64.8 | 144 | 64.6 | 150 | 64.1 | 156 | 63.9 | 162 | 64.0 | 168 | 63.9 |
| Total | 5,010 | 56.5 | 5,297 | 53.6 | 5,569 | 51.8 | 5,854 | 50.4 | 6,088 | 50.4 | 6,331 | 50.4 | 6,585 | 50.4 |
| **Departmental Income** | 3,859 | 43.5 | 4,587 | 46.4 | 5,178 | 48.2 | 5,765 | 49.6 | 5,997 | 49.6 | 6,236 | 49.6 | 6,484 | 49.6 |
| **Operating Expenses** | | | | | | | | | | | | | | |
| Administrative and General | 905 | 10.2 | 956 | 9.7 | 1,005 | 9.4 | 1,055 | 9.1 | 1,097 | 9.1 | 1,141 | 9.1 | 1,187 | 9.1 |
| Management Fee | 266 | 3.0 | 297 | 3.0 | 322 | 3.0 | 349 | 3.0 | 363 | 3.0 | 377 | 3.0 | 392 | 3.0 |
| Marketing | 543 | 6.1 | 574 | 5.8 | 603 | 5.6 | 633 | 5.4 | 658 | 5.4 | 685 | 5.5 | 712 | 5.4 |
| Franchise Fees | 187 | 2.1 | 214 | 2.2 | 236 | 2.2 | 258 | 2.2 | 268 | 2.2 | 279 | 2.2 | 290 | 2.2 |
| Property Operations and Maintenance | 591 | 6.7 | 625 | 6.3 | 657 | 6.1 | 689 | 5.9 | 717 | 5.9 | 746 | 5.9 | 775 | 5.9 |
| Energy | 545 | 6.1 | 570 | 5.8 | 595 | 5.5 | 620 | 5.3 | 645 | 5.3 | 671 | 5.3 | 698 | 5.3 |
| Total | 3,037 | 34.2 | 3,236 | 32.8 | 3,418 | 31.8 | 3,604 | 30.9 | 3,748 | 30.9 | 3,899 | 31.0 | 4,054 | 30.9 |
| **House Profit** | 822 | 9.3 | 1,351 | 13.6 | 1,760 | 16.4 | 2,161 | 18.7 | 2,249 | 18.7 | 2,337 | 18.6 | 2,430 | 18.7 |
| **Fixed Expenses** | | | | | | | | | | | | | | |
| Property Taxes | 349 | 3.9 | 363 | 3.7 | 378 | 3.5 | 393 | 3.4 | 409 | 3.4 | 425 | 3.4 | 442 | 3.4 |
| Insurance | 121 | 1.4 | 126 | 1.3 | 131 | 1.2 | 136 | 1.2 | 142 | 1.2 | 147 | 1.2 | 153 | 1.2 |
| Reserve for Replacement | 355 | 4.0 | 395 | 4.0 | 430 | 34.0 | 465 | 4.0 | 483 | 4.0 | 503 | 4.0 | 523 | 4.0 |
| Total | 825 | 9.3 | 884 | 9.0 | 939 | 8.7 | 994 | 8.6 | 1,034 | 8.6 | 1.075 | 8.6 | 1,118 | 8.6 |
| **Net Income** | (3) | 0.0 | 467 | 4.6 | 821 | 7.7 | 1,167 | 10.1 | 1,215 | 10.1 | 1,262 | 10.0 | 1,312 | 10.1 |

from the lease is limited while the downside risk is significant. 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 structure and enter instead into either management contracts or property ownership.

Management companies eager to secure a particular location or property have offered guarantees to the ownership, effectively reducing the risk to ownership while allowing the operator to participate in the upside potential.

**Exhibit 19-5 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 | 161 | 181 | 199 | 214 | 222 | 231 | 240 |
| Beverage | 129 | 145 | 159 | 171 | 178 | 185 | 192 |
| Other Income | 92 | 103 | 112 | 120 | 124 | 129 | 134 |
| Total Rent | $1,890 | $2,238 | $2,535 | $2,765 | $2,875 | $2,991 | $3,110 |

**Hotel *B* (normal 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 | $1,675 | $1,742 | $1,812 |
| Food | 135 | 147 | 157 | 168 | 174 | 181 | 188 |
| Beverage | 108 | 117 | 125 | 134 | 139 | 145 | 151 |
| Other Income | 80 | 86 | 92 | 97 | 101 | 105 | 110 |
| Total Rent | $1,494 | $1,686 | $1,849 | $2,009 | $2,090 | $2,173 | $2,260 |

**Exhibit 19-6 Division of Hotel *A* Net Income Under Property Lease**

| | Year 1 | Year 2 | Year 3 | Year 4 | Year 5 | Year 6 | Year 7 |
|---|---|---|---|---|---|---|---|
| Net Income | $1,439 | $2,475 | $3,316 | $3,910 | $4,065 | $4,230 | $4,397 |
| Plus RE Tax | 349 | 363 | 378 | 393 | 409 | 425 | 442 |
| Less Rent | 1,890 | 2,238 | 2,535 | 2,765 | 2,875 | 2,991 | 3,110 |
| Net to Tenant | ($102) | $600 | $1,159 | $1,538 | $1,599 | $1,664 | $1,729 |
| Rent | 1,890 | 2,238 | 2,535 | 2,765 | 2,875 | 2,991 | 3,110 |
| Less RE Tax | 349 | 363 | 378 | 393 | 409 | 425 | 442 |
| Net to Landlord | $1,541 | $1,875 | $2,157 | $2,372 | $2,466 | $2,566 | $2,668 |

**Exhibit 19-7 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 | $330 | $385 | $432 | $469 | $487 | $507 | $527 |
| Plus Incentive Fee | 235 | 348 | 440 | 506 | 527 | 548 | 570 |
| Net to Management Company | $565 | $733 | $872 | $975 | $1,014 | $1,055 | $1,097 |
| Net Income | 1,439 | 2,475 | 3,316 | 3,910 | 4,065 | 4,230 | 4,397 |
| Less Management Fee | 330 | 385 | 432 | 469 | 487 | 507 | 527 |
| Net to Owner | $1,109 | $2,090 | $2,884 | $3,441 | $3,578 | $3,723 | $3,870 |

**Exhibit 19-8 Hotel *A* Under Lease vs. Management Contract**

| | Management Company | Property Owner |
|---|---|---|
| Lease | $8,188,000 | $15,644,000 |
| Management Contract | 6,310,000 | 20,695,000 |

**Exhibit 19-9 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 | ($3) | $467 | $821 | $1,167 | $1,215 | $1,262 | $1,312 |
| Plus RE Tax | 349 | 363 | 378 | 393 | 409 | 425 | 442 |
| Less Rent | 1,494 | 1,686 | 1,849 | 2,009 | 2,090 | 2,173 | 2,260 |
| Net to Tenant | ($1,148) | ($856) | ($650) | ($449) | ($466) | ($486) | ($506) |
| Rent | 1,494 | 1,686 | 1,849 | 2,009 | 2,090 | 2,173 | 2,260 |
| Less RE Tax | 349 | 363 | 378 | 393 | 409 | 425 | 442 |
| Net to Landlord | $1,145 | $1,323 | $1,471 | $1,616 | $1,681 | $1,748 | $1,818 |

**Exhibit 19-10 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 Fee | $266 | $297 | $322 | $349 | $363 | $377 | $392 |
| Plus Incentive Fee | 82 | 135 | 176 | 216 | 225 | 234 | 243 |
| Net to Management Company | $348 | $432 | $498 | $565 | $588 | $611 | $635 |
| Net Income | (3) | 467 | 821 | 1,167 | 1,215 | 1,262 | 1,312 |
| Less Management Fee | 266 | 297 | 322 | 349 | 363 | 377 | 392 |
| Net to Owner | ($269) | $170 | $499 | $818 | $852 | $885 | $920 |

**Exhibit 19-11 Hotel *B* Under Lease vs. Management Contract**

| | Management Company | Property Owner |
|---|---|---|
| Lease | ($4,562,000) | $10,803,000 |
| Management Contract | $3,677,000 | $3,875,000 |

## » 19.05 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-tier or second-tier. First-tier companies operate lodging facilities for third parties under management contracts and provide day-today operational supervision and property management as well as national or regional customer recognition through their trade names. Hilton, Hyatt, Marriott, and Sheraton are examples of first-tier management companies. Second-tier management companies also operate lodging facilities for third parties and provide day-to-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, American General Hospitality, Richfield Hospitality, and Hospitality Equity Investors.

### [2] Pre-Opening and Technical Services

In addition to daily operations, management companies also frequently contract to provide pre-opening services and technical services. Pre-opening services are provided by the management company before the opening of a facility to the public. Typical services include a pre-opening plan and budget, personnel recruiting and training, sales and advertising, purchasing, and establishing an account system and controls. Pre-opening 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 pre-opening services, fees for technical services are generally separate from and in addition to fees charged for management supervision.

## » 19.06 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 agree-

ment, both parties should understand each other's motivations for entering into a management contract.

## [1] Advantages for Operator

### [a] Inexpensive, Rapid Expansion

Because management contracts typically require very little in the way of capital outlay on the part of the operator, 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. As mentioned previously, management companies may also extend guarantees to ownership, but are typically paid a higher incentive fee if this is the case. The management fee set by the contract is generally structured so that 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. The lead time involved with developing 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 typical 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 that of 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. The typical range of critical mass for a first-tier company is forty to fifty hotels under contract; for second-tier companies, the range is usually ten to fifteen 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. Consequently, 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, Four Seasons, and Motel 6, follow a general 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 public 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 the 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.

## [2] Disadvantages for Operators

### [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 early 1990s, many second-tier hotel companies provided short-term management contracts to lending institutions 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.

### [b] Minimal input in Ownership Decisions

Most management agreements apply minimal restrictions on the owner's ability to transfer ownership to another party. An undercapitalized 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 pro-

viding 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 as a result of 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, typically upon a sale, that allow owners to terminate the agreement upon payment of a stipulated cancellation fee. The disruption in management deployment and public identity, however, 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

A management contract with a first-tier management company immediately gives the owner's hotel a national or regional identification. This recognition is achievable only through a second-tier management company if coupled with a franchise affiliation.

#### [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. As a result, 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 sufficient income remains 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 prematurely or without a sale. First-tier management companies, concerned about adverse publicity from losing their identification within a particular market generally require a non-cancelable contract that exceeds ten years in length, in addition to one or more extension clauses. Second-tier operators 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 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.

### [d] Sale of Property

The sale of a hotel property is often much more difficult if it must be sold subject to an existing management contract. Hotel companies rarely purchase hotels operated by other companies; therefore, an ongoing non-cancelable contract reduces the number of possible buyers and consequently increases the time required to find a qualified buyer. For this reason, the sale of a hotel with management in place often brings a lower price than if the property were 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 20 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. If the occupancy level is low, 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 additional 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.

### [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. Because a hotel company generally receives a greater economic benefit from sending guests to its owned hotels rather than to properties it manages, the possibility for unfair practices is always present. Owners should be aware of this basic conflict and be sure that management agreements include provisions restricting possible abuse.

## » 19.07 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 identifi-

able name (e.g., Hilton, Sheraton, or Marriott) and management expertise. A second-tier management company has no "brand-name" image and therefore can offer only 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.

### [b] Corporate Identity

First-tier companies have a strong interest in running successful operations. Consequently, some chain affiliations, as previously noted, are available only by 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 is so specialized, only a few hotel chains (e.g., Marriott, Sheraton, Hilton, and Hyatt) have made this infrastructure investment 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 200 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 effect 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 is typically longer than that for a company in the second tier. Most first-tier companies require contract terms of at least ten years. Because a first-tier operator is actually granting a license for the use of its name, 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. Because early contract termination generates adverse publicity for the operator, management companies are reluctant to provide the property owner with any form of termination provision that might end a contract early. During the past several years, the use of performance termination standards has become more common 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.

### [e] Less Flexibility in Negotiations

First-tier hotel companies typically 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.

### [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 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 opera-

tors, 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 generally pass up opportunities involving distressed hotels or those properties for which 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 off 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.

### [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. Consequently, the resulting compensation is often not commensurate with the benefits provided.

### [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 pre-opening services; initial inventories 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.

## » 19.08 MANAGEMENT COMPANY OPERATINO 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 such topics 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 thirty 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 its 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.

## » 19.09 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 should 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
- 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—for example:

- 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
- Pre-opening services
- Technical services
- Auditing
- Market demand studies

## » 19.10 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 the following:

- 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 must be identified, 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 serves 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 class, luxury). The market position best suited for the subject property's particular location and the correct class for the subject property can be established on the basis of 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 the 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 a better project.

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 (i.e., 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] Issues During Management Company Selection

### [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.

### [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. 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.

### [c] Qualifications of Key Personnel

A hotel management company is, of course, no better than the actual staff that provides management services. 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.

### [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 costs of some central services, such as reservation systems, are charged back to the individual properties within the chain on a pro-rata formula basis.

## [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. 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. 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.

## [g] Operating Projections

The preparation of a ten-year projection of income and expense (including management fee) for the subject property should be considered. The purpose of this 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 ten-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; consequently, 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, that operator might appear to be a favorable choice compared with other management companies. If the owner ties the performance cancellation clause to this set of optimistic projections, however, 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.

## [h] Miscellaneous Information

The following miscellaneous information should be considered:

- List of references from the management company
- Audited financial statements and projected budgets

- 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

## [7] Selection Rating System

Exhibit 19-12 contains a system made up of a series of questions whose answers consist of responses 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.

**Exhibit 19-12 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 |

**Exhibit 19-12 (cont.)**

| 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 |

**Exhibit 19-12 (cont.)**

| Characteristic | Score |
|---|---|
| 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 |
| 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 |
| **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. (The listing of bargaining power factors is based on material presented in *The Negotiation and Administration of Hotel and Restaurant Management Contracts,* by James J. Eyster (School of Hotel Administration, Cornell University, 1988), p. 21,730.)

**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—for example, short operating terms or 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—for example, 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 Air in Los Angeles; and 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 that 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 the 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] Issues During Negotiation

Prior to actually presenting an opening offer, both the owner and the 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 fourteen major terms that form the basis of the agreement and are primary issues in the negotiations. The following list describes these fourteen major terms and the basic objective of the owner and operator in negotiations concerning them. These management contract provisions were identified in James Eyster's *Negotiation and Administration of Hotel and Restaurant Management Contracts* (p. 35,736) as the provisions most likely to generate concerns for owners and operators and to be the focus of contract negotiations.

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 cannot 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.

HVS

# CHAPTER 20

# Hotel Management Contracts and Related Documents


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## » 20.01 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. 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. The author wishes to acknowledge the research and findings of management contracts contained in James Eyster's *Negotiation and Administration of Hotel and Restaurant Management Contracts,* p. 41,779.

## » 20.02 CONTRACT TERM

The term of a management contract is the length of time for which 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 while allowing 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 incom-

petent operator along with buying out the contract for a reasonable price, then the length of the contract term becomes less important.

First-tier hotel companies generally insist on long initial contract terms because of the high start-up costs associated with such agreements. Therefore, contracts with first-tier operators usually run for an initial term of between ten and fifteen 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 three and ten 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.

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 the 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,

## » 20.03 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 gross revenue, creating an incentive for the operator to in-

crease 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 at which 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 Exhibit 20-1, The format shown here is standard for such income statements.

Assume that the hotel will be operated by a first-tier management company and the owner believes that 5 percent of total annual revenue, or $781,000, is fair compensation for the services and chain identity of the management company. The owner is willing to pay 3 percent of total revenue ($469,000) as a basic fee, but wants the remaining portion of the total fee ($312,000) 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 Exhibit 20-1: 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.")

Exhibit 20-2 gives the percentages of standard line items that are needed to yield the required additional management fee of $322,000.

If the incentive fee is calculated as a percentage of Income Before Fixed Charges, it would have to be 6.2 percent of the line item in order to yield the required $312,000. If the calculation is made using Income After Debt Service, the necessary percentage would be 17.8 percent.

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 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 overbuilt 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, for which a period of occupancy build-up and initial operating losses are expected.

**Exhibit 20-1 Hotel Income Statement**

Number of Rooms: 300 | Stabilized Occupancy: 73% | Average Rate: $113.14

| | ($000) | Percentage of Total Revenue |
|---|---|---|
| **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 | 15,693 | 100.0 |
| **Departmental Expenses** | | |
| Rooms | 1,908 | 21.1* |
| Food and Beverages | 4,685 | 77.5* |
| Telephone | 348 | 101.2* |
| Other Income | 157 | 60.3* |
| Total | 7,098 | 45.2 |
| Departmental Income | 8,598 | 54.8 |
| **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 | 3,931 | 25.0 |
| Income Before Fixed Charges | 4,664 | 29.8 |
| **Fixed Charges** | | |
| Property Taxes | 405 | 2.6 |
| Insurance | 135 | 0.9 |
| Reserve for Replacement | 392 | 2.5 |
| Total | 932 | 6.0 |
| Income Before Debt Service | 3,732 | 23.8 |
| Debt Service | 2,415 | 15.4 |
| Income After Debt Service | $1,317 | 8.4 |

*Percentage of departmental revenue

**Exhibit 20-2 Percentages Required to Yield Management Fee**

| Line Hem | Required Management Fee | Line Item amount | Required percentage |
|---|---|---|---|
| Income before fixed charges | $312,000 | $5,064,000 | 6.2% |
| Income before debt service | $312,000 | $3,910,000 | 8.0% |
| Income after debt service | $312,000 | $1,752,000 | 17.8% |

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 gross revenue, the operating expenses to the management company generally range from 1 percent to 2 percent. A basic fee of 3 percent of total revenue will cover all of the operator's costs and leave an adequate 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.

## » 20.04 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 knowl-edgeable 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 (Hotel Association of New York City, Inc., *Uniform System of Accounts for Hotels* (8th ed.) HANYC, Inc. (1986)) which is a standard chart of accounts detail-

ing 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 statistics pertaining to the operating expense account entitled "Administrative and General," as shown in Exhibit 20-3.

**Exhibit 20-3 Comparing Operating Statistics of Two Properties**

| | Administrative & General | |
|---|---|---|
| **Unit of Comparison** | **Hotel *A*** | **Hotel *B*** |
| Dollars per available room | $2,659 | $2,915 |
| Dollars per occupied room | $10.01 | $9.45 |
| Percent of total revenue | 9.2% | 8.3% |
| Percent of rooms revenue | 20.7% | 14.1% |

On the basis of 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. These are described in the following paragraphs.

*Daily reports.* These reports should provide information regarding revenues and occupancy and should include details of all authorized complimentary rooms.

*Monthly reports.* These 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 sheet, identification of sources and uses of funds, details of capital expenditures, and a Manager's summary and overview of operations.

*Annual reports.* These 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.* These 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. Financial reports must be prepared on a timely basis to be of the greatest value to the owner and operator.

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, be a problem for 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, reason exists 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.

## » 20.05 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 has no input in the budgeting process or, at the other extreme, has the opportunity to exert a great deal of control over the operation through a strict review. Generally, the owner has some power to approve the budget.

Under normal circumstances, a management company submits 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 twelve 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 Expenses

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:

1. 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.
2. 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.
3. An overview of long-term marketing strategy for the next three to five years.
4. A description of the marketing program for the next twelve 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 twelve months. The leasing report describes the status of any leased space on the property for which tenant leases will expire during the next twelve 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.

## » 20.06 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 sixty to ninety 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 time at which 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 of 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 approve either 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 (thirty to sixty 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 because all decisions are final, 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 because an arbitration hearing does not require legal representation or extensive preparation, it is much less expensive than litigation.

The only occasional disadvantage to an arbitration proceeding is that it can take fifteen to thirty 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 fifteen years of experience).
- Time limits on the process (e.g., five days to select an arbitrator, five days to hear the case, and three 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 at 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), thereby accomplishing the same upgrade, 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 seldom, however, allow owners to have such power over annual plans. Occasionally, first-tier companies 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 has been approved, the management company must operate within its budgetary limits. However, 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., $20,000) can be used in place of a percentage, but such an amount must be regularly revised to account for inflation.

## » 20.07 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 previously outlined. 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.

## » 20.08 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 such 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 should 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, because 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 ten to twenty days of the breach; the party then has thirty to forty-five 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's 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 the 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 following 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 eighteen 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 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 is a declining economy or overbuilt market, make 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 are inappropriate and unnecessary. The owner generally counters with provisions that permit swift operator removal for any deficiency in performance. The final contract, which reflects 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 management company selection process. Owners assume that if the management company was attempting to sell its services on the basis of such projections, 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.* These serve as a basis for negotiation.
- *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.
- *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, for example, states 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 ter-

mination, 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 twelve-month period. This calculation equates to a 25 percent to 50 percent discount rate, which is generally appropriate for gross rather than net income to the management company.

## [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 off Operator Activity in the Hotel Business

Because some management contracts extend for long periods of time, 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 concerns 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.

## » 20.09 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 in which cash flow is insufficient to cover debt service. If this portion accrues at interest and is ultimately repaid some time in the future, 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. Occa-

sionally, fee structures are negotiated that stipulate than 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.

*Pre-opening services.* Owners are often able to negotiate reduced charges for the pre-opening services of operators in the case of a new hotel. The typical range of these costs is shown in Exhibit 20-4.

**Exhibit 20-4 Costs for Pre-Opening Services**

| Class of Hotel | Amount per Room |
|---|---|
| Luxury | $4,100 to $6,400 |
| Standard | $2,500 to $4,800 |
| Economy | $1,600 to $2,300 |

- *Working capital.* All hotels require working capital to purchase inventories and operating supplies and to fund other types of start-up costs. The typical range of these costs is shown in Exhibit 20-5.

**Exhibit 20-5 Working Capital Costs**

| Class of Hotel | Amount per Room |
|---|---|
| Luxury | $2,900 to $4,000 |
| Standard | $1,900 to $3,100 |
| Economy | $1,300 to $1,800 |

- *Furniture, fixtures, and equipment (FF&E).* If required, this outlay can represent a significant investment on the part of the operator. FF&E costs typically range as shown in Exhibit 20-6.

**Exhibit 20-6 Furniture, Fixtures, and Equipment (FF&E) Costs**

| Class of Hotel | Amount per Room |
|---|---|
| Luxury | $14,800 to $32,300 |
| Standard | $10,400 to $18,300 |
| Economy | $5,400 to $9,900 |

- *Outright payment of key money.* In some highly desirable hotel markets (e.g., 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 previously), with the expectation of receiving a return pan 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-on 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, 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.

## » 20.10 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 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 bene-

fit 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 pre-established by the management company and are 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,

## » 20.11 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 the 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 toward 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 forty-five to ninety days, but in most instances, the remaining party is permitted sixty 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.

## » 20.12 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 re-constructed. 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 provisions, the sharing of insurance or condemnation proceeds is usually not justified unless the insur-

ance 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.

## » 20.13 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.

## » 20.14 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 shortfall 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 6 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 FP&E is in new condition. If this approach is used, it is likely that there will not be sufficient capital in the fund when shortlife 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. Exhibit 20-7 shows the typical useful lives of various FF&E components.

**Exhibit 20-7 Useful Lives of FF&E Components**

| Item | Years of Useful Life |
|---|---|
| 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 the exhibit 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.

## » 20.15 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 market 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 spillover 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.

## » 20.16 INDEMNIFICATION

Most hotel management contracts contain clauses that indemnify each party from various liabilities and losses. Owners and operators face different risks in their respec-

tive 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.

## » 20.17 PRE-OPENING MANAGEMENT SERVICES

Since most hotel management agreements are structured primarily for operating lodging facilities, hotel companies that are taking over a newly-constructed hotel generally draw up an additional contract to cover pre-opening management services. The period known as the pre-opening 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 pre-opening 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 pre-opening period include:

- *Pre-opening 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.

Compensation for pre-opening services can be structured in various ways. It is difficult to define a typical pre-opening fee, because many operators are willing to provide these services at or near their cost in order to obtain a long-term management contract; consequently, 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 pre-opening services.

- *Amount per room:* A schedule of pre-opening 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 pre-opening 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 pre-opening cost overruns.
- *Actual costs:* A provision that the operator will be reimbursed for all expenses incurred during the pre-opening 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.

## » 20.18 TECHNICAL SERVICE ASSISTANCE

One of the additional services provided by some hotel management companies prior to and during the pre-opening phase of a hotel development is called technical ser-

vice 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 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 such assistance are not attempting to take over the development responsibilities of creating a hotel; they are merely another consultant providing overall project review, critique, recommendations, and approval. Compensation for technical service assistance is generally a negotiated flat fee paid in stages over the development phase.

These services are usually considered separate and distinct from the pre-opening services because they require a specialized level of expertise.

The hotel owner should exercise particular care when entering into a technical service agreement with a hotel management company. The in-house capabilities of the operator must be carefully evaluated in order to be sure that the technical services will be performed by knowledgeable experts. The operator must also have a sufficient number of personnel providing these services so that critiques, recommendations, inspections, and approvals can be made on a timely basis. Some hotel companies overextend themselves in the development area, thereby causing costly delays. Owners should also realize that hotel management companies are primarily interested in obtaining long-term management agreements and will at times consider pre-opening and technical services a loss leader or giveaway in order to secure the contract.

**Exhibit 20-8 Hotel Management Contract**

Agreement made _____ *[Date],* between the owner of _____ *[name of hotel or motel],* of_____ *[address],* _____ *[city],* _______ County, _____ *[state],* referred to as owner, and _____ *[hotel management company],* a corporation organized under the laws of _____ *[state],* having its principal office at _____ *[address],* _____ *[city],* _______ County, _____ *[state],* referred to as manager.

## RECITALS

1. Owner owns the _____ *[hotel or motel]* and parking lot situated at _____ *[address],* _____ *[city],* _____ County, _____ *[state],* referred to as _____ *[hotel or motel},* together with all furniture, fixtures, machinery, appliances, operating equipment, books, records, and other personal property used in the operation of the _____ *[hotel or motel}.*

2. Owner desires the benefit of the experience and the services of manager on the terms set forth in this agreement, and manager is willing to accept employment on the terms set forth in this agreement.

For the reasons set forth above and in consideration of the promises of the parties, the parties agree as follows:

## SECTION ONE

## TERM OF AGREEMENT

The term of this agreement shall extend from _____ *[Date},* to _____ *[Date}.*

## SECTION TWO

## TERMINATION OF AGREEMENT

This agreement may be canceled at any time by mutual agreement of owner and manager, and this agreement may also be terminated by owner in accordance with the provisions set forth below.

## SECTION THREE

## ACCEPTANCE OF EMPLOYMENT

Owner employs manager to operate _____ *[hotel or motel}* and render the services stated in this agreement, and manager accepts such employment and shall discharge such duties all in accordance with the terms set forth in this agreement.

## SECTION FOUR

## SERVICES OF MANAGER

Manager shall be the exclusive manager of _____ *[hotel or motel},* and manager shall provide owner with the services customarily provided for in such instances, including the following:

*a.* Accounting. Manager shall keep all accounts and supervise all audits and bookkeeping and submit monthly statements to owner showing the details of

_____ *[hotel's or motel's]* operations. All records shall be open to the inspection of owner or owner's agents, counsel, or auditors at all reasonable hours.

*b.* Buying. Manager shall make available to _____ *[hotel or motel}* its buying power, without profit on any purchase which may be made.

c. Referrals and advertising. Manager shall exert reasonable efforts to direct patronage from other hotels and motels that it manages to owner's _____ *[hotel or motel],* and will follow a program of displaying advertising of hotels or motels it manages, including owner's _____ *[hotel or motel],* in the lobbies or public rooms of other hotels and motels it manages.

*d.* Resident manager. Manager will appoint a capable resident manager and necessary department heads, deemed capable of maintaining and operating owner's property as a first-class hotel or motel. If a resident manager shall not prove to be satisfactory to owner, owner may in writing request manager to discharge a resident manager, setting forth the reasons for the action. If the grounds of the removal set forth by owner shall be sufficient to constitute a violation of the terms of this agreement, a resident manager shall be discharged by manager. If manager does not consider the validity of the objections to be sufficient, then the dispute shall be submitted to arbitration, as provided for in Section Sixteen.

## SECTION FIVE

## BONDING OF EMPLOYEES

Manager shall maintain adequate fidelity bonds on employees engaged in the operation of _____ *[hotel or motel},* the premiums for which shall be charged as operating costs.

## SECTION SIX

## INSURANCE

Subject to the approval of owner, manager shall secure all insurance policies necessary to the proper maintenance and preservation of _____ *[hotel or motel}.* The proceeds of all insurance policies shall be payable to owner. And in the event of an insurance payment for casualties suffered from fire or other cause, owner shall have the sole right to determine how the proceeds shall be reinvested in _____ *[hotel or motel}.*

## SECTION SEVEN

## DEPOSIT OF FUNDS

All funds derived from the operation of _____ *[hotel or motel]* shall be deposited by manager in _____ *[bank].* The funds shall be expended by manager on the operation of _____ *[hotel or motel]* and on the payment of taxes, insurance, and workmen's compensation and liability premiums. Any excess funds are to be duly accounted for _____ *[quarterly]* to owner in accordance with the provisions of this agreement.

On or before the _____ day of each month, manager shall deposit in _____ *[bank]* to the joint accounts of both parties, a sum of money equal to one-twelfth of the ad valorem taxes assessed against _____ *[hotel or motel}* ______ *[if appropriate, add: and one-twelfth of the interest and principal due on the _____ (mortgage or deed of trust) for the current year}.* The funds so deposited shall be used to pay the taxes as they mature _____ *[if appropriate, add:*

*and to pay the current interest and principal requirements on the _______ (hotel or motel) _______ (mortgage or deed of trust)].*

If required by owner, manager shall furnish an adequate fidelity bond not in excess of _____ Dollars ($_____) requiring manager to _____ *[quarterly]* account for such revenues in accordance with the provisions of this agreement. The premiums for the bond shall be paid by owner.

**SECTION EIGHT**

**CONTROL OF EMPLOYEES**

Manager shall have full power and authority to take all actions to bring about an efficient operation of _____ *[hotel or motel]* and to maintain it as a first-class _____ *[hotel or motel],* except for actions specifically prohibited in this agreement. Manager shall have exclusive authority to hire and discharge all employees necessary for the operation of _____ *[hotel or mote!}* and to fix their compensation, to approve allowances for rooms, food, and privileges to officers and employees of owner and manager. But manager shall not enter into any labor agreement without the express written consent of owner.

**SECTION NINE**

**LIABILITY FOR LOSSES**

All expenses or damages incurred in the operations of _____ *[hotel or motel]* shall be paid by manager from the funds which may be derived from the operation of _____ *[hotel or motel].* Manager shall be liable only for the loss or damage sustained by reason of the dishonesty or the willful gross negligence on the part of its officers.

**SECTION TEN**

**CIVIC DUTIES OF MANAGER**

It is understood and agreed between owner and manager that manager shall discharge its civic duties to the citizenship of _____ *[city]* with reference to those activities which it is generally considered must be carried out for the general benefit of the community, such as, reasonable contributions to the local Chamber of Commerce, _____ *[charitable organization],* and other civic organizations. It is considered to be to the best interest of both parties that _____ *[hotel or motel]* shall constitute an integral part of the civic and commercial activities of _____ *[city],* Contributions must first be approved by owner and shall be treated as an expense of operation to _____ *[hotel or motel}.*

**SECTION ELEVEN**

**MANAGER'S COMPENSATION**

As compensation for services to be rendered in accordance with this agreement, manager shall receive a fixed annual management fee of _____ Dollars ($_____) payable in equal monthly installments. Manager shall also receive a portion of the net cash receipts derived from the operation of _____ *[hotel or motel]* as set forth in this agreement. The portion of the net cash receipts to be paid to manager in addition to the fixed annual management fee shall be the following percentages of excess receipts above the cost of operation, taxes, insurance, interest and principal requirements, as set forth:

*a.* _____ Percent (_____%) of the first _____ Dollars ($_____) or any portion thereof;

*b.* If such excess receipts shall exceed _____ Dollars ($_____), then manager shall receive _____ percent (_____%) of the next _____ Dollars ($_____); and

c. If such excess receipts shall exceed _____ Dollars ($_____), then manager shall receive _____ per cent (_____%) of all the excess receipts above _____ Dollars ($_____).

The term "excess receipts," as used above, is defined to mean all sums received in the operation of_____ *[hotel or motel}* after payment of: *(1)* all operating expenses, including cost of maintenance, repairs and replacements of operating equipment and fixed annual management fee, (2) ad valorem taxes assessed in respect of _____ *[hotel or motel],* and *(3)* premiums on insurance, worker's compensation and liability policies and fidelity bonds.

## SECTION TWELVE

## MAINTENANCE OF OPERATING EQUIPMENT

_____ *[Hotel or Motel]* property and all furniture, fixtures, machinery, appliances, operating equipment, and all personal property used in the operation of _____ *[hotel or motel}* shall be maintained in first-class repair, and in such condition that the equipment shall be satisfactory for the operation of a first-class _____ *[hotel or motel}*. Manager may expend from the funds derived from the operation of _____ *[hotel or motel}* an amount adequate for these purposes.

## SECTION THIRTEEN

## ACCOUNTING PERIOD

The net cash receipts derived from the operation of _____ *[hotel or motel}* shall be determined at the termination of annual periods, the first to be the period beginning _____ *[Date},* and terminating _____ *[Date}*. Subsequent annual periods shall begin on the first day of _____ *[month}* thereafter and terminate on the _____ day of _____ *[month}*. The periods shall be referred to as "accounting periods." Promptly on the expiration of each accounting period, or as soon as may be practicable, manager shall cause to be prepared an accurate statement of all transactions relating to the operation of _____ *[hotel or motel}* for the preceding accounting period, and submit the statement to owner. On the determination of the amount of excess receipts, settlement shall promptly be made between owner and manager. Any compensation paid to the directors, officers, or employees of owner shall not be included in operating expenses as that term is used in this agreement, but this provision shall not prevent owner from including the expenses for purposes of income tax returns.

## SECTION FOURTEEN

## TERMINATION

This management contract shall be subject to termination by the owner in the event manager shall violate any one or more of the terms of this contract, which violation shall result in inefficient management or other conditions detrimental to the operation of _____ *[hotel or motel}* as a first-class _____ *[hotel or motel}*. If owner deems that manager has violated the terms of this contract or that this contract

is subject to termination for any reason stated in this contract, it shall give manager written notice, specifying the manner in which this contract has been violated and granting manager _____ days within which to comply with the objection or objections. If manager shall fail or refuse to comply with any valid objection so made within _____ days from receipt of the written notice, owner may terminate this contract. Any notice shall be delivered to the president or vice-president of manager and may be delivered in person or by registered mail, addressed to such address as may be furnished by manager.

**SECTION FIFTEEN**

**ARBITRATION**

In case of dispute as to the validity of any cause for termination of this agreement, the removal of resident manager, or the interpretation of any provision of this agreement, the dispute shall be settled by arbitration. Owner shall appoint one arbitrator, manager shall appoint another arbitrator, and the two arbitrators so appointed shall appoint a third impartial and disinterested arbitrator/The decision of the majority of the arbitrators shall in the absence of fraud or concealment be binding on both parties.

**SECTION SIXTEEN**

**TERMINATION UPON INSUFFICIENT REVENUE**

If the revenues derived from the operation of _____ *[hotel or motel]* shall be insufficient to pay and discharge all items of expense, interest, and principal requirements specified in subdivisions 1 to 4 in Section Twelve, this agreement may be terminated by owner unless manager advances the necessary funds to meet the expenses. Should manager advance any funds necessary for this purpose, manager shall be reimbursed for the advances out of future receipts derived from the operation of _____ *[hotel or motel]* before excess receipts are divided between owner and manager.

**SECTION SEVENTEEN**

**RESTRICTIVE COVENANT**

Manager shall not have any interest in any other _____ *[hotel or motel]* within the radius of _____ miles of _____ *[hotel or motel]* during the term of this agreement.

**SECTION EIGHTEEN**

**ASSIGNMENT**

Manager may not assign this agreement or any of the rights and duties expressed in this agreement. Owner shall have the right to assign this agreement only on the sale of _____ *[hotel or motel]* to a third party.

The parties have executed this agreement at _____ *[designate place of execution]* on _____ *[Date]*.

*[Signatures]*

*[Acknowledgments]*

HVS

# CHAPTER 21

# Hotel Development


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## » 21.01 INTRODUCTION

The hotel development process is multi-dimensional and is driven by market dynamics (demand characteristics and potential performance), land and development costs, and selection of the appropriate type of facility and brand under which the hotel will operate. No one aspect of development can be considered without regard to the others.

Each phase of the process will be identified and discussed in this chapter. Exhibit 21-1 delineates the process in sequential stages.

**Exhibit 21-1 Developing a Time-Line for a 200-Room Commercial Hotel**

| Months From Opening | Event |
|---|---|
| 17 | Perform a market analysis and select a market suited for hotel development |
| 16 | Narrow focus to a particular site |
| 16 | Determine best type of hotel product for specific site |
| 15 | Prepare preliminary economic market study and appraisal |
| 15 | Negotiate the price and terms for acquiring site. Tie up site with as many contin-gencies as possible |
| 14 | Start zoning approval process and verify availability of all necessary licenses and permits |
| 14 | Line up architect and work on preliminary layout and concepts |
| 14 | Line up franchise affiliation |
| 14 | Line up hotel management company |
| 13 | Start preparing working architectural plans and specifications |
| 13 | Start lining up debt and equity financing |
| 11 | Start pro-selling efforts |
| 11 | Line up development team and request construction bids |
| 10 | Start construction |
| 5 | Start pre-opening functions |
| 0 | Open hotel |

## » 21.02 LOCATION STRATEGIES

### [1] Where To Develop

Fundamental to hotel development is a complete and comprehensive understanding of the site location process. Like retail siting, lodging is a location-driven business. Hotel siting consists of (1) identifying appropriate market(s) for property development, analyzing demand generators within each market to select trade areas that will optimize occupancy potential; and (2) selecting a specific location affording the greatest possible visibility and accessibility for potential guests. Brand selection and positioning of product relative to industry segmentation have a direct bearing on location strategies.

The location paradigm for proper lodging site selection is directly dependent on "lodging demand generators" located within a one- to three-mile radius of a proposed facility. Excepting those who stop mid-trip for a break in a journey, commercial and leisure travelers typically have a reason for traveling to, and the need for lodging accommodations in, a given area. Major commercial centers, universities, retail complexes, hospitals, airports, and resort/tourist destinations are some but not all of the room right generators.

In siting it is important to look not only to an existing room base, but also, particularly in emerging growth markets, for those businesses, facilities, or other factors that will draw travelers into the market and result in demand for hotel rooms. Industry feasibility experts possess the analytical tools and data bases to assess potential demand based upon product type within a given trade area. An assessment of market potential will test site suitability for demand level, estimated change in demand and the resultant impact of that change on rate and occupancy, and special project location characteristics.

With the site identified and the demand generators validated and quantified into achievable property performance, the developer must not forget visibility and acceptability. Will the facility and its signage be clearly visible from a major traffic arterial? How accessible will the property be from the road on which it is located? Many hotel siting authorities believe that if the hotel can be seen, the traveler will "find the way."

## [2] Segment and Brand

Segment and brand are important factors for the developer for at least three reasons. First, segment differentiates on price. As land prices increase, economic justification of a project may require higher achievable room rates. Second, the higher the brand penetration in a given geographical area, the greater the probability that that brand will maximize operating revenues. Third, consumer acceptance of the brand and segment selection must be viewed in light of the targeted guest base. While certain mid-priced or economy brands are generally well accepted, the target customer for a specified location may require a full-service facility to meet guest expectations and amenity requirements.

## [3] The Financial Factors

With full deference to the maxim that hotel development is a location-driven endeavor, the ability of a proposed project to meet economic feasibility requirements is fundamental to its viability. When assessing room demand, the developer must consider the following:

- The realistically achievable rate and occupancy possible for the type of lodging facility proposed
- The relative competition
- Trends within the trade area selected
- Future changes in conditions within the market that can positively or negatively affect projected performance

Consider the early-to-mid 1980s, when conditions favored hotel development. Advantageous tax laws, aggressive lending practices and a prevailing view that performance measures would stay favorable forever led to a massive building boom in all tiers of the industry. Excess profits led to ruinous competition. No matter how many rooms at a given intersection, there was always room for 100 more. The building frenzy stopped only after the collapse of the real estate markets, chaos within the savings and loan industry, and a severe recession. Developers paid no heed to demand factors associated with supply.

As the lodging industry has matured, developers have been forced to confront the realities of price competitiveness, branding, existing supply and its condition, and trend factors.

An integral part of the equation is the proposed total project capital cost. The site may satisfy all of the visibility and accessibility factors but be priced in excess of permissible levels to support the project. Alternatively, site preparation expenses or building design modifications for site adaptation may be cost-prohibitive given achievable performance levels.

In assessing the economic feasibility of a project, the developer must acknowledge the interrelationship of a multitude of variables, including the following.

- Project cost estimate, which includes:
  - —Land
  - —Site preparation
  - —Construction
  - —Furniture and equipment
  - —Professional fees
  - —Development fee
  - —Transaction and loan fees
- Projected performance, including:
  - —Achievable rate
  - —Achievable occupancy
  - —Expense factors

No simple means of assessment exists to allow for the proper analysis of both the cost components and performance expectations. However, if the highest and best use of a site is lodging, then the factors to support that decision will be a function of capital expenses to achievable revenue.

Developers evaluate hotel performance in a number of ways. Some of the more common approaches include evaluating cash on cash returns after ramp-up and stabilization or internal rates of return assuming a sale at the end of the tenth full year of operations. Discounted cash flow analyses are also used, but more to rank the viability of and prioritize multiple projects.

For the entrepreneur or hotel franchisee company, the ability to assess market demand and demographics and match those factors to an appropriate product type and brand is important. Land and site preparation costs are the most important variable to control.

## » 21.03 TIME STRATEGIES

In the world of sports, it is a disciplined rule that being first also means being best; in the competitive world of business, this rule often rings true as well. So, when it comes to hotel development, should we not also strive to be first? Not when being first may mean losing the game. In the game of hotels and hotel development, sometimes the winner is second, third or even fourth.

As the financing spigot for hotel construction remains wide open, the industry is witnessing development levels unmatched since the 1980s. With the threat of overbuilding in certain markets, no developer wants his hotel to be the last to open its doors for fear of missing out on demand capture to other new hotels. However, is it better to be the first to open, only to have supply continually increase and erode all of the demand? Timing can play an essential role in the feasibility of a project.

The question of when to build is often determined by the developer, who typically has timetables set forth for the project. Very rarely does this timetable incorporate a holding period to allow for market demand increases or to await the absorption of other new supply. Rather, the developer typically specifies the earliest possible opening date, hoping to be the early bird who gets the most of the worm before there's no worm left. Many developers feel that by publicly marketing their proposed development immediately, other potential projects may be dissuaded from entering

the market. However, a new project announcement may well induce other developers to take interest in the market. It is the responsibility of the appraiser to determine the highest and best use of the subject parcel, and that consideration includes the timing of the use. If the determination of the highest and best use is hotel development, it is possible that a calculated delay in the construction of the property could return a higher present value to the land than would immediate development.

## [1] When Is the Market Strongest?

The basic premise on which delayed timing becomes viable holds that the net present value of the future returns of the proposed hotel, built immediately, is less than that of the returns based on a predetermined future construction of the hotel, less discounted holding period costs. A determination of the proper holding period of vacant land can be accomplished through an iterative calculation using variable opening dates. The Appraisal Institute's "Highest & Best Use and Market Analysis" stresses the importance of timing in determining a parcel's optimal use.

To better illustrate the impact of timing considerations, we will use the example of a 3-acre parcel of vacant land proposed for the development of 150-room all-suite hotel, A market analysis conducted in January 1997 indicated that 12 hotels existed in the market that would be competitive with the subject property, each weighted based on their assumed competitive degree to the subject. It was further determined that aside from the subject property, two other competitive hotels were anticipated to enter the market within the next year, one in February 1997 and one in April 1997. The developer indicated that the subject property could be open and operational by January 1998. Other determinations from the market analysis concluded that the market was stable, with occupancies approximately 75 percent and average rates in the low $100s, and that some unaccommodated demand existed in the commercial segment because of the substantial weight that this market segment represented. Average rate growth was currently 10 percent, but is expected to assume inflationary levels as new supply enters the market.

After assigning degrees of competitiveness to the proposed subject property based on its facilities, franchise affiliation, and market segmentation, the subject property's occupancy levels were forecasted for Scenario 1 (Exhibit 21-2), which assumes the original project timing (i.e., to be open by January 1998). The process of occupancy projection accounts for projected market changes, the entrance of other competitors to the area, and the absorption of unaccommodated demand. The results of the occupancy forecast are shown in Exhibit 21-2.

The subject property is affected in 1998 as it enters the market, primarily because of the recent opening of two other competitors in the market. Its occupancy then ramps up as increased market demand accommodates the new hotel rooms. The subject property then stabilizes at a "normalized" level in the fifth year, which reflects the anticipated results of the property during its remaining economic life, given any and all changes in the life cycle of the hotel.

A second scenario can then be envisioned whereby the developer of the subject property allows the market more time to absorb the other new supply before developing its own product (the cost of holding the land will be considered in a financial analysis presented later in this article). Assuming an opening date of January 1999, and assuming the subject property to contain the same degree of competitiveness used in Scenario 1, a new forecast of occupancy may be calculated, the results of which are shown in Exhibit 21-3.

**Exhibit 21-2 Scenario 1—Subject Property Occupancy Assuming January 1998 Opening**

*Source: HVS International*

| Year | Occupancy |
|---|---|
| 1998 | 66% |
| 1999 | 71 |
| 2000 | 76 |
| 2001 | 78 |
| Stabilized | 76 |

**Exhibit 21-3 Scenario 2—Subject Property Occupancy Assuming January 1999 Opening**

Source: *HVS International*

| Year | Occupancy |
|---|---|
| 1998 | Holding period |
| 1999 | 67% |
| 2000 | 73 |
| 2001 | 78 |
| 2002 | 80 |
| Stabilized | 76 |

**Exhibit 21-4 Scenario 3—Subject Property Occupancy Assuming January 2000 Opening**

*Source: HVS International*

| Year | Occupancy |
|---|---|
| 1998 | Holding period |
| 1999 | Holding period |
| 2000 | 69% |
| 2001 | 75 |
| 2002 | 80 |
| 2003 | 82 |
| Stabilized | 76 |

Using the same variables as in Scenario 1, Scenario 2 shows greater occupancy potential for the subject property based on its later opening date. At the time of its opening, the two other market entrants have had more time to stabilize in the market, allowing demand levels to increase slightly before the subject property opens. The subject property is then stabilized at the same occupancy as in Scenario 1, which again serves to incorporate future upward and downward fluctuations in the market. Having the subject property wait yet one more year produces predictable results for a third scenario, as shown in Exhibit 21-4.

It should be noted that the subject property is considered equally competitive relative to the market in each of the three scenarios; however, the hotel achieves greatest occupancy levels in its initial years of operation in Scenario 3 by waiting for the impact of other new competition to subside.

## [2] When to Build?

After a first glance at all three scenarios, one may infer that waiting a few years before development may be the highest and best use of the land. However, as the highest and best use is concerned with the present return of future earnings to the land, the cost of holding the land and the cost of discounting income back from later years may be greater than the additional benefits achieved by higher initial occupancy levels, To test its correctness, each scenario's occupancy forecast may be input to a forecast of income and expense. Discounting the net income and construction costs to the present allows the appraiser to calculate which scenario results in the greatest net present residual land value.

In a forecast of income and expense for the subject property, we have analyzed operating statements from similar, all-suite properties in order to determine proposed income and expense levels. The average rate for the subject property was positioned in current dollars, and then inflated according to marketwide growth projections. (Hence, each scenario will have different first-year average rate levels, but different only by inflationary factors.).

Income and expense statements can then be formed using the comparable operating statements and a fixed-and-variable model. The fixed-and-variable model was developed by HVS International and is based on the premise that hotel revenues and expenses have one component that is fixed and another that varies directly with occupancy and facility use. A projection can be made by taking a known level of revenue or expense and calculating its fixed and variable components.

This model has been used to develop a five-year forecast of income and expense based on each of the three scenarios, with the development of the property (cost outlay) occurring in Year One.

Year One represents the period subsequent to any holding period used by the scenario, and a sixth year net operating income, incorporating the same stabilized occupancy level for each scenario, is then calculated for reversionary purposes. The construction costs and cash flows are then discounted back to the present to determine the current residual land value, thus determining the highest and best use timing for the project development. The following assumptions were set forth for these models:

- Inflation for revenues, expenses, land holding costs, and construction costs is set at 3.5 percent.
- The discount rate is determined to be 13.0 percent in each scenario.
- Rooms revenue was calculated through the previous derivation of occupancy and average rate in each scenario. Income and expense levels were calculated through the fixed-and-variable process described earlier, with inflationary gains noted subsequent to the stabilized year.
- A terminal capitalization of 11.0 percent was used for reversionary calculations in Scenario 1; 25 basis points were added to this in each subsequent scenario to adjust for the inherent risk of a more distant reversionary period.

Exhibits 21-5, 21-6, and 21-7 detail each scenario's calculation of residual land value.

The residual land calculations show that the present return to the land is greatest in Scenario 2. Thus, the conclusion in this analysis is that the development of the subject property should be delayed one year, allowing the market to absorb new supply anticipated in the immediate future; however, the delay is not so long as to be affected by the increased risk inherent in long-term delays. An iteration may be done to more precisely determine appropriate development timing.

**Exhibit 21-5 Scenario 1—Immediate Development**

Source; *HVS International*

| **Year Ending:** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** |
|---|---|---|---|---|---|---|
| Total Rooms: | 0 | 150 | 150 | 150 | 150 | 150 |
| Occupied Rooms: | 0 | 36,135 | 38,872 | 41,610 | 42,705 | 41,610 |
| Days Open: | 0 | 365 | 365 | 365 | 365 | 365 |
| Occupancy: | 0.0% | 66.0% | 71.0% | 76.0% | 78.0% | 76.0% |
| Average Rate: | $0.00 | $122.61 | $126.90 | $131.34 | $135.94 | $140.69 |
| | **Total $** | **Total $** | **Total $** | **Total $** | **Total $** | **Total $** |
| **Revenue*** | | | | | | |
| Rooms | $0 | $4,431 | $4,933 | $5,465 | $5,805 | $5,854 |
| Food | 0 | 201 | 219 | 239 | 252 | 256 |
| Beverage | 0 | 40 | 44 | 48 | 50 | 51 |
| Telephone | 0 | 122 | 135 | 148 | 157 | 159 |
| Other Income | 0 | 32 | 34 | 36 | 37 | 38 |
| Total | 0 | 4,826 | 5,365 | 5,936 | 6,301 | 6,358 |
| **Departmental Expenses** | | | | | | |
| Rooms | 0 | 1,221 | 1,299 | 1,381 | 1,444 | 1,479 |
| Food and Beverage | 0 | 230 | 244 | 258 | 269 | 276 |
| Telephone | 0 | 72 | 77 | 81 | 85 | 87 |
| Total | 0 | 1,523 | 1,620 | 1,720 | 1,798 | 1,842 |
| **Departmental Income** | **0** | **3,303** | **3,745** | **4,216** | **4,503** | **4,516** |
| **Operating Expenses** | | | | | | |
| Administrative and General | 0 | 399 | 421 | 444 | 463 | 475 |
| Management Pee | 0 | 217 | 241 | 267 | 284 | 286 |
| Marketing | 0 | 192 | 202 | 213 | 223 | 229 |
| Franchise Fees | 0 | 310 | 345 | 383 | 406 | 410 |
| Property Operation and Maintenance | 0 | 214 | 251 | 265 | 276 | 283 |
| Energy | 0 | 233 | 243 | 253 | 263 | 271 |
| Total | 0 | 1,565 | 1.703 | 1,825 | 1,915 | 1,954 |
| **House Profit** | **0** | **1,738** | **2,042** | **2,391** | **2,588** | **2,562** |
| Fixed Expenses | | | | | | |
| Property Taxes | 0 | 139 | 144 | 149 | 154 | 160 |
| Insurance | 0 | 48 | 50 | 52 | 53 | 55 |
| Reserve for Replacement | 0 | 145 | 161 | 178 | 189 | 191 |
| Land Holding Costs (Taxes and Insurance) | 15 | 0 | 0 | 0 | 0 | 0 |
| Total | 15 | 332 | 355 | 379 | 396 | 406 |
| **Net Income** | **$(15)** | **$1,406** | **$1,687** | **$2,012** | **$2,192** | **$2,156** |
| **Less:** Development Costs | | | | | | |
| (excluding land) | $(13,000) | | | | | |
| **Plus:** Reversion (11.0% terminal cap) | | | | | | |
| Property Sale | | | | | $19,601 | |
| **Less:** Fees and Commissions (3.0%) | | | | | 588 | |
| Net Reversion: | | | | | $19,013 | |
| Total Property Cash Plow: | $(13,015) | $1,406 | $1,687 | $2,024 | $20,373 | |
| Present Value of Cash Flows @ 13.0%: | $(11,518) | $1,101 | $1,169 | $1,241 | $11,057 | |
| **Residual Land Value:** | $3,051 | | | | | |

*All income, expense, cash flow, and value figures are expressed in 1,000s.

**Exhibit 21-6 Scenario 2—Open in 1999**

*Source: HVS International*

| **Year Ending:** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** |
|---|---|---|---|---|---|---|---|
| Total Rooms: | 0 | 0 | 150 | 150 | 150 | 150 | 150 |
| Occupied Rooms: | 0 | 0 | 36,682 | 39,968 | 42,705 | 43,800 | 41,610 |
| Days Open: | 0 | 0 | 365 | 365 | 365 | 365 | 365 |
| Occupancy: | 0.0% | 0.0% | 67.0% | 73.0% | 78.0% | 80.0% | 76.0% |
| Average Rate: | $0.00 | $0.00 | $126.90 | $131.34 | $135.94 | $140.69 | $145.62 |
| | **Total $** | **Total $** | **Total $** | **Total $** | **Total $** | **Total $** | **Total $** |
| **Revenue*** | | | | | | | |
| Rooms | $0 | $0 | $4,655 | $5,249 | $5,805 | $6,162 | $6,059 |
| Food | 0 | 0 | 209 | 231 | 251 | 265 | 263 |
| Beverage | 0 | 0 | 42 | 46 | 50 | 53 | 53 |
| Telephone | 0 | 0 | 127 | 142 | 156 | 165 | 163 |
| Other Income | 0 | 0 | 33 | 35 | 37 | 39 | 40 |
| Total | 0 | 0 | 5,066 | 5,703 | 6,299 | 6,684 | 6,578 |
| **Departmental Expenses** | | | | | | | |
| Rooms | 0 | 0 | 1,265 | 1,352 | 1,437 | 1,503 | 1,523 |
| Food and Beverage | 0 | 0 | 238 | 253 | 268 | 280 | 284 |
| Telephone | 0 | 0 | 75 | 80 | 85 | 88 | 90 |
| Total | 0 | 0 | 1,578 | 1,685 | 1,790 | 1,187 | 1,897 |
| **Departmental Income** | **0** | **0** | **3,488** | **4,018** | **4,509** | **4,813** | **4,681** |
| **Operating Expenses** | | | | | | | |
| Administrative and | 0 | 0 | 413 | 437 | 461 | 481 | 490 |
| Management Fee | 0 | 0 | 228 | 257 | 283 | 301 | 296 |
| Marketing | 0 | 0 | 198 | 210 | 222 | 231 | 236 |
| Franchise Fees | 0 | 0 | 326 | 367 | 406 | 431 | 424 |
| Property Operation and Maintenance | 0 | 0 | 246 | 261 | 275 | 287 | 292 |
| Energy | 0 | 0 | 241 | 251 | 262 | 271 | 280 |
| Total | 0 | 0 | 1,652 | 1,783 | 1,909 | 2,002 | 2,018 |
| **House Profit** | **0** | **0** | **1,836** | **2,235** | **2,600** | **2,811** | **2,663** |
| **Fixed Expenses** | | | | | | | |
| Property Taxes | 0 | 0 | 143 | 148 | 154 | 159 | 165 |
| Insurance | 0 | 0 | 50 | 51 | 53 | 55 | 57 |
| Reserve for Replacement | 0 | 0 | 152 | 171 | 189 | 201 | 197 |
| Land Holding Costs (Taxes and Insurance) | 15 | 16 | 0 | 0 | 0 | 0 | 0 |
| Total | 15 | 16 | 345 | 370 | 396 | 415 | 419 |
| **Net Income** | **$(15)** | **$(16)** | **$1,491** | **$1,865** | **$2,204** | **$2,396** | **$2,244** |
| **Less:** Development Costs (excluding land) | | | $(13,455) | | | | |
| **Plus:** Reversion (11.25% terminal cap) | | | | | | | |
| Property Sale | | | | | | $19,949 | |
| **Less:** Fees and Commissions (3.0%) | | | | | | 598 | |
| Net Reversion: | | | | | | $19,350 | |
| Total Property Cash Flow: | $(15) | $(13,471) | $1,491 | $1,865 | $2,204 | $21,746 | |
| Present Value of Cash Flows @ 13.0%; | $(13) | $(10,549) | $1,033 | $1,144 | $1,196 | $10,445 | |
| **Residual Land Value:** | $3,256 | | | | | | |

*All income, expense, cash flow, and value figures are expressed in 1,000s.

**Exhibit 21-7 Scenario 3—Open In 2000**

*Source: HVS International*

| **Year Ending:** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | **2004** |
|---|---|---|---|---|---|---|---|---|
| Total Rooms: | 0 | 0 | 0 | 150 | 150 | 150 | 150 | 150 |
| Occupied Rooms: | 0 | 0 | 0 | 37,778 | 41,062 | 43,800 | 44,895 | 41,610 |
| Days Open: | 0 | 0 | 0 | 365 | 365 | 365 | 365 | 365 |
| Occupancy: | 0.0% | 0.0% | 0.0% | 69.0% | 75.0% | 80.0% | 82.0% | 76.0% |
| Average Rate: | $0.00 | $0.00 | $0.00 | $131.34 | $135.94 | $140.69 | $145.62 | $150.7 |
| Total $ | | Total$ | Total $ | Total $ | Total $ | Total $ | Total $ | Total $ |
| **Revenue*** | | | | | | | | |
| Rooms | $0 | $0 | $0 | $4,962 | $5,582 | $6,162 | $6,537 | $6,271 |
| Food | 0 | 0 | 0 | 221 | 244 | 265 | 279 | 273 |
| Beverage | 0 | 0 | 0 | 44 | 49 | 53 | 56 | 55 |
| Telephone | 0 | 0 | 0 | 135 | 151 | 165 | 175 | 169 |
| Other Income | 0 | 0 | 0 | 35 | 37 | 39 | 40 | 41 |
| Total | 0 | 0 | 0 | 5,397 | 6,063 | 6,684 | 7,087 | 6,809 |
| Departmental Expenses | | | | | | | | |
| Rooms | 0 | 0 | 0 | 1,323 | 1,414 | 1,503 | 1,571 | 1,577 |
| Food and Beverage | 0 | 0 | 0 | 248 | 265 | 280 | 292 | 295 |
| Telephone | 0 | 0 | 0 | 78 | 84 | 88 | 92 | 93 |
| Total | 0 | 0 | 0 | 1,649 | 1,763 | 1,871 | 1,955 | 1,965 |
| **Departmental Income** | **0** | **0** | **0** | **3,748** | **4,300** | **4,813** | **5,132** | **4,844** |
| **Operating Expenses** | | | | | | | | |
| Administrative and General | 0 | 0 | 0 | 430 | 456 | 481 | 502 | 508 |
| Management Fee | 0 | 0 | 0 | 243 | 273 | 301 | 319 | 306 |
| Marketing | 0 | 0 | 0 | 207 | 219 | 231 | 241 | 244 |
| Franchise Fees | 0 | 0 | 0 | 347 | 391 | 431 | 458 | 439 |
| Property Operation and Maintenance | 0 | 0 | 0 | 257 | 272 | 287 | 299 | 303 |
| Energy | 0 | 0 | 0 | 250 | 261 | 271 | 282 | 289 |
| Total | 0 | 0 | 0 | 1,734 | 1,872 | 2,002 | 2,101 | 2,089 |
| **House Profit** | **0** | **0** | **0** | **2,014** | **2,428** | **2,811** | **3,031** | **2,755** |
| **Fixed Expenses** | | | | | | | | |
| Property Taxes | 0 | 0 | 0 | 148 | 154 | 159 | 165 | 170 |
| Insurance | 0 | 0 | 0 | 51 | 53 | 55 | 57 | 59 |
| Reserve for Replacement | 0 | 0 | 0 | 162 | 182 | 201 | 213 | 204 |
| Land Holding Costs (Taxes and Insurance) | 15 | 16 | 16 | 0 | 0 | 0 | 0 | 0 |
| Total | 15 | 16 | 16 | 361 | 389 | 415 | 435 | 433 |
| **Net Income** | **$(15)** | **$(16)** | **$(16)** | **$1,653** | **$2,039** | **$2,396** | **$2,596** | **$2,322** |
| **Less:** Development Costs (excluding land) | | | $(13,926) | | | | | |
| **Plus:** Reversion (11.5% terminal cap) | | | | | | | | |
| Property Sale | $20,194 | | | | | | | |
| **Less:** Fees and Commissions (3.0%) | | | | | | | | 606 |
| New Reversion: | $19,588 | | | | | | | |
| Total Property Cash Flow: | $(15) | $(16) | $(13,942) | $1,653 | $2,039 | $2,396 | $22,184 | |
| Present Value of Cash Flows @ 13.0%: | $(13) | $(12) | $(9,663) | $1,014 | $1,107 | $1,151 | $9,430 | |
| **Residual Land Value:** | $3,013 | | | | | | | |

•All income, expense, cash flow, and value figures are expressed in 1,000s.

## [3] Is the Future Really That Clear?

Obviously, this analysis is subject to come limitations. Some of these limitations include the following;

- The uncertainty of other possible hotel developments in future years.
- The subjectivity inherent in determining appropriate terminal capitalization rate increases. Does a 0.25 percent increase for each delayed year of opening appropriately reflect increased risk in the project?
- The degree to which other factors may be held constant in each scenario. For example, an adjustment to the subject property's average rate of growth may be warranted in one scenario and not another.
- The determination of whether or not the same discount rate is appropriate in each scenario. While some developers may feel that immediate development lowers risk because their project may dissuade other development, other developers believe that one new project actually induces others to build.

Each of these considerations in market specific and must be adequately judged by the appraiser on a case-by-case basis.

## [4] Waiting for the Economy to Change

Finally, the speed at which the subject property reaches a stabilized occupancy also affects the feasibility of the project. In this sense, general economic conditions can also dictate optimal development timing for hotels. Hotels that may have been marginally feasible for development in 1994 may have been more viable if they were developed in 1996, based solely on economic conditions prevailing in the market area. To illustrate this point, we have analyzed the first year occupancy and average rate performance for 24 Residence Inns by Marriott that have opened during the past 3 years. These figures are presented in Exhibit 21-8.

**Exhibit 21-8 First-Year Occupancy and Average Analysis**

*Source: HVS International*

| | 1994 | 1995 | 1996 |
|---|---|---|---|
| Occupancy | 68% | 77% | 82% |
| Average Rate | $63 | $82 | $86 |

The revenue per available room (RevPAR) performance of the hotels that opened in 1996 was approximately 65 percent greater than the same hotel types that opened in 1994, indicating, perhaps, that more favorable economic conditions may have warranted delayed construction for projects proposed for 1994. Although this is a simplified comparison between hotel starts, it does serve to illustrate the potential benefits inherent in delayed development.

The consideration of development timing in the hotel industry is critical in this current era of available financing. With the proliferation of new construction (particularly in the limited-service segment and in markets containing limited barriers to entry), the analysis of when to build plays an important role in the valuation process. As may have been proved in certain markets, sometimes it's better just to wait.

## » 21.04 THE DEVELOPMENT TEAM

Having carefully selected a market and a trade area within the market, and having identified a site that on a preliminary basis is determined to support the proposed project, the developer contractually commits to a site, subject to favorable due diligence. The process after site selection is divided into the Design Phase and the Construction Phase. The developer works with a number of different people in these phases, including the following.

*Architect/engineer.* Working as a team both the project architect and engineer undertake a myriad of responsibilities to determine (i) whether the site as selected will accommodate the proposed facility, (ii) the extent of governmental requirements for project approval, (iii) easements, set-back requirements and other burdens on the land affecting project lay-out and efficient utilization of the site, and (iv) any cost implication of the foregoing on the overall project. The "Design Phase" team is charged in all respects with determining land use requirements with respect to the specific project and how those requirements affect the project.

*Real estate counsel.* Working with the engineer, the attorney assists in negotiating and preparing contracts, locating easements that affect the site, and vacating or relocating those easements. Should the zoning classification affecting the proposed site not accommodate lodging, counsel can be of assistance in an initiative to rezone the property. Variances to building and zoning codes may be required, for example to reduce the requisite number of parking spaces or landscape buffers. Counsel can play an active role in those endeavors.

*Project manager.* For the inexperienced developer, a project management firm can provide valued, cost-saving advice through both the Design and Construction Phases of the project. Project management services are more prevalent in the development of larger full service hotels.

*Interior design specialist.* Depending on the size and type of project, the services of an interior design firm may be required to achieve a well coordinated "look" and "feel" for the proposed facility.

*Food service equipment consultants.* If a full-service facility or a mid-priced hotel with food service is proposed, proper planning of food service layout and equipment is vital to efficiency of operations.

In some instances, particularly when governmental restrictions require specific studies, environmental engineers or special project facilitators may be hired to assist in obtaining the necessary entitlements from governmental agencies. This is particularly true in Florida, California, and other coastal regions or other environmentally- sensitive areas of the country. Also, certain areas of the country may require impact studies relating to traffic, hospitals, schools, or other social or public improvements. Specific project management firms can be of assistance to the developer in expediting the review process.

## » 21.05 THE CONTRACTING PROCESS

After preliminary investigation has been performed on a specific site, and early indications are that the project will meet both financial and development feasibility tests, it is imperative that the site be properly secured by a contract. The developer's counsel should prepare a form of land purchase agreement that allows the developer a sufficient period of time in which to perform additional studies to ensure that the site and the market dynamics will in fact support the project. Typically, land sellers will allow the purchaser up to 180 days within which it can conclude the necessary development, market, and economic feasibility studies and also to complete design of the facility.

The experienced legal artisan will prepare on behalf of the developer a contract that allows a "Preliminary Requirements Period" during which the developer can complete the necessary studies and make the necessary investigations to determine his ability to develop the site. This preliminary requirements period usually lasts from 60 to 120 days. While the contract document may require the posting of an earnest money deposit upon its full execution, typically the earnest money is not at risk (i.e., subject to forfeiture) if the developer elects to abort the project at any time during the Preliminary Requirements Period.

Thereafter, the final phase of diligence would subject the developer to placing his earnest money at risk. It is during that period that the developer has sufficient information to warrant going forward with the project. Also during that period the plans are finalized and submitted to the local governmental authorities for review, approval, and the issuance of permits.

The sophisticated developer together with his lawyer and architect should be in a position to complete diligence, complete design of the facility, obtain the necessary plan review by governmental authorities, and obtain permits prior to land closing. It is smart to minimize the holding period on the land and thereby avoid associated carrying costs.

## » 21.06 EVALUATING PROJECT FEASIBILITY

### [1] Design Phase

Necessary steps during the design phase include:

- Preparing a preliminary site plan.
- Obtaining both a boundary and topographic survey of the property.
- Obtaining a soils report of the property from a certified soils engineer.
- Conducting necessary environmental tests on the property to ensure that no soils contamination is present.
- Reviewing and updating the site plan so that it reflects information provided by the preceding tests and reports.

The following factors could have a significant cost impact on the project if not carefully reviewed and analyzed.

*Utilities availability.* During the design phase the project engineer should determine that all utilities required to support the project be at one or more of the boundaries of the property. The failure of any utility to be at the boundary of the property typically means that an extension of that utility must be made by the seller at the seller's expense.

*Easements and setbacks.* The project engineer, in conjunction with the title examining attorney, should review all easements and setback requirements imposed either by legal document or by applicable zoning law or other governmental regulations. In many instances, setback requirements preclude the construction of the facility as contemplated or severely cut into required parking spaces. Additionally, landscape or other buffers required by governmental authority may have an impact on the land use planning of the specific site. Finally, easements that impact the property will have a bearing on the ability to develop, construct and operate the proposed improvements. Hence, both engineer and lawyer need to carefully review all easements which burden the property being reviewed for purchase.

*Topographic condition.* The project engineer, in conjunction with the architect, needs to determine whether the topographic conditions of the property will accommodate the proposed improvements, or if changes to the property need to be made and, if so, at what expense. In many instances properties with a severe slope require retaining walls, or the slope will need to be cut by major excavation of the site—all resulting in increased cost to the facility.

*Soil and the conditions of soil.* In many places in the country, soils conditions are unacceptable to support certain types of construction. A licensed, competent soils engineer must evaluate the conditions of soils based upon the intended location of the improvements as shown by the preliminary site plan. If the soils condition will not support the improvements, a determination must be made if the soils can be corrected and at what cost to the project.

The site plan needs to be reviewed to ensure that any of the problems revealed during the design feasibility period do not adversely affect the proposed location of the facility.

Assuming no major problems, the architect and engineer prepare working drawings and plans and specifications for the improvements for submission to the local governmental agencies for review, comment, revision, and approval. Once this has been accomplished, the project will be ready for bidding. The developer will select a list of competent contractors to whom to submit the plans and specifications for bidding. At this point, the project moves to the construction phase.

## [2] The Construction Phase

Upon review and acceptance of the appropriate bid from a licensed general contractor, the developer is ready to proceed with the construction of the improvements. Again the architect and attorney should carefully assist the developer in protecting the developer's interest in the contracting phase. Hotel development can last as little as seven months or as long as 18 months, depending on the type of facility. During that period, presumably, financing will come from interim sources. It is in the developer's best financial interest to ensure timely completion of the project, thereby minimizing construction-related interest.

Many developers in the industry today are using risk reward contracts, which reward contractors for early completion of a facility and penalize those who are unable to complete on a timely basis absent delays associated with acts of God, force majeure or governmental impositions. The industry commonly sees three types of contracting arrangements between the developer and general contractor.

1. Competitively bid situation for qualified general contractors who are asked to bid the job employing their own subs.
2. Negotiated contract with a general contractor who may have been utilized in the past by the developer.
3. Developer acts as general contractor and bids out various aspects of the construction project to appropriate sub-contractors.

In certain instances, when the facility's construction time is critical to certain performance attributes, developers will enter into a design build arrangement with a general contractor. Typically, this arrangement is not favorable unless the developer has extensive experience with the contractor. The developer should carefully review with his attorney and architect the merits of requiring the contractor to bond the project. Typically the benefits outweigh the costs.

## » 21.07 PRE-OPENING/OPENING

The final months of construction are generally hectic, often not allowing the developer enough time to devote attention to the myriad tasks associated with opening of the facility to the public. It is imperative for the developer to have his pre-opening team on site as much as eight weeks but certainly not later than six weeks prior to the scheduled opening. The pre-opening team will assist in the hiring and training of the support staff, oversee the final furnishing and punch out of the guest rooms and other guest-sensitive areas and begin an aggressive marketing program in anticipation of the scheduled opening of the property.

All too often the pre-opening and opening activities associated with the proposed lodging facility take a back seat to the development process. This is a mistake. Pre-opening and opening activities can play a major role in enhancing the revenue stream from the day the property opens its doors to accept guests; marketing dollars spent on pre-opening usually prove to be a good investment in revenue production.

## » 21.08 PROJECT FINANCE

The project has been analyzed, its market feasibility attributes discussed, the developability of the project has been assured, and now the ultimate questions are regarding project finance. What type of financing will be available to the developer to allow him to conclude the project on economically feasible terms? As we noted earlier, there is a relationship between project cost and achievable rates and occupancies to determine project performance. Similarly, in the area of project finance, the amount of money that will be available (i.e., what percentage of the project cost can be financed) and the applicable rate of interest (i.e., what is the debt service on the project going to be) have a bearing on the feasibility of a proposed lodging facility.

Prior to the debacle in the industry of the late 1980s and early 1990s, real estate financing remained an orderly, standardized practice that matched developers with investors and lenders. As the lodging industry matured in the late 70s and early 1980s, the financing process, stimulated by favorable tax incentives and high inflation rates, increasingly involved financial institutions becoming equity or quasi-equity partners.

When the impact of overbuilding in all areas of real estate, including hotels, made itself felt in the late 1980s and early 1990s, financial institutions and lenders of all kinds found themselves reluctant owners of properties for which there was no market, except at drastically reduced prices. This situation gave rise to the fall of the savings and loan industry and the collapse of many long-recognized commercial banking institutions. Many hotel properties found themselves in the hands of regulators with the FDIC, FSLIC, or the Resolution Trust Corporation (RTC). It was not until the mid 1990s that much of the distressed hotel inventory was sold off and prices began to stabilize in stronger markets. With the revival in the industry, new construction has once again begun and lenders, albeit slowly, are returning to the marketplace. In addition to the traditional sources of funding, mortgage conduits and other forms of debt are being provided to the lodging industry through Wall Street sources.

Financing of lodging properties does not resemble that of office, industrial or residential projects. Lodging properties rely on the success of a business. They are often viewed as high-risk investments with potentially tremendous up-side potential. Lenders, therefore, tend to concentrate on those projects that are well-conceived, well-located and that involve experienced developers and operating companies. The cash flow from a lodging property available for debt service depends on local and national economic conditions, quality of management and unpredictable travel patterns.

The type of project financing depends upon the specific project and the needs of the developers, Typically, developers will secure 100% of their project cost through construction or interim financing, assuming that there is a take-out or some form of permanent financing with a loan-to-value ratio of 75% or less. The most common short-to-intermediate-term debt instruments available for financing hotel projects today include the following: construction loans, combined construction and term loans, and term and bullet loans.

The six major long term debt instruments include convertible mortgages, land sale lease backs and leasehold loans, permanent loans, mortgages with a kicker, wrap around mortgages and other long term debt instruments. Briefly, the type of financing provided by each of the aforementioned instruments is as follows:

- *Convertible mortgages.* One hundred percent of the project's development cost is provided to the developer, as is control of the property for a definitive term of years. The loan, while either at or below market rate, provides for the lender to receive a fixed interest return with a participation (usually 10 to 50%) of the cash flow after debt service. Additionally, the lender would receive the right to convert the mortgage into 50% of the equity at an agreed upon conversion date. This type of instrument is used more by insurance companies, pension funds and foreign trusts as opposed to more conventional and commercial lending institutions.
- *Land sale leasebacks and leasehold loans.* Under this scenario, the lender acquires from the developer the land at market value and then leases it back at a low rate (10 percent to 13 percent of the land value; 3 percent to 4 percent of gross room sales) for forty to fifty years. The lender participates in loan term capital appreciation through payments by the developer of future cash flows and a share of the property's appreciation.
- *Permanent loans.* Permanent financing takes all forms in today's environment, ranging in term length from as few as three years to as many as thirty. In some cases, the longer the term, the greater the requirement on the part of the lender to participate in cash flows. Loan principle amounts depend on a debt coverage ratio usually of 1.10 to 1.35 times the projected cash flow before debt service. In some cases shorter term loans have bullet provisions with interest only payments for five to seven years with the principle balance being due and payable at the end of the term.
- *Mortgages with a kicker.* This financing method provides the developer with a loan at market or below market rate but with a long or extra long term. The amount of the loan depends on the coverage. The lender will participate not only in future cash flows (10 to 50%), but also in part of the residuals or, in some cases both.
- *Wrap-around mortgages.* Typically, this type of financing is provided by sellers or credit companies and entail a fixed rate on the underlying wrap mortgage plus a share of the residuals, a kicker, or both.
- *Other long-term debt instruments.* These types of financing include seller financings, exchanges, second mortgages and standby mortgages. In most cases, these forms of financing are primarily used when other, more favorable, financing methods will not cover all development costs, operating deficits, cost overruns or land acquisition costs.

Sound feasibility attributes, realistic performance projections evidencing sup-portable coverage ratios combined with sound credentials for the hotel operator are all essential to obtaining project financing in today's environment. Lenders want as-

surances that debt service payments are achievable not only during good economic times, but also during adverse times. While project finance is not the topic of this chapter, the components of financing must be part of the overall equation in the final analysis of project feasibility.

## » 21.09 FACTORS SUPPORTING THE URBAN CORE HOTEL DEVELOPMENT BOOM

Moderately priced downtown hotel development and redevelopment is, suddenly, quite the rage. Due in equal part to strong real estate economics and wishful thinking, urban core hotel development has become a central theme in the downtown rescue remedies of many urban planners, downtown development agencies, and, not least, developers. This section reviews some of the factors that have spawned this urban core mid-market hotel boom and reviews current statistics that seem to corroborate the downtown development play.

In broad review, the stars that have aligned themselves for the current hotel development syzygy are, briefly, as follows:

- A lack of mid-priced hotel rooms in most North American downtowns and hoteliers' realization of the premium that a mid-market hotel can achieve vis a vis the same suburban properties;
- The closing window of opportunity to acquire underutilized, convertible historic, and class "B" and "C" buildings;
- The returning appeal and rediscovery of many North American downtowns;
- The pressure that cities have applied to utilize and reinvigorate "blighted" areas of downtowns;
- The return of fundamental strength in the demand for hotel rooms;
- Developers' decreasing fear of development in urban core locations;
- The force of equity and debt looking for larger-sized deals, propelled in part by agents like Starwood Lodging, Patriot American, and other REITs;
- The attempts of hotel franchisers to keep up with competitors by securing distribution channels through developing hotel rooms under their "flag";
- A competitive investment market for Historic Tax Credits that, spun off by some developments, are often the IRR-push that make deals conceivable, and;
- A suburban-based lodging boom of epic, pre-RTC proportions, the enormity of which may cause even the most imperious of developers to turn introspective.

### [1] The Developers and the Risks

If this partial list seems monumental, consider the legion of developers pursuing development in downtowns. Developers—from ex-Studio 54 impresario lan Shrager, ex-investment banker Robert Kimpton, and night club operator House of Blues, to more pedestrian developers of Marriott, Hampton Inns, and Embassy Suites—are acquiring existing, non-lodging assets to redevelop as hotels.

Is this spate of development misguided? Certainly not. The majority of these developments are well conceived and will perform on an income-before-debt-service-basis. The question of their financial success (income *after* debt service) will hang in

the balance, awaiting the jury's return from the next real estate cycle. Is this to say that the current tide of optimism on which downtowns are riding is ephemeral? Again, certainly not. Many observers feel that the decline that downtowns suffered in the past 40 years is an aberration, simply a temporary adjustment to factors such as suburban development precipitated by the post-war development of the federal Interstate system. If risks exist in the development, ownership, and operation of an urban core hotel, then what compelling reasons are there to pursue a downtown hotel deal? In short, because there are potentially fewer risks and greater returns than investing in suburban hotel development. "Potentially" because the money in an urban core hotel development is made in the pre-development and construction phases, not in operation. If care, restraint and circumspection are not deployed in pre-development, the hotel could fail no matter how well the hotel penetrates demand.

## [2] Understanding the Risks

The keys to the successful urban-core hotel project are completing thorough market due diligence, lowering of costs, and reduction of development and construction risks. The steps include:

- *Market selection.* Selecting and studying a market that has long-term durability of demand based on residential activity, tourism, general strength of the downtown, office space absorption, job creation, and other tangible and intangible measures;
- *Supply and demand.* A clear understanding of both urban and suburban, room night demand and the market position, rate, occupancy, and market segmentation of primary and secondary competitor hotels; understanding of all planned supply in the suburbs and urban core;
- *Property inventory.* A thorough review of the convertible building and devel-opable land inventory in the urban core;
- *Failed deals.* An understanding of who has tried to put deals together at what locations for hotels and apartments and why they failed, if not completed;
- *Successful deals.* For those completed projects, a thorough understanding of development costs, how and to whom they sold rooms after opening, how rate structure changed over time;
- *Development team.* Selection of a development team of architect and general contractor, both of whom should have broad ground-up hotel and renovation experience;
- *Target property.* Identification of suitable convertible buildings and/or devel-opable land;
- *Building program.* Based on the above due diligence, making studied decisions as to building program, types of rooms, levels of service and, if opted, franchise;
- *Budget pricing.* Program sketches and general contractor's budget pricing of identified properties;
- *Development challenges.* Discussions with lenders, franchisers, and city officials to understand development challenges;
- *Purchase and sale.* Negotiating a purchase and sale agreement that provides ample time for continued building and market due diligence and, most importantly, time to receive a building permit;

- *Thorough property analysis.* Conducting thorough property analysis, prior to risking any hard funds, that includes: legal, zoning, structural, state/local historic, asbestos, lead paint, Phase One and Two, parking, traffic and retail market review.

Urban core hotel development is dramatically more dynamic than suburban development. Sponsors whose deals get done have one common attribute; flexibility. Complete understanding of the above issues enhances this flexibility.

## [3] History of Downtown Hotels

But what are the underlying reasons for the sudden interest in urban hotel development? The answer lies in the review of twentieth century urban real estate. Downtowns have been the centers of commerce, entertainment and education for millennia. For the first half of this century downtowns were primarily the place to stay at a full-service hotel; namely one that provides food and beverage and extensive meeting areas and public space. Turn-of-the-century high-rise downtown hotels, whose development was made possible by the elevator, created critical density to justify high downtown land prices and the costly level of services that the full-service or convention hotel provides. With mass transportation spokes feeding the downtown hub, hotels provided a convenient meeting place and temporary residence for business travelers and tourists, and full-time residences to the well-heeled. The cost to develop these large hotels was great. The competition was limited, prior to the 1960s, to other downtown hotels since suburban hotel development was not then significant. Choice in the type of hotels was limited to luxury, convention, first class, or, farther from the core, economy properties.

## [4] Hotel Segmentation

Market segmentation occurred later after the advent of chain affiliation. The 1970s ushered in a period of large-scale franchising of hotels. Prior to the 1970s chain affiliation was limited. Yet to be created were lodging options such as mid-market, extended-stay, or limited-service properties.

Several events occurred that had an impact on the lodging landscape:

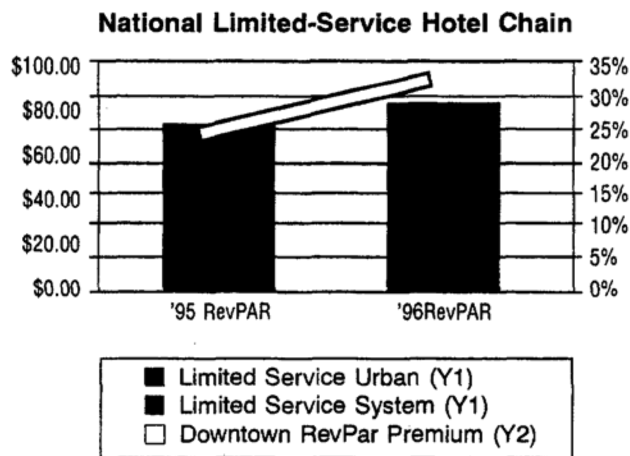
- America became more mobile, spawning increased room night demand from business and family travel;
- In response, chain affiliations offered the traveling public recognized names and relatively consistent guest experiences at anticipated levels of service. With this came the proverbial two-story, rambling, "down and out" Holiday Inn, where the car-driving business traveler could back their car to the room and be assured, generally, of a consistent, predictable hotel stay;
- The post-war suburban development boom of the fifties and sixties led to development of suburban hotels, which, due to lower land costs, could build horizontally less expensively than building vertically in the downtown, thus providing a price advantage;
- Cities entered a period of urban flight, losing population and industrial employment, promulgated by suburban development of less expensive residential units and modern, less costly industrial and office space;
- Perceptions of cities' safety and vitality turned pejorative;

• The development of urban-core hotels declined by the late 1960s as hotel development focused on the suburbs.

If one views the hotel industry as evolutionary, periodically rolling out new concepts and products, these factors left downtowns with outdated products and properties. The trend of hotel "roll-outs," like smaller, limited-service hotels, started in the late 1970s, accelerated into the eighties and was perfected solely in the suburbs. Downtowns were largely, if not virtually, ignored in this boom.

What started in the late 1970s as a means by hotel franchisers to attract more room nights became "segmentation," the still-prevailing trend of differentiation among hotels. Twenty-five years ago the hotel traveler had four options in his choice of hotels: luxury, convention, first-class, and economy. Hotels at that time tried to be all things to all people. With the concept of segmentation came the attempt to appeal to a certain group of guests with certain specific needs.

**Exhibit 21-9 Urban vs. Suburban Performance**




One of the clearest shifts in this new segmentation was the removal of restaurants and meeting space. Costly to construct and expensive to staff and operate, these elements were eliminated by the full-service hotel companies that began to develop "limited-service" hotels. Major hotel companies like Holiday Inn and Marriott began to tinker with their full-service concepts and found that people who didn't use restaurants, concierges, meeting spaces, and retail spaces didn't want to pay a room rate as if they had.

Hoteliers found an untapped market: guests that don't want to pay for services they won't use. Developers found there to be a less resistance from banks to borrow funds to develop these limited-service and mid-market hotels since the construction cost was substantially less without restaurants, bars, retail, and meeting spaces. These hotels most often had fewer rooms and employees and generally ran at higher occupancies and lower break-even points than full-service hotels.

Because of higher land and construction costs in the downtown, these newly segmented hotels were built in the suburbs, which in the seventies and eighties were often the economic engines of a market. Brands like Hampton Inn, Courtyard, Wyndham, Embassy Suites, Residence Inn, Fairfield Inn, and a multitude of others, got their start in the 1980s. (It is interesting to note that the personal computer and Courtyard by Marriott both received their introduction in 1984; both the limited-service hotel and the computer have become a ubiquitous part of American life in 14 years.)

Since the inception of the limited-service hotel in 1984 there now exist well over 10,000 such properties with well in excess of 1.2 million rooms; according to Coopers and Lybrand, an additional 105,000 to 125,000 hotel rooms will be built in each of the next four years. The vast majority of these are limited-service and limited-service extended-stay properties; 95 percent will be built in the suburbs. As a comparison, approximately 152,000 rooms were added in 1986.

This was the first limited-service boom, and it was abbreviated by the savings and loan crisis. Development of all hotels nearly ceased from the late 1980s through the early-1990s as the post-savings-and-loan glut of overbuilt hotels was sold off, often priced at 30 to 50 percent of replacement cost. Rarely were hotels built in urban cores during this post-RTC period. The exceptions were those that were the centerpieces to civic redevelopments and received substantial subsidies.

On the coattails of the early 1990s' economic expansion came a real estate recovery in which hotel occupancies and rates rebounded from the dismal levels of the late 1980s. A subsequent limited service development boom, the second development boom for limited-service hotels, ensued as lenders, comforted by the simpler operations, brand strength, and lower per-room development cost of limited-service hotels, made construction and take-out debt available, though with considerably more strings attached than were attached to loans in the last development cycle. With equity plentiful (and fully invested in deals) lenders embraced certain limited-service chains. Limited-service hotel development has proliferated from the early-1990s. The epicenter of this development was again the suburbs, where cheap land, continued strengthening room-night demand, and unabated suburban development made a compelling story to lenders and equity, alike.

The supply of lower-priced rooms in the suburbs created a rate imbalance between suburb and city. Though both suburban and urban occupancies improved during the recovery, the *average daily rate* of downtowns rocketed. As cities like San Antonio, Seattle, Chicago, New York, and Denver recast themselves and regained their attractiveness to residents, businesses, tourists, and conventioneers, hotel occupancy and rates soared. Because of this more even mix of demand, downtowns often had less seasonality and more consistency in weekday versus weekend demand than the suburbs, due in large part to elements like:

- New downtown sports stadiums and arenas that boost weekend occupancy and mid-week rates;
- Tourist attractions, museums, parks, and waterfronts that attract individuals and families and, more importantly, groups that eat up hotel rooms and create scarcity, propelling rates quickly;
- A return and strengthening of downtown residential development that often is the unsung cornerstone of a city's rebirth;
- Convention and special events that, once again, are held in downtowns, creating longer guest stays as conventioneers lingered in the city's core to enjoy a more unique shopping and entertainment experience than that of the suburbs.

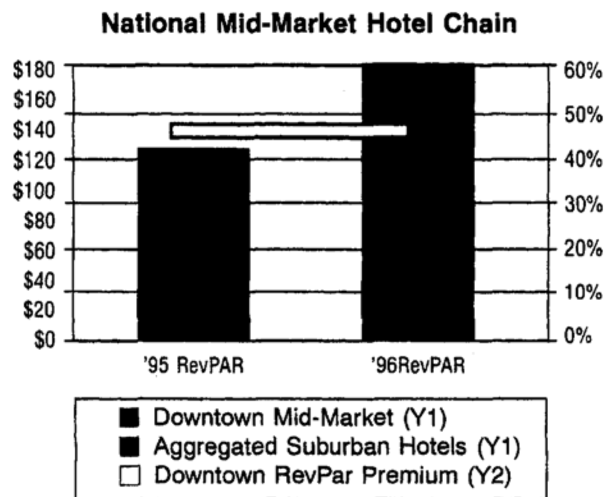
Building limited-service or mid-market hotels in certain downtowns seemed to make "rate" sense. A higher average daily rate should be achieved in the downtown limited-service hotel than in the comparable suburban property since the average daily rate of downtowns is generally higher than in the suburbs, and the competitors in the downtown are generally higher-priced full-service properties. Downtown's existing older, poorer, and less competitive properties were able to ride the coattails of the higher-rated downtown properties and achieve rates often unimaginable for a comparable facility in the suburbs. With no new development, the downtowns had become bifurcated markets based on quality of the hotel asset.

Therefore, following the limited-service precepts, wouldn't there be room night demand in the downtown that *didn't* want to pay for concierge services, meeting, and restaurant space? If so, this room night demand would expect to pay less than at a full-service property. But how much less was the key since, though the rate for a downtown limited-service property would be more than for its suburban counterpart, the rate may not have been enough to justify ground-up development. This was the question that we asked as we studied what we thought was a market opportunity to develop a limited-service hotel in downtown Denver in 1995. Statistics collected and models created, clear trends emerged suggesting that we could determine:

- The premium that a downtown limited-service hotel would achieve over the same suburban brand;
- The discount that the downtown limited-service hotel would surrender to its full-service competitors.

Generally, the limited-service or mid-market hotel flags could achieve a 30 to 50 percent RevPAR premium (Average Daily Rate times occupancy) over their suburban counterparts. (See Exhibit 21-10.) These same limited-service and mid-market hotels would operate at a 25 to 40 percent discount when compared to Average Daily Rate of the "first-class" downtown hotels. The basis for this high level of performance relative to the suburban property goes to the heart of the issue of this article. While new, lower price-point hotel concepts were routinely and efficiently unveiled and built in the suburbs, downtowns were nearly entirely neglected in the last two hotel development cycles. This dynamic created a gap in the downtown hotel brand continuum relative to the suburbs that continues to this day. The premiums that limited-service and mid-market hotels receive in downtowns are illustrative of the lack of less-expensive hotels in the downtown.

**Exhibit 21-10 Urban (Chicago) vs. Suburban Performance**




It became clear that nearly any commercially acceptable suburban franchise would receive a hefty premium if operated in the downtown. This was the case with a moderately priced limited-service brand that, in the handful of markets where a downtown property was built, received a 30 to 40 percent premium over the nearest suburban hotels of the same brand. This was also the case with urban core extended-

stay properties in comparison to that chain's predominantly suburban properties. Although not as great a premium as the limited-service and mid-market properties, this chain of extended-stay properties still achieved approximately a 20 percent premium to the rest of the suburban system.

In short, this analysis corroborated the fact that a large premium existed for operating a suburban-based property in the downtown. Because of the greater barriers to entry and higher entry costs associated with downtown hotel development, this premium may remain fairly certain.

This being said, the downtown lower-priced hotel will not be entirely immune from the effects of over-supply in the suburbs, should this occur again as it did in the late 1980s. Until this time and perhaps beyond, these franchised properties will continue to outperform their suburban kin.

## [5] Development vs. Renovation Costs in the Urban Core

The question of market rate feasibility now established, the question of development cost and financial feasibility needed determining. The first step is to determine the site for development. This question needs to be refined to buying land for development or buying an existing building for redevelopment. Somewhat surprisingly, the spread between new construction and renovation aren't as great as one might expect.

Land prices in downtowns clearly are greater than in the suburbs. But consider the land economy of building up rather than out. Land for a suburban limited-service property ranges from $7,000 to $15,000 per room based on land prices of $6 to $15 per square foot for three and a half acres. Even with land costs in downtowns rebounding to a range between $50 to $200 per square foot, the downtown hotel needs only a $15,000 square foot building foot print (excluding parking). This yields a per-room land cost of $5,000 to $20,000 per room, not that terribly different from the suburban range. Since the downtown guest will expect a higher level of finish, the furniture, fixtures, and equipment will be 10 to 30 percent more expensive than the suburban property.

The greatest difference in cost is the premium for high-rise construction; stick-built or steel stud horizontal construction in the suburbs is far less expensive than building with concrete in the downtown. Fire refuge areas, sprinkler systems, fire command stations, back-up generators, and other conditions imposed by mid- or high-rise construction add approximately 20 percent to the cost of a downtown project.

The ultimate development cost for the suburban limited-service mid-market property is in the range of $50,000 to $85,000 per room. The corresponding cost of a ground-up downtown mid-market property is approximately $150,000 to $200,000.

To be feasible, the average daily rate at a hotel built for $150,000 per room must exceed $160. This high an average daily rate for a mid-market property would be unattainable in most downtowns. Generally, therefore, the concept of ground-up development in the urban core is not feasible. The feasible average daily rate for the limited-service property is approximately $90 to $140. Backing into a feasible development cost, the project can support a total development cost of up to $130,000 per room.

This new-construction per-room cost cannot often be achieved in the downtown. The way to achieve this development cost is to acquire an existing building and convert it. In short, though not as great as one might imagine, the discount on development costs in renovation versus new construction is approximately 20 to 25 percent. Considering the benefits of historic tax credits, the discount may exceed 30 percent. In the broadest measure, the tax credit of 20 percent of all approved development costs, in practice, pays for the cost of the building.

## [6] Mixed-Use Solution

In order for the downtown hotel project to get built, given all of its complexities and greater costs, it often takes creativity and an ability to layer on income streams from uses other than the hotel. In effect, the project that started purely as a downtown hotel metamorphoses, along the path of pre-development, to embrace other components. Uses like retail, parking, and office add revenue strength to the project and make use of less-utilized space within the building. Symbiotic uses to the business traveler range from the obvious, like restaurants, business centers, and coffee shops, to the merely convenient, like office uses.

The 450,000-square-foot Macmillan Building on Third Avenue in Manhattan typifies the creativity of the hotel developer. The building will be condominiumized into three units and converted retail, office, and hotel uses. The developer is left with the space for a 320-room Courtyard by Marriott. But a 320-room property would only require approximately 230,000 square feet of space, leaving the developer with nearly half of the space uncommitted in a building purchased for $100 per foot. The developer needed to realize value in the uncommitted space. Therefore, the developer attempted to recapture some of the acquisition cost by condominiumizing and selling off two of the three condo units. The first two floors of the building are to be purchased as one condo and leased as retail space. The Marriott Courtyard will occupy the top half of the building in its condo unit. This condo unit will extend to the first floor, which affords it street access for an entry foyer. The middle condo unit will be purchased by Sloan-Kettering Cancer Center as a midtown office. Sloan-Kettering will convert the space in its own condo unit to a medical office.

Downtown hotel development, though seemingly all the rage, is based on solid fundamentals. Current fundamentals, like the premium that urban limited-service properties enjoy over their suburban kin, present a compelling case for urban core development. This fact has not been lost on developers who have seized it, capitalized on the returning luster of downtowns, and packaged it to lenders and investors hungry to invest cash. The unlikely set of concurrent circumstances that have fostered this development boom are based more on maximizing arbitrage in current economics of urban real estate than on hotel operations or branding.

The issue, in the end, may turn out to be a bad arbitrage play, but that unbridled suburban hotel development added too many rooms, and the whole market, urban and suburban, suffered. If suburban development creates disequilibrium in the suburban market, it will likely have a negative rate impact on urban hotels. This is one of nagging specters that will continue to lurk until the hotel industry begins the downslope of the current development cycle and the jury returns from its real estate deliberations.

CHAPTER 22

# International Markets

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## » 22.01 DEVELOPED VS. DEVELOPING COUNTRIES

Countries with rapid development offer more opportunities to the investor than those with slower growing economies. At the same time, there is a great deal more risk— political and financial—associated with a rapidly expanding economy. One way of overcoming this risk is to deal in assets that are easily salable, thus allowing the rapid conversion to currency that can be withdrawn from the market. Such investments also allow a level of hedging to be used as a fallback against risk in the marketplace.

Unfortunately, hotels are large static assets with high capital costs and poor conversion abilities. In addition, hotels are not easily transferred among investors, which means that the hotel owner is exposed to risk on an ongoing basis; every time the operation is exposed to market uncertainty, the capital value of the operation is affected. For these reasons, an investor should be very careful about entering a developing market.

Return, however, is a function of risk; while a hotel in a developed market is a more stable investment, it will not yield the return that is possible in a developing marketplace.

## » 22.02 BACKGROUND FOR EUROPEAN COUNTRIES

If a firm is to control its development and grow in international markets, it is important that it pay attention to what are known as "environmental factors." These are as follows:

- *The economy.* The overall strength of a country's economy affects the availability of credit, the willingness of people to borrow, and, ultimately, the level of demand. Interest rates and currency fluctuations affect both the cost of and the demand for imports and exports.
- *Capital markets.* The state of capital markets in the country invested in has a direct bearing on the cost and availability of loan capital. It also reflects and influences the willingness of investors within the country to invest in internal markets rather than overseas. Capital markets have been shown to have a great effect on the economy as a whole.
- *Government.* The governments of many countries seek to encourage foreign investment through the allocation of grants and industry initiatives. Also crucial is the degree of government regulation of the economy. Political decisions made either internally or on an international scale can have devastating effects within the hotel industry.
- *Labor markets.* The availability of labor and skill bases is crucial and must be investigated.
- *Suppliers.* In third world and developing countries, maintaining the supply of raw materials for construction, refurbishment, and everyday running stock is an enormous challenge, one that is to a large extent nonexistent in a developed country.
- *Markets.* The influence of local and international tourism markets and the presence of competitors must be taken into account.

This chapter will begin with a discussion of the markets of Europe.

HVS

## [1] Europe's Legal Framework

International legal practice in Europe is mostly carried out through branch offices, alliances, informal associations, referral relationships, and foreign lawyer employment. On the whole, lawyers are a vital part of European real property transactions as technical facilitators. In the United Kingdom, for example the solicitors' profession still has a statutory monopoly on conveyance work. This has been challenged in recent years and will change, albeit slowly. The legal framework in Europe has been complicated somewhat in recent years by the application of European Community (EC) laws and directives, which have challenged bodies of law in individual countries.

Because there is nothing in the EC treaty that creates any EC function or power relating to the ownership or transfer of land, the national laws of each member state govern those matters. However, certain aspects of real property transactions may be affected incidentally by provisions of the EC treaty.

The major common-law jurisdictions of Europe are England, Wales, Scotland, Northern Ireland and the republic of Ireland, while the remaining jurisdictions are essentially civil law systems. The systems vary principally in their approach to case law. In both groups legislation plays an increasing role in the regulation of real estate matters, both in the private aspects of ownership and transfer and in the public aspects of planning, building controls, and more general environmental concerns. However, the traditions of statutory interpretation also vary' considerably between the two regimes.

The land tenure system originated in private law, according to the doctrine of binding precedent and with substantial contribution from professional practice. Legislation has introduced important measures such as registration of title and reform of old case law. It has also intervened to provide important rights (e.g., rent control for residential tenants and lease renewal rights for business tenants) and to impose planning and environmental controls of increasing complexity.

The status of court decisions in relation to civil law is quite different than under common law. Legislation has increasingly replaced or reformed original code provisions or enacted controls not included in the original codes. The planning, building, and development policies of individual European countries are discussed subsequently in this chapter.

The EC has an increasingly positive attitude towards foreign investment. Most countries make no distinction between foreign and domestic investors, though in certain sectors and in certain countries restrictions remain. For example, foreign investment in France is restricted in banking and insurance. In Spain it is restricted in the gas, water, electric, and railway industries. The state-controlled industries of Italy are restricted. For the most part, however, countries use attractive incentive packages to encourage investment.

## [2] Cultural Differences

The following section offers generalizations about some of the cultural differences found in the international markets as an aid to understanding how to conduct business there. The categorizations outlined are the product of the research of Fons Trope-naars of the Centre for International Business Studies (CIBS).

### [a] Universalism vs. Particularism

This is essentially the difference between rules and relationships. Universalist behavior or rule-based behavior focuses on the rules governing the conduct of areas of be-

havior. The belief of people in a universalist society is that all should be treated equally under the law and that people should adhere to the regulations and rules laid out by the society they live in. Particularists, in contrast, see rules as applying in certain circumstances and not in others. Particularists will choose whether to adhere to the rules or not depending on the situation they find themselves in. Universalist countries include the USA, Switzerland, Sweden, Norway, Germany, Britain, the Netherlands, Denmark, Finland, and Austria. Particularist societies include Russia, Hungary, Bulgaria, Romania, Greece, Spain, France, Portugal, Oman, and Egypt.

Particularist countries put more faith in personal relationships, and as a result, more time is often needed to conduct business; they also see the universalist need for contracts and high powered negotiations as suspect. Universalists, on the other hand, might see the time it takes to establish these relationships as a waste of time and a sign of a lack of commitment. For this reason, this cultural difference can lead to misunderstandings. The following lists summarize the differences between the two categories.

For universalists:

1. Focus is more on rules than on relationships;
2. Legal contracts are not subject to easy change;
3. Trust is based on the honoring of a contract; and
4. A deal is a deal.

For particularists:

1. Focus is more on relationships more than on rules;
2. Legal contracts can be readily modified;
3. Trust comes from establishing worthiness over time; and
4. Relationships evolve.

### [b] Affective vs. Neutral

Affective cultures are those that show their emotions, whereas neutral societies are those that do not willingly show their emotions. This does not mean, of course, that those cultures that do not seek outlets for their emotions are devoid of emotion; in most cases, it is simply a matter of social convention. There are considerable differences in this regard among European countries, with Germany being the most neutral and Italy and France being the most affective. The differences have a great influence on the way relationships are formed and communication occurs within these different cultures.

Neutral and affective cultures often find each other immensely confusing in a business context. This confusion can lead to difficult problems in negotiations.

### [c] Sequential vs. Synchronic Time Orientation

How different cultures view time is a very important aspect to doing business. In hotel development terms, it becomes all the more crucial, because the development process is a lengthy one that requires a great deal of coordination of resources. Sequential cultures such as the United Kingdom and the United States of America tend to run "on time" with attention paid to appointment times. In such cultures, people set specific goals and wish to complete one task before embarking on the next.

Synchronic cultures, such as the southern European countries, often prefer to do more than one thing at a time. They are less goal-specific and see time as an indicator of direction and not a controller of action.

## » 22.03 THE EUROPEAN COUNTRIES

### [1] United Kingdom

The United Kingdom hotel market remains strong with operating performances for both London and the provinces continuing to lead their European counterparts. Average occupancy levels declined slightly in the capital but the Provinces enjoyed a marginal increase, while average room rates for the United Kingdom increased by approximately 9% across the board. The branded budget sector continues to grow throughout the country, especially in city center locations, causing increasing concern from independent hotel owners. The strength of the market has continued to motivate sales activity and development from both domestic and foreign investors.

Some felt at the beginning of 1998 that London in particular was nearing the peak in the cycle, and yet transaction activity continued steadily throughout the year. Exhibit 22-1 shows that London hotels still lead Europe in Value per room.

**Exhibit 22-1 Hotel Values Per Room in Euro 1993-1998**

*Source: HVS International*

| | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|
| London | 245,617 | 276,810 | 293,330 | 358,743 | 496,007 | 504,990 |
| Paris | 360,262 | 352,336 | 340,709 | 316,953 | 389,947 | 433,515 |
| Geneva | 234,149 | 250,549 | 272,657 | 265,541 | 267,766 | 279,867 |
| Zurich | 204,242 | 220,064 | 221,492 | 211,042 | 236,044 | 267,574 |
| Rome | 155,319 | 170,562 | 160,459 | 205,974 | 238,614 | 264,487 |
| Amsterdam | 122,574 | 130,897 | 145,949 | 170,177 | 192,981 | 213,762 |
| Madrid | 149,874 | 142,183 | 142,416 | 161,663 | 188,540 | 209,076 |
| Europe | 145,812 | 147,066 | 149,256 | 162,042 | 190,528 | 204,202 |
| Barcelona | 85,399 | 78, 074 | 84,504 | 110,015 | 141,299 | 172,308 |
| Istanbul | 100,258 | 100,896 | 96,454 | 123,435 | 165,709 | 165,276 |
| Vienna | 153,557 | 144,497 | 150,496 | 145,934 | 141,970 | 157,959 |
| Brussels | 121,886 | 115,376 | 120,223 | 127,017 | 143,492 | 155,594 |
| Stockholm | 87,589 | 94,355 | 103,986 | 136,182 | 150,744 | 153,216 |
| Copenhagen | 97,643 | 105,259 | 109,116 | 124,337 | 144,450 | 150,920 |
| Budapest | 86,012 | 91,683 | 82,204 | 97,733 | 143,425 | 147,349 |
| Warsaw | 121,855 | 108,790 | 108,499 | 124,157 | 144,352 | 147,349 |
| Frankfurt | 136,758 | 134,160 | 137,916 | 130,606 | 137,920 | 141,829 |
| Prague | 129,487 | 110,150 | 104,350 | 111,747 | 134,533 | 136,485 |
| Lisbon | 102,966 | 98,029 | 95,877 | 108,879 | 112,256 | 127,098 |
| Athens | 86,393 | 84,405 | 84,627 | 96,554 | 113,645 | 126,896 |
| Berlin | 134,394 | 132,243 | 129,863 | 114,150 | 126,866 | 126,796 |

## [2] Belgium

The recovery of the Belgium hotel market, in terms of occupancy and average room rates, has led to increased interest from investors. Brussels still lags the European average for hotel valuation (Exhibit 22-1), despite improved hotel conditions.

## [3] France

The market recovery enjoyed by the French hotel market in 1997 was sustained in 1998. Continued growth in occupancy levels was enjoyed, in particular, in provincial cities, such as Marseilles and Paris, which hosted some of the 1998 football World Cup games. The month of June saw occupancy levels soar to new heights in certain cities due to the estimated half a million visitors for the games. There were concerns that the World Cup events would deter traditional demand from the leisure and commercial sectors and that this would have a negative impact on occupancy levels. These concerns proved to be unfounded in cities situated in the north of France; however, particularly in the southern regions, others did report a decrease in domestic leisure and commercial demand. The strengthening of the French economy and the strong US dollar, British pound and Italian lira have also contributed to some of the growth in demand for hotel accommodation. Paris was the principal beneficiary of the strengthening of the French market, enjoying strong growth in both rooms occupancy and average room rate. Paris hotel values remain strong and are second only to London (see Exhibit 22-1).

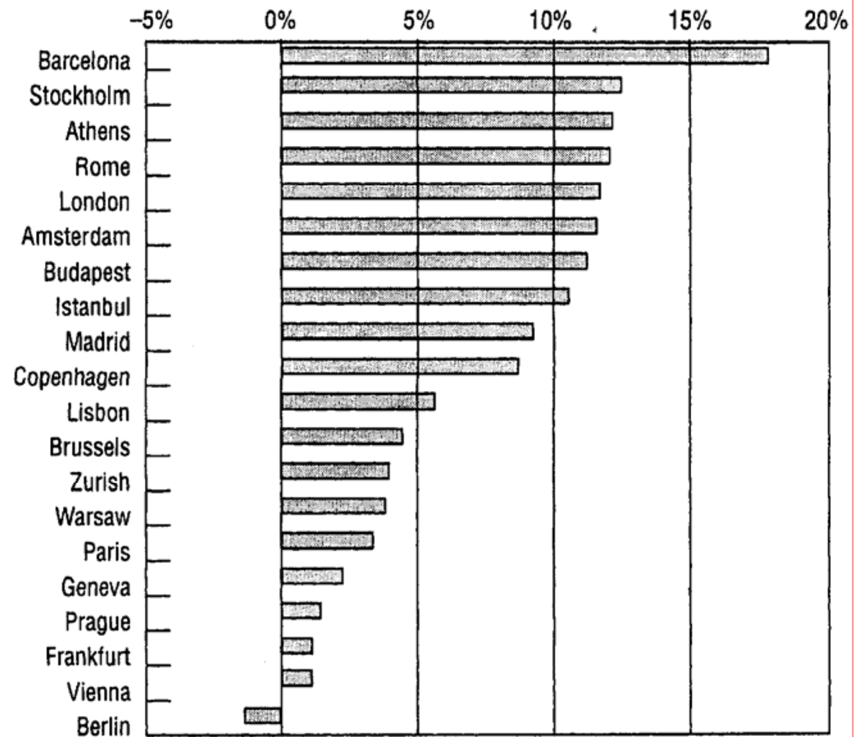
## [4] Germany

The German hotel market still seems to be suffering from the economic recession of the early 1990s. The hotel construction boom continues in Germany between May 1997 and April 1998, 80 new hotels with almost 14,000 rooms were constructed throughout the country. A further 140 hotels with over 37,000 rooms are planned over the next three years. New hotels are particularly prevalent in Berlin, with fewer than 64 hotels planned or under construction. Berlin is the only major European city to actually have its value decrease between the years 1993-1998 (See Exhibit 22-2, Average Annual Compounded Growth Rate 1993-1998). Although performance has been low in 1998, hopes are high for the future. For Berlin, in particular, an increase in demand is expected with the relocation of the German government from Bonn to Berlin and the arrival of 12,000 civil servants. Frankfurt is also one to watch as it capitalizes on being home to the Euro.

## [5] Italy

The Italian hotel market is the largest in Europe in terms of the number of hotel rooms; Italian tourism is second in the world (behind the USA) in terms of receipts. It is also the fastest growing in terms of foreign tourist visits between the years 1994-1998 (see Exhibit 22-3).

In the last 24 months, the national government appears to have achieved notable success in stabilizing Italy's economy and developing a level of confidence among domestic and foreign investors. The current Ulizo coalition has continued to work off its most recent predecessors, to drive Italy into the European Market Union, although this has been at the cost of stern monetary and fiscal control of the economy.




## [6] The Netherlands

The Netherlands has suffered for years from an abundant supply of hotel rooms for several years. It has finally worked off this excess room supply and values have increased dramatically in the few years (See Exhibit 22-4). The average has increased from below the European average in 1993 to well above average by 1998.

## [7] Portugal

After suffering from a prolonged recession in recent years, the Lisbon hotel market enjoyed buoyant performance during 1998, largely due to the hosting of Expo '98. RevPar in five-star hotels improved by up to 40% compared with the 1997 performance, which was mainly driven by average rate growth. Occupancy grew by approximately 10%, despite Lisbon's hotel market being subject to a huge increase in supply in all categories compared to 1997.

It is envisaged that the hotel supply in and around Lisbon will increase by 12% in 1999, which includes a 150-room Marriott golf resort hotel situated one hour's drive of the city. Demand for new hotels in other regions of Portugal such as the Algarve is also set to increase in 1999. This is partly as a result of improved infrastructure, a prime example being the recently modernized and enlarged Lisbon Portela Airport, but also as a result of key European source markets that are benefiting from favorable economic conditions.

Exhibit 22-3 Foreign Tourist Arrivals to Italy and Other Key European Countries (1994-98)

*Source: WTO*

| Rank | Foreign Tourist Arrivals to: | 1994 | 1995 | 1996 | 1997 | 1998 | 1998 as a % of Total | % Growth 1994-98 |
|---|---|---|---|---|---|---|---|---|
| 1 | France | 61,312,000 | 60,033,000 | 62,406,000 | 66,864,000 | 70,000,000 | 32% | 14% |
| 2 | Spain | 43,232,000 | 39,324,000 | 40,541,000 | 43,403,000 | 47,743,000 | 22 | 10 |
| 3 | Italy | 27,480,000 | 31,052,000 | 32,853,000 | 34,087,000 | 34,829,000 | 16 | 27 |
| 4 | UK | 20,794,000 | 23,537,000 | 25,163,000 | 25,515,000 | 25,475,000 | 12 | 23 |
| 5 | Germany | 14,494,000 | 14,847,000 | 15,205,000 | 15,837,000 | 16,504,000 | 8 | 14 |
| 6 | Switzerland | 12,200,000 | 11,500,000 | 10,600,000 | 10,600,000 | 11,025,000 | 5 | -10 |
| 7 | Netherlands | 6,178,000 | 6,574,000 | 6,580,000 | 6,674,000 | 6,170,000 | 3 | 0 |
| 8 | Belgium | 5,309,000 | 5,560,000 | 5,829,000 | 6,037,000 | 6,152,000 | 3 | 16 |
| | **Total Foreign Tourist Arrivals** | **190,999,000** | **192,427,000** | **199,177,000** | **209,017,000** | **217,898,000** | **100%** | **9%** |

**Exhibit 22-4 Hotel Values—% Change in local currency**

*Source: HVS International*

| | 1994 | 1995 | 1996 | 1997 | 1998 | 1994-1998 |
|---|---|---|---|---|---|---|
| Barcelona | -1.8% | 14.0% | 25.7% | 29.4% | 22.6% | 123.2% |
| Athens | 5.6 | 8.3 | 13.6 | 17.7 | 16.6 | 78.3 |
| Zurich | 1.6 | -1.5 | -5.1 | 10.8 | 14.8 | 20.8 |
| Lisbon | 0.2 | 0.1 | 11.5 | 2.6 | 13,4 | 30.2 |
| Stockholm | 9.1 | 15.3 | 17.4 | 9.0 | 12.5 | 81.1 |
| Vienna | -5.9 | 4.3 | -3,0 | -3.3 | 11.8 | 2.9 |
| Rome | 14.9 | 7.8 | 15.0 | 11,6 | 11.6 | 77.5 |
| Madrid | 1.9 | 5.5 | 9.6 | 17.5 | 11.5 | 54.3 |
| Amsterdam | 6.6 | 11.4 | 16.6 | 13.4 | 11.4 | 75.0 |
| Paris | -2.2 | -3.3 | -8.6 | 22.3 | 11.3 | 17.7 |
| Europe | 1.5 | 6.2 | 7.7 | 12.0 | 9.1 | 41.8 |
| Brussels | -6.7 | 4.1 | 5.6 | 13.3 | 8.4 | 26.0 |
| Budapest | 8,6 | 1.6 | 13.3 | 27.2 | 8.3 | 72.2 |
| Warsaw | -9.1 | 13.0 | 9.1 | 0.8 | 6.4 | 20.2 |
| Geneva | 0.9 | 6.5 | -3,2 | 0,1 | 5.9 | 10.2 |
| Prague | -13,4 | 7.3 | 2.1 | 4.4 | 5.7 | 4.8 |
| Copenhagen | 7.8 | 3.4 | 12.2 | 15.0 | 4.8 | 50.7 |
| Istanbul | 2.5 | 8.3 | 22.0 | 16.4 | 3.9 | 63.9 |
| Frankfurt | -1.9 | 2.8 | -5.3 | 5.6 | 2.8 | 3.7 |
| Berlin | -1.6 | -1.8 | -12.1 | 11.1 | -0.1 | -5.7 |
| London | 12.7 | 16.8 | 16.6 | 15.3 | -1.0 | 75,2 |

## [8] Spain

Spain has shown very little growth in recent years as hotel building has slowed dramatically. However, recently international hotel operators and entrepreneurial investors alike have been talking about Spain as a likely growth area, despite its slow hotel growth rate.

## [9] Central and Eastern Europe

After the collapse of communism in the period 1989-1990, investors became very interested in Central and Eastern Europe. Still, because of the recession there was not much development. Interest rates were high, and there was a squeeze on the availability of development finance. Another reason for the lack of development in these nations is their considerable political uncertainty. However, the Czech Republic, Hungry and Poland have stabilized their political structures as well their economics. With the three above mentioned counties joining NATO, the outlook for the future development of hotel projects will be carried out in a stable environment. Russia is still experiencing great difficulty economically and is still considered an extremely risky hotel development opportunity.

However, with the advent of free market economies in the Czech Republic, Hungry and Poland there has been a rush to build properties and create a short term overbuilt market. In fact the hotel valuation for the major cities in these counties has performed below the European average in 1998 compared to 1997 (See Exhibit 22-4, Hotel Values - % Change).

## [a] The Czech Republic

The Czech Republic has come a long way during the past three years, with GDP growth estimated at 4.2 percent for 1995. An important reason for this growth is the entrance of the Republic into the world trade market, as reflected by a 20 percent to 30 percent increase per year during the past three years in export growth. The willingness to trade, coupled with rising consumer demand, has resulted in increased imports and, ultimately, economic expansion. In contrast to many of its neighbors, unemployment in the Czech Republic is relatively low, at 3.2 percent for 1994 and an estimated 3.5 percent in 1995. Inflation has also been kept in check, quite a feat in light of the rapid expansion of the economy and the huge capital inflows to the country. Interest rates are still high compared with the rest of Europe, but they are in line with neighboring countries and could be said to be reasonably low considering the present economic status of the country. The next few years should bring no real slowdown to the economy, and if inflation can be kept in check, the future prospect looks favorable.

Prague probably will become one of the main centers for hotel development in Central Europe. There are numerous hotel projects under construction in the capital, and there is interest from other major international chains. The following hotels can now be found in the Republic: the Ramada Renaissance, the Grand Hotel Bohemia, and the Savoy, with Hilton taking over the management of the Atrium hotel in 1995. However, the current climate is one of rising costs and low average rates, which are not the best conditions for new hotels. Still, those hotels already in place will achieve good returns when this trend reverses in the near future. The country still has many interesting investment opportunities, which will no doubt be enhanced by the AAA rating given by Standard and Poor's. Investment in development projects has continued to be led by Austrian banks such as Raiffeisen and Girocredit, and Munich-based Hypobank has also become involved in the development of some prime real estate sites. The French institution Caisse des Depots has also been heavily involved in the market. ING has announced plans to become involved in the development of various large-scale projects in the area. On the whole, European investors have lower yield expectations than those of their U.S. counterparts; considering the state of the economy and the length of time it will take to mature, companies accepting lower yields in the interim will be in a better strategic position than the late entrants.

## [b] Hungary

The Hungarian economy has slowed slightly, down from 2.9 percent GDP growth in 1994 to close to 2.0 percent growth in 1995. The reason for this was the government's austerity package, designed to implement needed economic reform. The reform dampened the still buoyant export performance as well as the country's relatively strong internal consumer demand. Meanwhile, privatization is making slow but steady progress, with small to medium-sized companies being established in all market sectors. Inflation remains high at 28.3 percent for 1995, despite the monetary controls imposed by the government. This figure appears ready to drop in 1996 and 1997, however, as the economy absorbs the impact of the economic reform. Employment is still high, at 10.3 percent, but it is forecast to stabilize at about 10 percent. The effects of the increase

have been offset in part by the high level of imports and inward capital flows required by the restructuring process.

Strong performance in the Budapest market between 1989 and 1992 was followed by poor market performance in 1993, as the initial "novelty travel" declined. In 1994, the market sector picked up again, as a result of increased political and economic stability and the implementation of the government's privatization program. In 1995, occupancy levels were stable, and there was moderate growth in average rates. There has been little new development in the marketplace recently, and the cancellation of the 1996 World EXPO will dampen prospects in the market. The Austrian bank Girocredit has been heavily involved in the marketplace, with German, Dutch, and French banks also entering the market on a lesser scale. The problems facing prospective investors in the Hungarian market are many and mainly bureaucratic. Another major obstacle seems to be the lack of suitable investment property—many of the prime locations are already owned by investors who are seeing a good return and therefore are under no pressure to sell. Another problem is that the values of much of the real estate are based on an "initial yield attainable" basis, which does not help those who would choose to value on a revisionary basis. Yields in other industrial sectors are currently running from 12 percent to 14 percent, though this should increase in 1996 as the first round of rent reviews take place. In January 1996, the Hungarian Insurance law was revised, bringing the regulatory environment closer to EU thinking on issues such as minimum capital requirements. This should increase the stability of the financial markets.

## [c] Poland

The Polish economy recorded yet another year of impressive economic expansion in 1995, with GDP growth of close to 5.7 percent, up from 5 percent the previous year. This was by far the best performing economy of the former Eastern bloc countries. There has been increased foreign direct investment in the country. The government is committed to a structural reform of the economy and is pursuing an almost egalitarian transition to free market economics. While unemployment is high, the economy on the whole is on sound footing.

Another reason for the lack of development in these nations is their considerable political uncertainty and lack of basic infrastructure. Warsaw hotels have declined markedly in performance since 1991, as the market has struggled to absorb the plethora of new hotel developments in the city. Occupancy rates, which stood at 70 percent in 1991, fell to 50 percent in 1993. In 1995, the occupancy rates improved, but average rates suffered. While there are a number of proposed new hotels, it is doubtful that they will be built until there is an increase in demand.

## [d] Russia

Russia has had perhaps the hardest time of the previously communist countries in developing a free market economy. This can be explained to an extent by its sheer size, which has led to a much greater level of economic mobilization. It has suffered countless setbacks in the last few years from political instability and large-scale upheaval. Despite all this, Russia has moved steadily toward attaining a market economy; in 1995, it reduced the contraction of the economy to -4 percent GDP growth—a large improvement on the previous year's -15 percent. Exports increased in 1995, helped in part by progress made with the government's privatization program. There has been a large decrease in the rate of inflation in the country, from 843 percent in 1993 to 131 percent in 1995 to a projected 25 percent in 1996. Although this will undoubtedly help the economy, it is a long way from offering the security needed by investors, especially when the currency continues to devalue. The restructuring in the

economy has had the unfortunate effect of increasing unemployment, which has contributed to the general feeling of unrest in the country. In the key cites in Russia, areas in which the first major investments are being made, there is increasing concern about the rise in Mafia-style business tactics and profiteering, which is making the country a high-risk area for new business ventures.

Most of the major development taking place in Russia at present is taking place in Moscow or St Petersburg. In Moscow, the major hotel developments have occurred after 1990, with the notable exceptions of the Savoy, the Metropole, and the National. There is huge potential for development in these two markets, and this has been supported by the rapid absorption of all the new hotels to have opened in the last few years. Between 1991 and 1993, the number of rooms in Moscow increased by 150 percent, with little effect on either occupancy or average rate. In 1995, four- and five-star hotels sustained an average rate in excess of $230 (U.S. dollars) and an occupancy rate of close to 68 percent. There are a large number of projects on the drawing board at the moment, and the marketplace looks set for a great deal of development during the next few years.

The investment market in Russia is still relatively underdeveloped. It is still very difficult to purchase property in Russia except through the vehicle of a Russian-owned company, and there is extensive and unclear legislation concerning the transfer of title over land. There is also the continuing risk of reappropriation of property, as the nation's commitment to capitalism is far from secure. The financial sector is still in disarray, suffering from both a lack of knowledge and high local financing costs. The number of banks being created is only just capable of keeping up with the number that are going into liquidation. It is almost impossible to ascertain the current yields being achieved by property investments in Moscow and St Petersburg—as there is little if no information available—some estimates put the range between 13 percent and 20 percent.

## » 22.04 MIDDLE EAST AND NORTH AFRICA

### [1] Overview

Prior to the 1970s, tourism demand in the Middle East was virtually nonexistent. The development of tourism facilities, primarily hotels, occurred in the late 1970s and the early 1980s, partly in response to demand from international travelers looking to capitalize on the wealth generated from oil production. Today, tourism in the region is a small but rapidly growing industry.

Regional tourism trends show that the Middle East and Africa have experienced above average growth rates compared to the rest of the world (see Exhibit 22-5, Regional Tourism Trends). However, the total increase in the number of visitors to the Middle East and Africa is only 18 million or 9 % of the total tourist increase in the years 1989-1998. In fact, of the top destinations in the world only Tunisia, Egypt, and Saudi Arabia rank in the top 35 (see Exhibit 22-6, Top Destinations World Wide).

### [2] Obstacles to Increased Tourism

Political instability in the Middle East and North Africa is the major obstacle to increased tourism. Tensions between the State of Israel and its Arab neighbors alone have resulted in numerous conflicts since 1948. Difficulties have arisen between Arab countries—for

example, the Iran/Iraq war and Iraq's invasion of Kuwait in 1990. In almost all Middle Eastern countries there is some type of conflict either above or just below the surface. It will not be until these tensions are finally eradicated that the industry will flourish.

**Exhibit 22-5 Regional Tourism Trends 1989-1998**

*Source: WTO*

| | Increase in Arrivals | | Average Annual Growth Rate | |
|---|---|---|---|---|
| **Region** | **1989-1998 (millions)** | **1989-93** | **1994-98** | **1989-98** |
| Africa | 11.1 | 7.6% | 6.9% | 6.8% |
| Americas | 33.2 | 4.5% | 3.1% | 3.7% |
| East Asia/Pacific | 39.2 | 10.5% | 3.1% | 6.9% |
| Europe | 106.2 | 3.9% | 3.0% | 3,8% |
| South Asia | 2.0 | 3.7% | 7.0% | 5.9% |
| Middle East | 7.1 | 7.4% | 5.1% | 6.9% |
| WORLD | 198.8 | 5.0% | 3.2% | 4.3% |

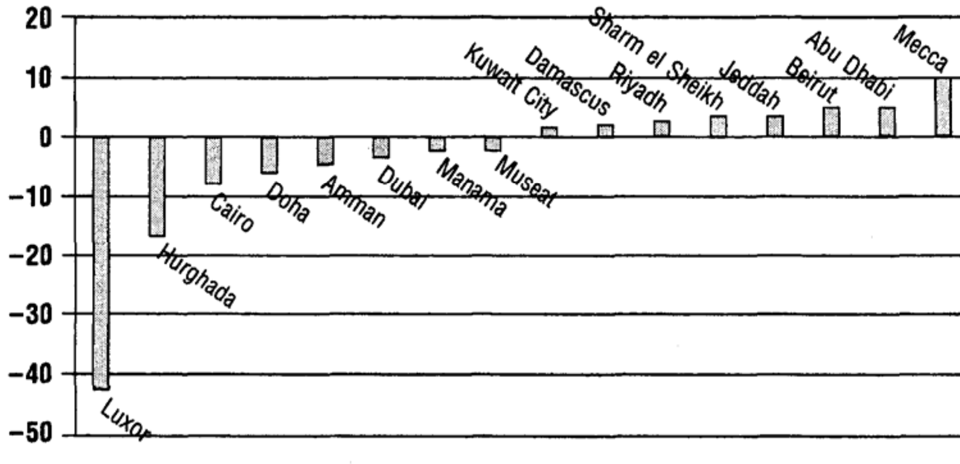
**Exhibit 22-6 Top Destinations Worldwide**

*Source: HVS International*

| **Rank Country** | | **Arrivals (OOOs)** | **%0f Total** | **Rank Country** | **Arrivals (OOOs)** | **%0f Total** |
|---|---|---|---|---|---|---|
| 1 | France | 70,000 | 11.2% | 11 Germany | 16,504 | 2.6% |
| 2 | Spain | 47,743 | 7.6% | 12 Czech Republic | 16,325 | 2.6% |
| 3 | United States | 47,127 | 7.5% | 13 Russian Federation | 15,810 | 2.5% |
| 4 | Italy | 34,829 | 5.6% | 14 Hungary | 14,660 | 2,3% |
| 5 | United Kingdom | 25,475 | 4.1% | 15 Portugal | 11,800 | 1.9% |
| 6 | China | 24,000 | 3.8% | 16 Greece | 11,077 | 1.8% |
| 7 | Mexico | 19,300 | 3,1% | 17 Switzerland | 11,025 | 1.8% |
| 8 | Poland | 18,820 | 3.0% | 18 Hong Kong | 9,600 | 1.5% |
| 9 | Canada | 18,659 | 3,0% | 19 Turkey | 9,200 | 1.5% |
| 1 | Austria | 17,282 | 2.8% | 20 Thailand | 7,720 | 1.2% |

| **Rank Country** | **Arrivals (OOOs)** | **%0f Total** |
|---|---|---|
| 29 Tunisia | 4,700 | 0.8% |
| 34 Egypt | 3,766 | 0.6% |
| 35 Saudi Arabia | 3,700 | 0.6% |

Religious fundamentalism still represents a major problem for the political and economic stability of the region and for the tourism industry in particular. The threat of fundamentalism is most acute in Egypt and Algeria. The terrorist attack at Luxor in the 1990s has devastated the tourism industry in Egypt, with occupancy at Luxor dropping over 40% between 1997 and 1998 (see Exhibit 2-7, Occupancy % Change).




## [3] Hotel Data

After significant growth after 1994, tourism receipts have leveled off until 1998 (see Exhibit 22-8, Regional Tourism Trends). However, as previously noted the increase has not been even across the board, with the Luxor and Cairo showing large decline in occupancy percent and Mecca showing the largest increase occupancy as a result of decreased tensions with its Arab neighbors.

**Exhibit 22-8 Regional Tourism Trends 1989-1998**

*Source: WTO*

| | Increase in Receipts | Average Annual Growth Rate | | |
|---|---|---|---|---|
| **Region** | **1989-1998 (US$ bn)** | **1989-93** | **1994-98** | **1989-98** |
| Africa | 5.1 | 8,8% | 8.5% | 8.7% |
| Americas | 61.1 | 10.9% | 6.2% | 8.1% |
| East Asia/Pacific | 39.5 | 12.0% | 3.8% | 8.9% |
| Europe | 110.2 | 9.2% | 6.0% | 7.7% |
| South Asia | 2.4 | 7.9% | 9.4% | 9.3% |
| Middle East | 5.2 | 6.1% | 11.0% | 8.9% |
| WORLD | 223.5 | 10.0% | 5.9% | 8.1% |

1998 has shown that most cities in the Middle East have had a significant drop in Average Room Rates due to overbuilding in Sharm el Sheikh and Hurghada. Cairo, despite a decline in occupancy, has been able to raise its average room rate between 1997 and 1998 (See Exhibit 22-9, Average Room Rate % Change). The better measure of hotel performance is RevPar and Mecca has seen the largest increase as pilgrims return to the holy city in large numbers. The Luxor area is still devastated from terrorist attacks and has seen its RevPar drop over 75% in 1998 from 1997 (see Exhibit 22-10).

**Exhibit 22-9 Average Room Rate—% Change 1997–1998**

*Source: HVS International*

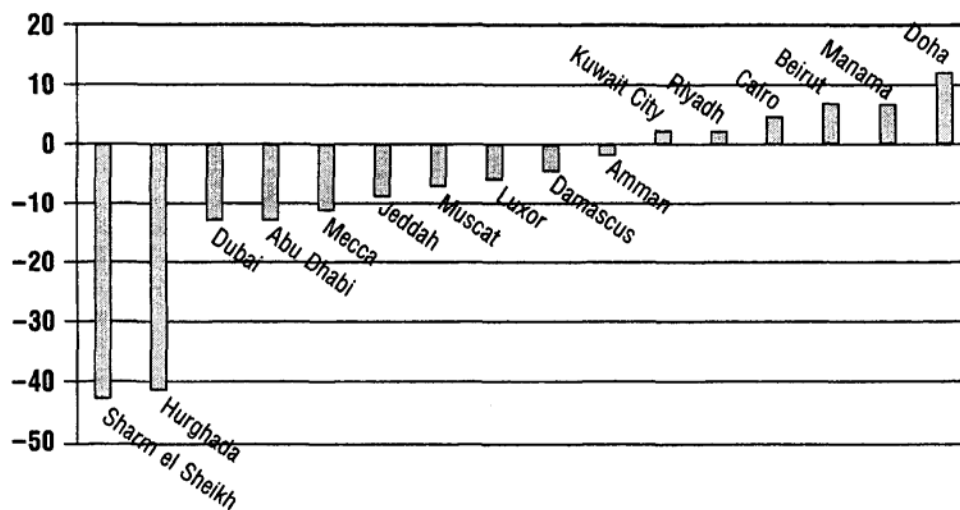
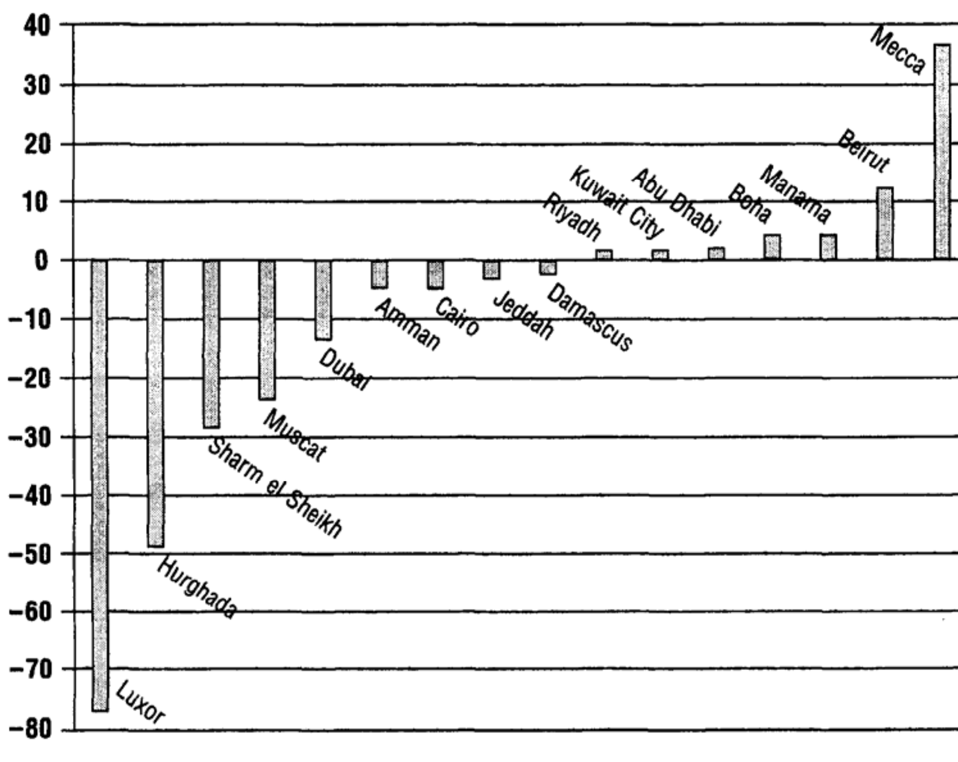



**Exhibit 22-10 RevPAR—% Change 1997–1998**

*Source: HVS International*

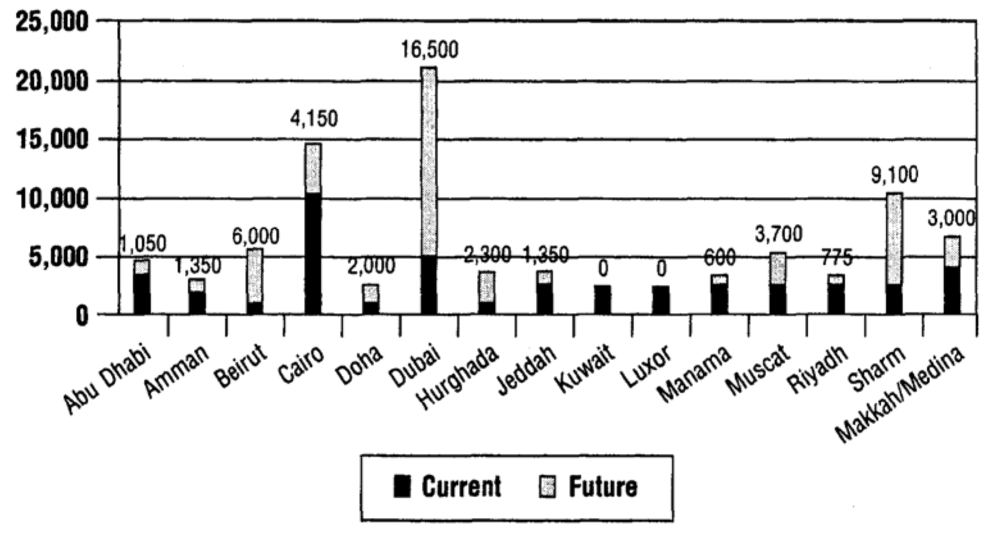



As the area tries to develop its tourist base, a large number of new hotel projects are planned for the future (see Exhibit 22-11, Current and Future Supply). Dubai plans to add over 16,500 rooms in the future in an attempt to become a major tourist destination. It currently has 5,000 rooms and so this would represent a three-fold in-

crease in rooms for an unproven market. Sharm and Makkah/Medina are also planning on an increase in tourist and business travel by planning for 9,100 and 3,000 room increases, respectfully. Beirut, after years of being devastated by civil war is counting on political stability to once again develop its tourism industry that was so important before the civil war by adding over 6,000 rooms in the future. Cairo is also planning to add over 4,000 rooms as it seeks peace with its fundamentalist minority.

**Exhibit 22-11 Current and Future Supply**

*Source: HVS International*




## » 22.05 COUNTRIES OF THE MIDDLE EAST AND NORTH AFRICA

### [1] Bahrain

Tourism continues to be seen as one of the sectors of the economy that will help the island become less dependent on oil revenues. Tourism revenues reached $213 million in 1993, up 20 percent from 1992, while the number of tourist arrivals stabilized at around 1.5 million. Despite the lack of archaeological attractions and the small size of the island, Bahrain was the fifth most popular tourist destination in the Middle East and North Africa in terms of total number of tourists in 1993, capturing 8.4 percent of total arrivals. The popularity of Bahrain is the result of improved road communication with Saudi Arabia via the King Fahad Causeway. Arrivals from Saudi Arabia and other Middle Eastern countries accounted for more than 80 percent of total arrivals in 1993.

Currently, the government's effort to promote tourism-related projects relies essentially on private initiative, rather than public-sector finance. Such projects include the construction of two golf courses and two conference centers as well as the recent completion of the airport extension, which enables the airport to handle up to 10 million passengers per year.

The up-market hotels in Manama City are all operated by international hotel companies, such as Sheraton, Inter-Continental, Hilton International, Forte, Holiday Inn and, more recently, Meridien (1994). Marriott and Oberoi hotels are expected to enter the market in the future.

Commercial business accounts for 65 percent of the up-market room nights in Manama City, while 25 percent is generated by government-related travelers and meeting attendees. The remaining 10 percent consists of individual leisure tourists, primarily from Saudi Arabia.

The government is actively promoting tourism to attract a larger share of tourists from other Middle Eastern countries (particularly Saudi Arabia) as well as Europe and the Far East. Provided that public funding is available to finance the necessary tourist infrastructure, Bahrain should be well positioned to capture more international visitors in the future.

## [2] Egypt

Future economic policy will be influenced by Egypt's commitments under the IMF Extended Fund Facility (EFF) accorded in September, 1993. A positive review by the Fund will allow a debt write-off of $4 billion. The government wants to maintain a strong pound in order to prevent capital flight and preserve business confidence. The economic reforms implemented so far should pay off in the form of strong and sustainable growth and declines in consumer prices, which in turn should provide real benefit to Egypt's impoverished population. This should also help to reduce support among the population for the religious fundamentalists. Privatization of state-owned assets is continuing, through limited-share floatations of the 300 or so public enterprises. The government is attempting to tap small investors' savings rather than attract large private investors and thereby maintain control of the public companies while strengthening the sector with private capital.

Despite continuing terrorist activity, Egypt remains one of the leading tourist destinations in the Middle East and North Africa. Egypt captured 2.3 million, or 13 percent, of the total tourist arrivals in the region in 1994; only Morocco and Tunisia attracted more tourists in the same year. The annual compound growth rate of tourist arrivals to Egypt from 1984 to 1994 was 4.2 percent. Preliminary figures for 1995 indicate an increase in the number of tourists by some 21 percent over 1994 figures. Tourism revenue in 1993 was only $1.3 billion (3.6 percent of GDP), down from the record level of $2.7 billion (7.7 percent of GDP) in 1992, Europe (primarily the U.K., Germany, France, and Italy) continues to be the principal feeder market with 48 percent of total arrivals, followed by other Middle Eastern countries with 30 percent of total arrivals. The supply of hotels in Egypt has increased by 8.7 percent between 1989 and 1993, with the development activity concentrated in the new tourist destinations along the Red Sea.

The presence of international hotel companies in the up-market category of the four major markets in Egypt—Cairo, Hurghada, Luxor, and Sharm el Sheikh—is well established. Cairo continues to be one of the main financial and commercial centers in the Middle East and attracts an even mixture of business and leisure travelers. Luxor, with its numerous Pharaonic artifacts, has always been a primary destination for tourists. Egypt's popularity as a winter sun destination is increasing every year.

The most significant factor affecting the economic future of Egypt is the return of international tourism demand, once the threat posed by religious fundamentalists is perceived to have lessened. While prospects for growth in business travel to Egypt are good, the confidence of international investors in the country's economy is closely linked to the future development of tourism. The current development of hotels along the Red Sea is likely to attract a large and previously untapped tourist market to Egypt.

## [3] Israel

The majority of tourists to Israel originate from Europe (approximately 60 percent) and North America (25 percent). Beside the negative impact of regional instability, Israel's penetration of source markets around the world has also been limited in the past by Israel's restricted global access and the relatively high cost of travel to and from the country. However, Israel's accessibility has improved significantly in the past two years, following El Al's inauguration of several Far Eastern routes—including Beijing, Bangkok (via Bombay) and Hong Kong—and the Israeli government's implementation of a new "open skies" policy in March 1994, which has brought about a widespread deregulation of the industry. Another important event was the June 1994 agreement between Israel and the Vatican to establish full diplomatic relations. This has resulted in a rapid increase in the number of Christian travelers visiting the numerous religious sites in Israel,

Jerusalem has always been the focal point of tourism in Israel. A recent Ministry of Tourism survey estimates that 91 percent of all tourists who come to Israel visit Jerusalem during the course of their stay. In order to meet the growing commercial and leisure demand, the local municipal and tourism authorities have plans to build an additional 10,000 hotel rooms in the city by the end of the decade.

Tel Aviv is the commercial and industrial heart of Israel. Today, the Tel Aviv "hotel strip" is a row of dated concrete high-rise properties that blight the scenic Mediterranean coastline. However, with several new international hotels in the planning and construction stages, existing hotels are preparing for the new competition. The new 550-room Inter-Continental Hotel, currently under construction and scheduled to open in 1997, represents the first new-build hotel in the city since 1981. Although there are several projects, including a Hyatt, in the planning stages, further additions to supply are likely to be constrained by the lack of available land and spiraling real estate values, which favor non-hotel development.

Eilat has been the site of most of the new hotel construction in Israel in recent years. Today, the resort has more than 5,500 hotel rooms, with a further 5,000 to 6,000 in the planning or construction stage. Eilat's real strengths as a resort are its short-haul proximity (a four- to five-hour flight) from the main tourism-generating countries in Europe and its guaranteed year-round sunshine.

Despite impressive growth in international visitors to Eilat in 1994, market occupancies have been hurt by the opening of several new hotels and an exodus of Israeli vacationers to Turkey, where prices are considerably cheaper. Although Eilat is presently the most developed resort on the Red Sea, it faces stiff competition from the rapidly growing and substantially cheaper Egyptian resorts of Sharm el Sheikh and Hurghada.

The increased interest in Israel as a tourist destination, coupled with the prospect of a lasting peace agreement, could significantly increase the number of leisure, religious, convention, and commercial visitors to the country.

## [4] Jordan

The dramatic improvement in Jordanian-Israeli relations has already brought Amman economic dividends in the form of debt relief of approximately $900 million. The mini-boom that Jordan experienced after the Gulf crisis continued in 1994. However, the economy has more recently been constrained by the embargo on Iraq, which is one of Jordan's largest trading partners. The government has announced 121 infrastructure projects aimed at developing the domestic economy and fostering economic cooperation in the region. Special attention has been given to the development of the

Jordan Rift Valley, the creation of a free trade zone in Aqaba and Eilat, and the joint promotion of tourism in the region.

Political instability in the Middle East has historically denied the Jordanian tourism industry the chance to develop to its full potential. Since 1992, however, the number of tourist arrivals has grown rapidly, recording an increase of 15.4 percent in 1993 and 11.6 percent in 1994. Much of this has come from cross-border tourism with Israel. Tourism receipts accounted for $563 million in 1993, representing an 11 percent contribution to GDP. Visitors from Middle Eastern countries dominate the total number of international arrivals. However, when only leisure travelers are considered, tourists from Europe represent the largest market. For the past three years, Italy (28 percent) has been the largest feeder market, followed by the U.K. (17 percent) and Germany (16 percent).

Recently, plans for several hotels in Amman have been announced. Also, the city of Petra has drawn substantial interest from both local investors and international hotel companies and it is expected that, in the next two to three years, between 800 and 1,000 rooms will be added to the existing supply. Several other hotel projects at various planning stages are currently rumored along the Dead Sea and in Aqaba.

## [5] Kuwait

Kuwait continues to attract a small number of commercial travelers and almost no leisure tourists. According to the WTO, there were only 73,000 arrivals in 1993. Kuwait has not actively encouraged tourism, although some hotels are attempting to promote weekend/short-break packages targeted at guests from neighboring Middle Eastern countries. In addition, commercial demand has not reached pre-invasion levels because of the continuing threat posed by Iraq. Nearly all visitors (81 percent) to Kuwait are from Middle Eastern countries. Despite the lack of new additions to the current stock of up-market hotels, the Kuwaiti hoteliers do not envisage growth in demand in the short-term.

ADRs in Kuwait City continue to be among the highest in the Middle East and North Africa and reached $175 in 1994 as a direct result of actions taken by the Kuwaiti Hotel Owners Association, which has set a minimum charge for up-market hotels. In 1995, this rate was reduced as the market was forced to become more competitive in order to attract business. However the results of such high average rates can be clearly seen in the occupancy levels. Business and government travelers represent more than 95 percent of total room night demand in the up-market hotels; the remaining 2 percent is generated from individual leisure travelers.

Despite the promotion of short breaks and weekend packages, the tourism segment is not expected to become a major source of demand for hotels in Kuwait City. Hotels are expected to continue to depend largely on government and business travelers for the vast majority of their business. Given the current low occupancy levels, no new up-market hotels are expected to enter the market.

## [6] Lebanon

Prior to the civil war, Lebanon was known as the "Switzerland of the Middle East," attracting large volumes of both business and leisure travelers. The country offered a diverse range of tourist attractions, from skiing in the mountains to swimming in the Mediterranean. Today, Beirut remains the capital and the main economic, political, and social center of the country. The stock of hotels in Lebanon has been drastically

reduced in comparison with pre-civil war levels. Today, the entire country has some 4,000 rooms, whereas in the 1970s, Beirut alone had 7,000 rooms.

Currently, there are only a few high-standard hotels operating in Beirut and, because of this, business travelers are forced to pay room rates well in excess of $125 for standard accommodation. These hotels achieve an occupancy of between 50 percent to 60 percent. Improvements in the overall transient accommodation are expected with the addition of new up-market hotel rooms as well as the reconstruction of damaged hotel properties.

Two tourism-related projects are being sponsored by the government: one is a leisure complex including a casino, a theater, and restaurant outlets; the other is a project for a 500-room hotel with a 1,000-seat conference center, likely to be operated by an international hotel company.

## [7] Morocco

The tourism industry in Morocco generates more than $1.2 billion, more than 4 percent of the country's GDP in 1993. The major locations of tourism and business interest in Morocco are Rabat, Casablanca, and Marrakech. The capital, Rabat, has only a limited supply of hotels offering international standard accommodation. Casablanca, one of the largest hotel markets in Morocco, is the commercial and financial center of the country. Marrakech is considered to be Morocco's most developed and popular tourist destination; however, its up-market hotels are suffering from a degree of oversupply.

Morocco is expected to remain the leading country in terms of volume of tourists in the region, because of its wide variety of tourist attractions and strong commitment by its government toward the sector. The current privatization program represents a good opportunity for potential investors to gain a foothold in a lucrative market. The long-term challenge for Morocco will be to maintain its unique image and ADR in the face of ever-increasing competition.

## [8] Oman

Tourism continues to represent a minimal portion of the national economy, accounting for 1 percent of GNP in 1993. The number of tourist arrivals to the Sultanate was 2 percent of the total number of tourist arrivals to the region in the same year. In contrast with the majority of other Gulf states, however, the largest proportion (approximately 30 percent) of visitors to Oman were from European countries, while arrivals from other Middle Eastern countries averaged only 13 percent per annum. Most of the international arrivals in Oman were business travelers. The government is actively involved in the promotion of the Sultanate's other tourism attractions, such as Nizwa, Rustaq, Mudarib Sur and Salah. It is expected that Oman will continue to attract only a small number of international visitors in the future, both for social reasons as well as the fact that the country's infrastructure is not capable of handling mass tourism at present.

The up-market hotel sector in Muscat has experienced an increase of nearly 10 occupancy points between 1993 and 1994, and a further 2 percentage points in 1995, while ADR has increased $9 in the last two years. The local up-market hotels are expected to see more competition as a result of the addition of the 250-room, five-star Hyatt hotel in 1995. Approximately 60 percent of the room nights in Muscat are generated by corporate and government-related travelers. The remainder is made up of

airline crews (27 percent), leisure travelers (10 percent), and conference attendees (3 percent).

The Sultanate is making an effort to attract more leisure visitors both from other Middle Eastern countries and from Europe. However, the limited tourism infrastructure will prevent Oman from being able to handle large volumes of leisure travelers in the short term. Business travel related to the oil and gas industries is expected to remain the largest market for the local hotel industry.

## [9] Palestinian Areas

Because of political and economic problems, demand for hotel accommodation is extremely limited from the commercial sector and nonexistent from the leisure sector. The supply of hotels in the Gaza Strip is limited to small lodging facilities, which account for a total of 92 rooms. Most of the government and commercial travelers are displaced to either Tel Aviv or Jerusalem. The existing hotels are generally outdated and do not provide facilities of an international standard.

It is envisaged that hotel demand in the Palestinian Areas will be dependent almost entirely on the redevelopment efforts in the area, at least in the short term. In fact, the numerous infrastructure projects planned for the area are expected to generate a considerable flow of travelers to the Gaza Strip and the West Bank. Reported published rates for double rooms in the local hotels range from $50 to $80. Plans are currently in place to start construction on the first international standard four- to five-star hotel in Gaza City. The 275-room hotel will be located approximately 2.5 kilometers from the city center and will be managed by Marriott Hotels.

## [10] Qatar

In the past, the development of the tourism sector has not been a priority for the Qatari government, and, as a result, there is little official information on the contribution of tourism to the national income.

In 1993, an estimated 160,000 tourists arrived in Qatar, an increase of more than 13 percent compared to 1992. In 1994 it is estimated that 172,000 tourists visited Qatar. This represents less than 1 percent of the total number of international travelers visiting the Middle East and North Africa as a whole. Although the Qatari government has recently started attending international travel shows to attract tour operators to the country, future growth will revolve around business travelers, particularly those involved in the oil and gas industries.

The up-market hotels in Doha registered an occupancy of 75 percent in 1995, up from 61 percent in 1994, while the ADR increased by $3. The Doha area has had an increase in business travelers since the Gulf War, largely because of increased activities in the oil and gas industries. Approximately 70 percent of room nights in the up-market hotels were bought by business and government-related travelers, 20 percent by airline crews, and 10 percent by leisure visitors and conference attendees.

Although Qatar has not actively tried to attract leisure travelers in the past, it has recently started, albeit in a limited way, to encourage international tourists to some of its beach resorts. Sporting events are also expected to generate leisure tourism, specifically from Middle Eastern countries and other Arab states.

## [11] Saudi Arabia

International tourism continues to be limited in Saudi Arabia, with strict visa requirements making it virtually impossible to visit the country for leisure purposes. There are very limited tourist statistics available, and only recently has some official data been published. However, the kingdom does attract a massive annual pilgrimage, being the keeper of the Islamic holy sites Mecca and Medina. In 1993, there were an estimated two million international arrivals, of which the majority were Muslim visitors to the holy sites.

Principal destinations remain the capital city, Riyadh, the commercial city, Jed-dah, and the holy cities of Mecca and Medina. Jeddah is the financial and commercial center as well as the main leisure destination. Seven hotels currently under construction will be operated by international hotel chains.

Non-pilgrimage tourist demand in Saudi Arabia will continue to be dominated by business travelers. Saudi Arabia will also follow the Middle Eastern trend of attracting more intra-regional travelers.

## [12] Syria

The tourism industry offers a small contribution to GDP, accounting for an estimated 2 percent of the national wealth and only 4.1 percent of total international tourist arrivals to the Middle East and North Africa in 1993. This limited contribution can be partly attributed to the government's lack of international tourism promotion. The country's political stance has also been a strong deterrent to investments in tourism, despite the abundance of unexploited archaeological and historical sites in the country. The poor tourist-related infrastructure, the limited supply of Western-standard hotels, and the country's historic isolation from the West have disinclined international tourists from visiting Syria.

Damascus remains the focus of any future growth in tourism. Over 70 percent of the estimated 700,000 visitors to Syria arrive from other Middle Eastern countries, while Europe, the second largest geographic market, represents only 15 percent of total tourists.

The supply of up-market hotels in Damascus is very small in comparison with other capital cities in the region. Despite the drop in occupancy rates from 1993 to 1994, occupancy totals in Damascus are still among the highest in the region, primarily because of limited competition.

Syria has tremendous potential for tourism development, having a diverse geography of deserts, mountains, and seashores rich in historical significance, and there is an increased level of interest among major international hotel chains in Damascus. However, a significant influx of international tourists will not occur until Syria is perceived to be a more open and inviting destination.

## [13] Tunisia

Tourism is a growing sector of the economy, accounting for more than 7 percent of total GDP in 1993, despite Tunisia's proximity to troubled Algeria and isolated Libya. The tourism industry in Tunisia is concentrated on less than 100 kilometers of the country's 1,300 kilometers of coastline, with the major share of investment concentrated in the resort areas of Hammamet/Nabuel, Sousse/Monastir, and the island of Jerba. Germany is by far the largest feeder market, followed by France, the U.K. and Italy. Europe accounted for 55 percent and Africa 23 percent of total tourist arrivals

in 1993. The continuing popularity of Tunisia as a tourism destination has spurred considerable investment in new hotel development, primarily along the coast.

Tunis and Hammamet are the major locations of tourism and business interest in Tunisia. Tunis has a limited supply of hotel rooms, dominated by Hilton, Meridien, and the domestic chain, Abou Nawas. Despite being the largest resort in Tunisia, Hammamet has only one property operated by an international hotel company, Sheraton.

The low occupancy levels achieved by hotels in Tunis and Hammamet in 1990 and 1991 were a direct result of the Gulf War. The business segment is the largest demand segment in Tunis (85 percent), with the balance made up by leisure groups and airline crews. In contrast, Hammamet hotels derive 85 percent of their demand from the tour operator market, and the balance from individual leisure travelers and incentive/conference business. ADR in Tunis hotels has stabilized at close to $60 since 1992. However, in Hammamet, a price war among local hotels and an increased supply of hotels has meant that ADRs have constantly dropped since 1992.

## [14] United Arab Emirates

The United Arab Emirates (UAE) has experienced a greater amount of tourism development during the past three years than any other nation in the Arabian Peninsula. Although Abu Dhabi is both the wealthiest emirate and the capital of the UAE, Dubai has the larger tourism market, with three golf courses, a race track, and a marina. Arrivals to Dubai now account for more than 6 percent of total tourists in the Middle East and North Africa. Although visitors from Middle East countries still represent the majority of visitors to Dubai (37 percent including UAE nationals), the share of Europeans increased from 20 percent in 1992 to 27 percent in 1993. An estimated 71,000 tourists from the former Soviet Union visited Dubai in 1993 and, although considered tourists, many of them visited the emirate to take advantage of Dubai's low consumer prices.

The uplift in occupancy in up-market hotels in Abu Dhabi was moderated by recent supply increases. Despite an increase in room supply, Dubai hotels achieved one of the highest occupancies in the Middle East and North Africa in 1994, with 74 percent, up from just 70 percent in 1993. It is expected, however, that occupancy will remain relatively flat or decline slightly in both Dubai and Abu Dhabi during the next few years to absorb the new supply. In addition, increased competition will be generated by small residence hotels (sixty to eighty rooms) catering to extended-stay guests who normally stay in up-market full service hotels.

While the UAE will capture more visitors in the future, Dubai will continue to be the dominant market, attracting both business travelers and an increasing number of leisure tourists traveling on package holidays. Given the significant level of recent hotel construction, as well as the development of more hotels in both Dubai and Abu Dhabi, it remains to be seen whether demand will be able to keep up with supply.

## [15] Yemen

The tourism contribution to the national economy in Yemen accounts for less than 0.3 percent of GDP. The number of visitor arrivals has remained stable between 1992 and 1993 and dropped in 1994 as a result of a civil war. European nationals are by far the largest portion of visitor arrivals, accounting for 64 percent of the total. With the government's recent focus on oil exploration, the vast majority of European travelers in Yemen are business travelers to Sana'a or Aden. The lack of tourism infrastructure and the unstable political environment means that significant volumes of leisure trav-

elers are unlikely to visit the country in the near future. The presence of international hotel chains is very limited, with only Sheraton, Taj, and Movenpick currently represented. Holiday Inn will soon manage a 200-room hotel in Aden.

The lack of leisure tourist infrastructure, combined with the unstable political environment, will prevent Yemen from attracting many leisure tourists in the foreseeable future. Any growth in the number of visitors will continue to be generated primarily from commercial business travelers seeking opportunities in the country's growing oil and gas explorations.

## » 22.06 ASIAN MARKETS VALUES

### [1] Hotel Values 1993 to 1997

In general, the strong growth of the economies in Asia, prior to 1997, had a positive impact on the performance of hotels throughout the region. In many instances, occupancy levels continued to grow as demand outpaced new supply. At the same time, hotels are able to increase their rates, overall profitability and, subsequently, their asset values. This upward trend in most markets is clearly demonstrated by the increases in hotel values from 1993 to 1996 (see Exhibit 22-12 and Exhibit 22-13).

**Exhibit 22-12 Asian HVI In US$ Ranked by Index in 1997**

Source: *HVS International*

| | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|
| Hong Kong | 1.620 | 1.989 | 2.616 | 2.861 | 2.221 |
| Tokyo | 2.769 | 2.484 | 2.603 | 2.300 | 1.984 |
| Average | 1.000 | 1.114 | 1.265 | 1.298 | 1.158 |
| Singapore | 1.113 | 1,298 | 1.626 | 1.463 | 1.134 |
| Seoul | 0.912 | 1.230 | 2.009 | 1.492 | 1.119 |
| Mumbai | 0.872 | 1.077 | 1.484 | 1.319 | 1.004 |
| Shanghai | 0.667 | 0.884 | 1.215 | 1.096 | 0.947 |
| Beijing | 0.599 | 0.816 | 1.142 | 0,973 | 0.789 |
| Jakarta | 0.912 | 0,880 | 1.009 | 0.973 | 0.778 |
| Manila | 0.482 | 0.530 | 0.644 | 0.890 | 0.778 |
| Ball | 0.434 | 0.539 | 0.612 | 0.655 | 0.599 |
| Bangkok | .0792 | 0.892 | 1.174 | 0.960 | 0.578 |
| Kuala Lumpur | 0.828 | 0.743 | 1.119 | 0.989 | 0.477 |

Between 1993 and 1996, values throughout the region increased by 30% on average. Manila recorded the strongest increase at 80%, closely followed by Hong Kong at 72%. During the period, the only city to show a value decline was Tokyo (at minus 19%), reflecting Japan's prolonged recession.

In the middle of 1997, this strong performance was interrupted by the onset of turmoil in the Asian economies. Sharply declining occupancy levels and room rates caused hotel values to decline by 11% on average in 1997, Kuala Lumpur experienced the most significant drop of almost 45%, followed by Bangkok at 31%. With

the exception of Bali and Manila, all other markets saw a decrease in hotel values during 1997.

By the end of 1997, only hotel values in Hong Kong, Tokyo, Singapore, and Seoul continued to remain above the Asian Average of around US$288,250 per room. This figure is only slightly above the Asian-wide average of US$277,0000 achieved in 1994, and is significantly below the Asian-wide average of US$314,000 achieved in 1995, indicating the severe impact of the economic turmoil on hotel values in Asia in 1997.

**Exhibit 22-13 Hotel Values per Room in US$ Ranked by Value in 1997**

Source: *HVS International*

| | 1993 | 1994 | % Change | 1995 | % Change | 1996 | % Change | 1997 | % Change |
|---|---|---|---|---|---|---|---|---|---|
| Hong Kong | 403,000 | 495,000 | 22.8% | 573,000 | 15.8% | 694,000 | 21.1% | 619,000 | -10.8% |
| Tokyo | 689,000 | 618,000 | -10.3 | 570,000 | -7.8 | 558,000 | -2.1 | 553,000 | -0.9 |
| Singapore | 277,000 | 323,000 | 16.6 | 356,000 | 10.2 | 355,000 | -0,3 | 316,000 | -11.0 |
| Seoul | 227,000 | 306,000 | 34.8 | 440,000 | 43.8 | 362,000 | -17.7 | 312,000 | -13.8 |
| Mumbai | 217,000 | 268,000 | 23.5 | 325,000 | 21.3 | 320,000 | -1.5 | 280,000 | -12.5 |
| Shanghai | 166,000 | 220,000 | 32.5 | 266,000 | 20.9 | 266,000 | 0.0 | 264,000 | -0.8 |
| Beijing | 149,000 | 203,000 | 36.2 | 250,000 | 23.2 | 236,000 | -5.6 | 220,000 | -6.8 |
| Jakarta | 227,000 | 219,000 | -3.5 | 221,000 | 0.9 | 236,000 | 6.8 | 217,000 | -8.1 |
| Manila | 120,000 | 132,000 | 10.0 | 141,000 | 6.8 | 216,000 | 53.2 | 217,000 | 0.5 |
| Bali | 108,000 | 134,000 | 24.1 | 134,000 | 0.0 | 159,000 | 18.7 | 167,000 | 5.0 |
| Bangkok | 197,000 | 222,000 | 12,7 | 257,000 | 15.8 | 233,000 | -9.3 | 161,000 | -30.9 |
| Kuala Lumpur | 206,000 | 185,000 | -10.2 | 245,000 | 32.4 | 240,000 | -2.0 | 133,000 | -44.6 |

## [2] Hotel Values 1998

More recent statistics show a further and more dramatic decrease in hotel values throughout the region during the first half of 1998. On average, values have declined by approximately 20%. All markets—with the exception of Seoul, Shanghai, Singapore, Manila, Mumbai, and Tokyo—have shown a decline in excess of 20 percent, with Hong Kong and Jakarta experiencing a decrease of greater than 40%. Bangkok is the only market in which hotel values have increased in 1998 (see Exhibit 22-14).

On average, hotel values have declined by approximately 27% since their peak (see Exhibit 22-15). Interestingly, in most markets, values peaked at the end of 1995 and started to decline before the economic crisis, primarily as a consequence of rising supply. The markets that have witnessed the greatest value declines are Kuala Lumpur (58%), Jakarta (48%), and Hong Kong (47%). Manila has only seen a decline of 7%.

While values have shown dramatic declines, to-date there is little or no evidence of sales occurring at these levels. Even prior to the economic crisis, very few significant sales of hotels occurred. Most activity was focused on new developments rather than the acquisition of existing properties. Partly as a consequence of ineffective bankruptcy laws, as well as the long-term view taken by most Asian investors, so far very few hotels have been offered for sale at realistic current values. HVS' analysis has shown that Asian hotels are currently trading at historically low values, but there are few true opportunities to actually capitalize on these depressed levels.

**Exhibit 22-14 Value per Room Comparison in US$ (December 1997 and July 1998)**

*Source: HVS International*

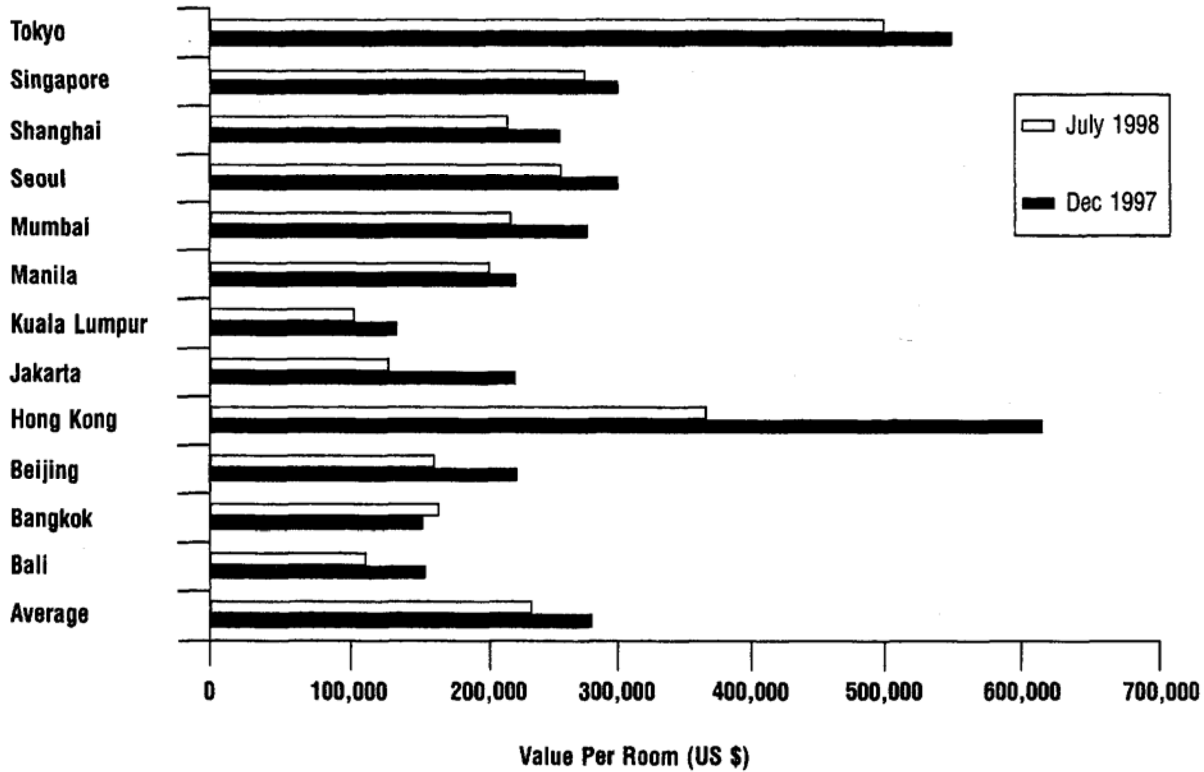
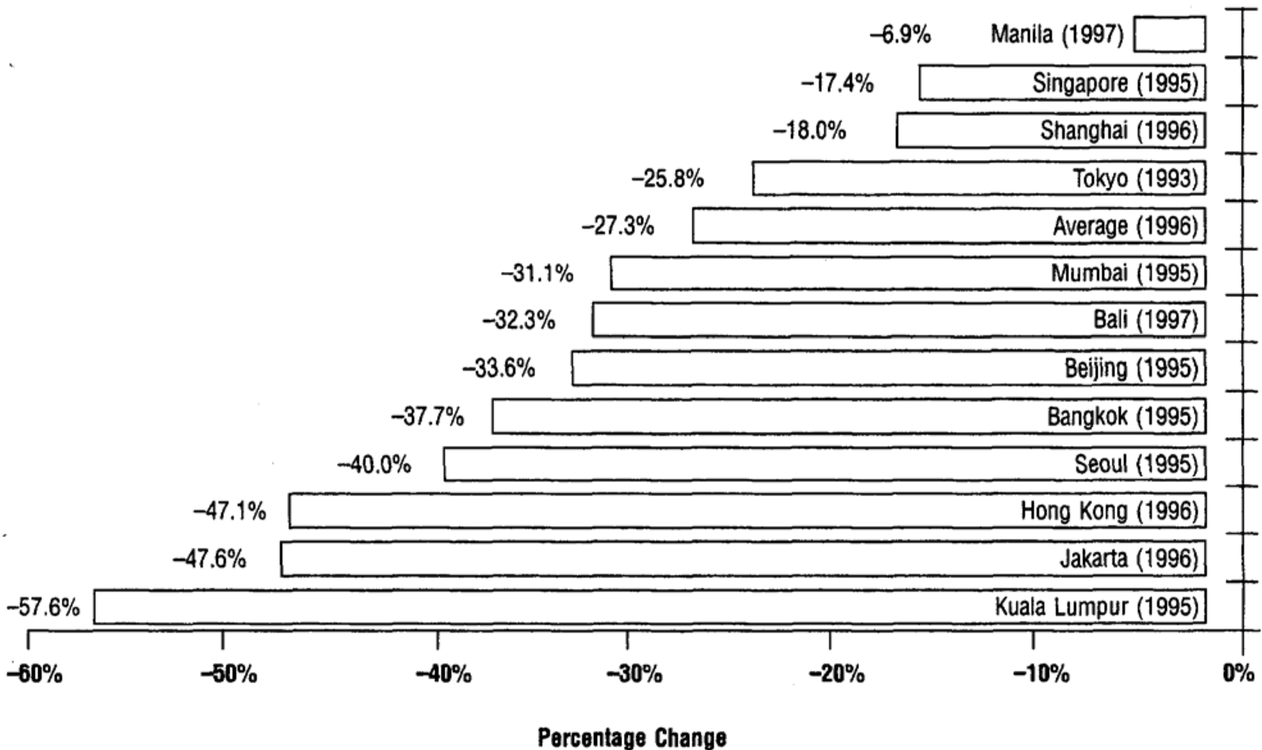



**Exhibit 22-15 Percentage Change from Peak Value**

*Source: HVS International*



## » 22.07 THE ASIAN COUNTRIES

### [1] JAKARTA AND BALI, INDONESIA

Although occupancies increased annually in Jakarta during the period 1993 to 1996, increased competition as a result of new supply limited increased in room rates, keeping room yields relatively stable. By the end of 1997, the economic crisis and the devaluation of the rupiah caused domestic social unrest and political riots in Jakarta and other parts of Indonesia, severely affecting both national and international demand. Hotel values dropped in 1997 after peaking in 1996.

As supply has remained relatively stable during the last four years, hotels in Bali have benefited from rising occupancy levels and average room rates. The combination of new supply and travelers' growing negative perceptions of Indonesia resulted in a drop in room yields during the first part of 1998.

After the stepping down of the former President Suharto in early 1998, the country accepted the IMF package to rescue the national banking system and economy. Among other plans, the government has introduced new legislation empowering banks to foreclosure more easily on defaulting borrowers, allowing transactions to take place more quickly than before.

Although the immediate economic outlook for Indonesia is improving in-line with the implementation of new laws and strengthening of the rupiah, hotel room yields are expected to increase only marginally, as new supply in both markets is likely to dilute any future demand growth. Hotel values are not expected to increase within the next 12 months.

### [2] Hong Kong

Strong demand growth and significant annual occupancy and average room rate growth during 1994 to 1996. As a result, profitability increased and asset values peaked in 1996. The strong dependence of Hong Kong on travelers from other Asian countries was felt strongly as soon as the currencies of feeder markets were devalued during 1997, when hotel occupancies dropped by almost 10% and average room rates declined significantly.

Although occupancy levels have started to recover, average room rates are still far below the 1996 levels, making it unlikely that Hong Kong will see pre-crisis hotel values for some time.

### [3] Beijing and Shanghai, PR of China

Although hotel values in Beijing and Shanghai peaked in 1996, average room rates and occupancy levels remained relatively stable during the period form 1995 to 1997. New supply only marginally affected occupancy and average room rate levels in both cities.

More recent statistics for both markets show a further decline in room yields, causing values to drop during the first part of 1998. The envisaged opening of new hotels, in combination with the persistent economic crisis in Asia, is expected to have a further negative effect on hotel values which are unlikely to reach 1996 levels within the foreseeable future.

## [4] Kuala Lumpur, Malaysia

A two-month haze caused by the burning of land by Indonesian farmers, combined with new supply, the general economic downturn, and subsequent devaluation of the ringgit caused occupancy and average room rates to decline during the first seven months of 1998. New supply and the current political problems in Malaysia are expected to depress the performance of hotels further and a recovery of hotel values in the immediate future is unlikely.

## [5] Mumbai, India

Hotel values in the five-star deluxe segment in Mumbai peaked in 1995 and have declined since. Although the average room rate continued to increase in 1996 and thereafter, as higher paying international business travelers replaced some domestic demand, hotel occupancies started to decline in 1996, mainly as a result of the slowdown in the domestic economy. With new supply envisaged to enter the market within the next five years, hotel values are not expected to reach 1995 levels within the immediate future.

## [6] Seoul, South Korea

Hotel values in Seoul peaked in 1995 and fell by almost 18% in 1996, due to a substantial decline in occupancies and average room rates. This downturn was caused primarily by the instability of the Korean economy and, to some extent, by the opening of the Ritz Carlton Hotel in 1995. Although no new supply has been added to the market since 1995, domestic economic difficulties and the depreciation of the won caused a further deterioration in the performance of the local hotel market during the latter part of 1997.

Like Indonesia and Thailand, South Korea accepted a bailout program from the IMF in order to restructure the banking system and to improve the domestic economy. As no substantial new supply is envisaged to enter the market within the next 12 months, the performance of the existing hotels is expected to improve as soon as the economy starts to benefit from the IMF aid plan and the won regains strength. We expect hotel values to start to increase over the next 12 months. However, the market is vulnerable to the potential recession considering a number of previous postponed hotel projects.

## [7] Tokyo, Japan

Unlike other Asian countries, Japan entered a recession in the early 1990s. Subsequently, hotel values have fluctuated in-line with the decline in room yields and net income. Tokyo hotel values achieved their highest level in the early 1990s and have declined every year since 1993.

As the Japanese economy depends on other Asian economies to a large extent, hotel values are not expected to increase within the foreseeable future. However, any improvement in the Japanese economy is likely to have a positive effect on hotel values as limited supply in envisaged to enter market.

## [8] Singapore

A relatively stable supply of Singaporean hotels in the 'very large' (more than 601 rooms) hotel segment allowed occupancy and average room rate levels to increase annually during 1993 to 1996. After hotel values peaked in 1996, the 1997 general economic downturn in Asia and the dependence of Singapore on travelers from other Asian countries resulted in a decline in room yields, causing values to fall for the first time in 1997.

Although significant new supply is expected to enter the Singapore hotel market, this will be limited mainly to smaller or lower grade hotels. Nevertheless, the incidence of business travelers trading down to lower classified hotels is likely to affect the occupancy growth of the very large hotels. However, we expect the average room rate levels to be broadly maintained. Although we expect hotel values to increase slightly over the next 12 months, as more people start to travel to Singapore again, we consider that the increase will be modest.

## [9] Manila, Philippines

Although occupancy levels started to fall in 1997 for the first time in several years, average room rates continued to grow as manila benefited from strong commercial demand and no new supply; hence, hotel values in greater Manila peaked in 1997

New room supply, further depreciation of the peso, together with the overall economic crisis in Asia are all expected to depress the performance of hotels in Manila further. Although we expect demand for hotel accommodation to increase, new supply is likely to dilute this demand growth. Therefore, we expect hotel values to fall slightly or to stabilize at current levels during the next 12 months.

## [10] Bangkok, Thailand

Up until early 1996, little new supply allowed occupancy levels, average room rates and, subsequently, hotel values to increase year-on-year. Although average room rate levels continued to grow, the market-wide occupancy started to fall in 1996, mainly as a result of new supply, causing hotel values to drop for the first time during the 1990s.

The collapse of the Thai economy and the subsequent devaluation of the baht, together with the general downfall of Asian economies, cause occupancies and average room rates to decrease in Bangkok during the latter part of 1997 and early 1998. More recent statistics, however, show a marginal increase in visitation, hence occupancies and average room rates have increased slightly during the last few months. As only limited new supply is envisaged, and a further sterilization of the Thai economy and strengthening of the baht as a result of the IMF rescue package is anticipated, we expect hotel values to continue to increase within the next 12 months.

HVS

CHAPTER 23

# Analysis of Casino Gaming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## » 23.01 OVERVIEW OF GAMBLING

Gambling is a near-universal pastime. The origins of gambling and the objects used in the ritual date back to our paleolithic ancestors who tossed polished dice-shaped bones, called astragalia. It is uncertain whether these objects were cast for prophecy, amusement, or to win the possessions of others; in any case, these acts began a custom that has survived throughout the ages. It was the gamblers of sixteenth -century Europe who provided the impetus for the formation of mathematical probability theory, when Antoine Gombauld posed a dice problem to Parisian mathematician Blaise Pascal. Since that time, hundreds of mathematicians, philosophers, and economists have pondered the laws of probability, statistical analysis, and calculus in an effort to master the games of chance.

Because of the widespread popularity of gaming throughout Europe, it is difficult to attribute the origin of gaming in the United States to one period or location. In addition, it is widely noted that Native Americans were enthusiastic gamblers centuries before the arrival of Europeans. The first casinos were placed in the early taverns of New England, where card games and other gaming activities were a part of everyday life. Gaming continued its immigration to America with the French colonization of New Orleans, and spread rapidly throughout the South, then north up the Mississippi. Following the Civil War, gaming in the form of state lotteries was introduced to replenish and rebuild the devastated South. As such, gaming flourished within the region, and soon the state of Louisiana became the center of all gaming activity in the United States. The gaming movement swept west with the "Gold Rush" (1848-1849); in many Western territories, gaming was declared neither legal nor illegal. As a result, gaming proliferated throughout the West until the early 1900s. Ironically, Nevada passed the first law banning gambling in the West, in 1910.

The modern era of casino gaming, as it is known today, began in 1931, when a bill to legalize gaming in Nevada was passed by the Nevada State Legislature in Carson City. Nevada enjoyed a monopoly on casino gaming until 1976, when New Jersey passed a referendum allowing legalized casino gambling in Atlantic City. Over the years, much suspicion regarding criminal involvement has surrounded the casino gaming industry in both Nevada and New Jersey. However, the tremendous amount of regulation on the part of both the Nevada and New Jersey gaming commissions has effectively eliminated the criminal element from the daily operation and ownership of legalized casinos. Although it is reported that elements of organized crime occasionally infiltrate a casino operation, these instances are relatively rare. Today's gaming industry, with its Wall Street backing, has become an accepted industry throughout the United States.

One form of gambling or another is now available in forty-eight of the fifty states. Casino-style gaming is currently legal in twenty-two states, in a variety of forms such as on riverboats, at riverside docks, and in saloons, and on various sites including Indian reservations, public parcels and waterways, and privately owned land. A combination of consumer acceptance and the local municipalities' need to increase revenue has resulted in an array of new jurisdictions and gaming venues.

## [1] Gross Wagering and Revenue Trends

Exhibit 23-1 presents the 2000 Gaming Residence and Future Revenue trends in the U.S. gaming industry. "Handle" is defined as the gross amount wager at any form of gambling, or the total amount of money wagered against the house. "Gaming Revenue" is defined as the total amount of money wagered against the house (handle) less winning payouts, or the total amount of money retained by the house from gaming transactions. From the consumer perspective gross gaming is the price paid for playing a commercial game.

Overall, total gaming revenue increased at an average annual rate of 10.2 percent from 1998 to 37.8 billion dollars.

Exhibit 23-2 shows the increase in gaming revenue by different gaming jurisdictions for the year 2000. Nevada continues to lead the nation with approximately 9.6 billion dollars in gaming revenue. Atlantic City is still in second place with approximately 4.3 billion dollars in gaming revenue. Mississippi gaming revenue continues to grow at a healthy pace and is now the third largest casino market in the country with approximately 2.6 billion dollars in gaming revenue. This represents a growth of 5.3% from the prior year.

Nevada's gaming revenue increased by 11.9% from 1998 and this can be attributed to the opening of the several new mega-resorts in Las Vegas market during the year (Bellagio late 1998, Mandalay Bay, Venetian, and Paris). New Jersey with the lack of any new development has shown the smallest increase in revenue growth of all gaming jurisdictions at 3.4%.

## [2] Table Game and Device Analysis by Market

Exhibit 23-3 provides an analysis of gaming win segmented into table game revenues and gaming device revenues. The operation, odds structure, playing habits, and derivation of win for table games and gaming devices are distinct and should be analyzed separately, given the available data. The following table presents total win by market, the total number of units within the market, and the win per unit per day (WPUPD) statistics for 1996 and 1997. The WPUPD figure is calculated by dividing the total gaming win by the number of units and dividing that figure by the total number of days in the period.

**Exhibit 23-1 2005 Adult Population and Potential Gamer Visits**

Source: *Bear, Steams & Co. Inc.; PricewaterhouseCoopers.*

| Market | 2005 Potential Gamer Visits | 2000 Gaming Revenue (MM) | 2005 Gaming Revenue Potential (MM) |
|---|---|---|---|
| **Connecticut** | | | |
| Ledyard/Montville, CT(1) | 27,360,197 | $1,868.9 | $2,835.3 |
| **Illinois** | | | |
| Chicagoland(2) | 24,182,195 | $2,015.4 | $2,803.3 |
| Peoria | 1,973,052 | $129.6 | $165.2 |
| Metropolis | 1,796,816 | $108,6 | $159.7 |
| **Indiana** | | | |
| Southeastern Indiana | 8,345,420 | $697.4 | $1,026.1 |
| Evansville | 1,070,003 | $96.6 | $108.6 |
| **Iowa** | | | |
| Council Bluffs | 9,902,919 | $347.3 | $442.5 |
| Quad Cities(3) | 4,899,763 | $210.2 | $256.0 |
| Dubuque | 2,702,159 | $115.9 | $134.4 |
| Des Moines | 4,070,497 | 184.9 | $233.3 |
| Sioux City | 940,216 | $35.2 | $49.4 |
| Ft. Madison | 635,030 | $30.0 | $30.9 |
| **Louisiana** | | | |
| New Orleans | 13,540,633 | $516.9 | $674.3 |
| Lake Charles | 6,764,033 | $341.3 | $408.6 |
| Baton Rouge | 2,903,699 | $163.9 | $201.5 |
| Shreveport | 12,604,306 | $685.0 | $871.4 |
| **Mississippi** | | | |
| Gulf Coast | 12,231,656 | $1,117.3 | $1,431,7 |
| Tunica | 7,866,283 | $1,194.3 | $1,411.3 |
| Vicksburg | 4,793,825 | $234.7 | $278.1 |
| Greenville | 1,823,680 | $73.0 | $76.8 |
| Natchez | 891,824 | $36.3 | $46.7 |
| **Missouri** | | | |
| Caruthersville | 391,495 | $22.8 | $23.4 |
| St. Louis | 16,942,962 | $683.8 | $996.1 |
| Kansas City | 13,494,436 | $560.0 | $749.8 |
| **New Jersey** | | | |
| Atlantic City | 35,700,845 | $4,164.2 | $5,085.5 |
| Nevada | | | |
| Las Vegas(4) | 41,036,842 | $6,075.0 | $7,506.1 |
| North Las Vegas | 7,714,864 | $236.0 | $329.1 |
| Laughlin | 5,167,014 | $559.7 | $650.0 |
| Reno-Sparks | 7,693,069 | $1,026.7 | $1,148.7 |
| South Lake Tahoe | 5,018,663 | $352.7 | $424.5 |
| **Michigan/Canada** | | | |
| Detroit-Windsor | 17,408,140 | $1,233.2 | $1,724.4 |
| Halifax | 1,128,892 | $36.0 | $49.4 |
| Hull | 3,657,599 | $129.3 | $166.9 |
| Montreal | 6,214,941 | $302.7 | $377.1 |
| Niagara Falls | 8,376,480 | $393.6 | $392.0 |
| Orillia | 4,700,755 | $313.2 | $311.8 |
| Point Au Pie | 1,211,886 | $23.6 | $33.4 |
| Sydney | 423,209 | $18.2 | $19,1 |

(1) Assumes slot win at 70%. (2) Illinois and Indiana properties.
(3) Illinois and Iowa properties
(4)LV gross gaming revenues include Boulder Strip, LV Strip, and Downtown LV.

## Exhibit 23-2 Gaming Market Performance ($ in millions)

*Source: Bear, Steams & Co. Inc.; State Gaming Control Boards.*

| Market | 1999 | Jan-00 | Feb-00 | Mar-00 | Apr-00 | May-00 | Jun-00 | Jul-00 | Aug-00 | Sep-00 | Oct-00 | Nov-00 | Dec-00 | 2000 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Colorado | $551.3 | $49.6 | $51.1 | $52.5 | $51.3 | $51.6 | $52.8 | $60.0 | $55.4 | $54.4 | $54.4 | $49.6 | $49.1 | $631.9 |
| *% Change* | *15.0%* | *17.3%* | *20.2%* | *17.1%* | *20.0%* | *9.2%* | *16.7%* | *16.8%* | *10.5%* | 72.9% | *13.5%* | 5.0% | *18.2%* | *14.6%* |
| Connecticut[1] | $1,750.3 | $138.0 | $151.9 | $162.1 | $158.9 | $156.6 | $150.2 | $177.6 | $169.1 | $162.1 | $158.8 | $148.0 | $135.5 | $1,868.9 |
| *% Change* | *9.9%* | *11.0%* | *15.1%* | *16.5%* | *8.1%* | *5.0%* | *7.8%* | 3.9% | *0.7%* | *7.8%* | *2.1%* | 5.2% | 7.3% | 6.8% |
| Delaware | $412.5 | $38.5 | $37.8 | $38.7 | $45.9 | $37.3 | $38.1 | $49.3 | $38.8 | $39.3 | $46.1 | $36.2 | $39.1 | $485.1 |
| *% Change* | *17.6%* | *15.6%* | 23.3% | *23.1%* | 42.9% | -5.3% | *19.8%* | *40.7%* | -77.7% | 79.5% | 72.7% | 9.7% | 47.6% | 26.0% |
| Illinois | $1,362.9 | $130.0 | $137.2 | $147.9 | $141.1 | $139.1 | $136.8 | $147.0 | $141.5 | $140.4 | $141.4 | $134.8 | $121.2 | $1,658.2 |
| *% Change* | 23.7% | 47.7% | 42.2% | *41.1%* | *31.8%* | 37.6% | 33.3% | *11.8%* | *10.7%* | *15.4%* | 9.6% | 8.6% | -2.4% | 27.7 |
| Indiana | $1,557.0 | $131.1 | $144.8 | $154.0 | $143.1 | $140.9 | $135.5 | $151.3 | $142.2 | $144.7 | $140.4 | $138.1 | $122.9 | $1,689.1 |
| *% Change* | *16.2%* | *20.2%* | *13.9%* | *14.0%* | 5.7% | 4.4% | *11.0%* | *6.8%* | 7.9% | *11.8%* | 3.3% | 8.7% | -2.5% | 8.5% |
| Iowa | $827.3 | $72.5 | $76.2 | $80.5 | $74.0 | $69.2 | $77.0 | $79.4 | $76.1 | $76.4 | $73.6 | $68.4 | $62.6 | $885.9 |
| *% Change* | *8.4%* | *22.5%* | *17.9%* | *14.7%* | 7.3% | *-^.3%* | *14.9%* | 5.7% | 7.2% | 70.4% | 3.0% | *-0.2%* | -6.4% | 6.8% |
| Louisiana | $1,433.6 | $133.7 | $144.7 | $150.5 | $139.4 | $140.7 | $141.1 | $155.3 | $138.3 | $148.7 | $136.6 | $132.5 | $145.6 | $1,707.1 |
| % Change | 8.3% | *23.1%* | 26.3% | *25.6%* | *18.4%* | *22.0%* | *20.7%* | *77.2%* | *20.0%* | *32.1%* | 6.7% | 6.2% | 74.9% | 79.7% |
| Michigan | $188.4 | $55.2 | $54.0 | $62.7 | $60.2 | $60.3 | $58.8 | $66.3 | $61.7 | $62.4 | $63.2 | $69.3 | $69.1 | $743.2 |
| *% Change* | *na* | *na* | *na* | *na* | *na* | *na* | *na* | *1276%* | 75% | *84%* | 83% | *105%* | 49% | 294.4% |
| Mississippi | $2,516.2 | $216.4 | $229.4 | $248.0 | $218.4 | $220.5 | $219.1 | $250.0 | $228.3 | $215.5 | $218.5 | $207.7 | $177.9 | $2,649.6 |
| *% Change* | *15.7%* | *12.3%* | *17.4%* | *11.1%* | 0.2% | *5.6%* | *2.5%* | 7.4% | 4.6% | *4.1%* | 6.0% | 3.8% | *-4.5%* | 5.3% |
| Missouri | $938.4 | $80.8 | $83.2 | $90.9 | $83.5 | $81.7 | $81.4 | $86.5 | $80.5 | $85.9 | $83.1 | $80.6 | $79.5 | $997.5 |
| % Change | *10.0%* | *14.6%* | *11.4%* | *13.0%* | *3.9%* | 2.2% | *8.3%* | 3.6% | 2.5% | 70.7% | 2.8% | 3.9% | 7.6% | 6.4% |
| Nevada | $9,020.5 | $866.5 | $751.6 | $836.5 | $785.7 | $799.1 | $747.8 | $827.6 | $814.4 | $788.5 | $811.3 | $799.9 | $794.1 | $9,602.9 |
| % Change | *11.9%* | 7.3% | *14.0%* | *12.0%* | *14.0%* | 5.3% | *8.0%* | *12.8%* | 6.7% | -3.8% | 2.7% | -3.7% | 5.7% | 6.5% |
| New Jersey | $4,164.2 | $305.9 | $337.8 | $361.2 | $365.5 | $362.8 | $377.2 | $429.3 | $404.4 | $379.2 | $345.1 | $336.7 | $295.3 | $4,300.3 |
| *% Change* | 3.4% | *2.2%* | *11.3%* | *7.9%* | *5.6%* | *-1.6%* | *6.1%* | 3.7% | 0.7% | 9.9% | -3.8% | 2.4% | -2.7% | 3.3% |
| **Total** | **$24,722.7** | **$2,218.2** | **$2,199.7** | **$2,385.3** | **$2,266.9** | **$2,259.7** | **$2,215.9** | **$2,479.7** | **$2,350.6** | **$2,297.4** | **$2,272.4** | **$2,181.8** | **$2,091.1** | **$27,219.7** |
| **% Change** | ***11.2%*** | ***14.7%*** | ***19.5%*** | ***17.5%*** | ***13.9%*** | ***8.7%*** | ***12.9%*** | ***11.5%*** | ***6.5%*** | ***7.0%*** | ***4.0%*** | ***3.3%*** | **4.0%** | ***10.2%*** |
| Native American | $9,614.7 | — | — | — | — | — | — | — | — | — | — | — | — | $10,644.3 |
| % Change | 73.3% | — | — | — | — | — | — | — | — | — | — | — | — | *10.7%* |
| **Total** | **$34,337.4** | | | | | | | | | | | | | **$37,864.0** |

(1) Connecticut revenues assume slot win at 70%.

**Exhibit 23-3 Table Game and Device Analysis by Market**

*Source: International Gaming & Wagering Business, August 1, 1995; HVS Gaming Services*

| | 1993 Win (000) | 1994 Win (000) | Percent Change | Number of Units (1993) | Number of Units (1994) | Percent Change | 1993 WPUPD[1] | 1994 WPUPD[1] | Percent Change |
|---|---|---|---|---|---|---|---|---|---|
| **Table Games** | | | | | | | | | |
| Nevada | $2,145,334 | $2,628,192 | 22.5 | 5,551 | 5,248 | (5.5) | $1,059 | $1,372 | 29.6 |
| New Jersey | 1,086,700 | 1,125,500 | 3.6 | 1,288 | 1,310 | 1.7 | 2,312 | 2,354 | 1.8 |
| Colorado | 24,453 | 26,875 | 9.9 | 249 | 253 | 1.6 | 269 | 291 | 8.2 |
| Deadwood, SD | 5,047 | 4,892 | (3.1) | 79 | 74 | (6.3) | 175 | 181 | 3.5 |
| Illinois Riverboats | 234,130 | 334,304 | 42.8 | 301 | 469 | 55.8 | 2,131 | 1,953 | (8.4) |
| Iowa Riverboats | 6,567 | 25,143 | 282.9 | 79 | 131 | 65.8 | 228 | 526 | 130.9 |
| Louisiana Riverboats | 5,860 | 191,293 | 3,164.4 | 59 | 437 | 640.7 | 272 | 1,199 3 | 40.7 |
| Mississippi Riverboats | 315,934 | 512,511 | 62.2 | 440 | 961 | 118.4 | 1,967 | 1,461 | (25.7) |
| Missouri Riverboats | N/A | 66,412 | N/A | N/A | 313 | N/A | N/A | 581 | N/A |
| Total | $3,824,025 | $4,848,710 | 26.8% | 8,046 | 8,883 | 10.4% | 1,302 | 1,495 | 14.8% |
| **Gaming Devices** | | | | | | | | | |
| Nevada | $3,944,042 | $4,307,727 | 9.2 % | 147,174 | 156,837 | 6.6% | $73 | $75 | 2.5% |
| New Jersey | 2,214,600 | 2,297,300 | 3.7 | 24,561 | 27,041 | 10.1 | 247 | 233 | (5.8) |
| Colorado | 235,367 | 298,810 | 27.0 | 10,361 | 11,472 | 10.7 | 62 | 71 | 14.7 |
| Deadwood, SD | 38,294 | 40,635 | 6.1 | 1,977 | 2,255 | 14.1 | 53 | 49 | (7.0) |
| Illinois Riverboats | 371,555 | 645,247 | 73.7 | 4,296 | 7,523 | 75.1 | 237 | 235 | (0.8) |
| Iowa Riverboats | 38,659 | 79,696 | 106.2 | 1,393 | 1,934 | 38.8 | 76 | 113 | 48.5 |
| Louisiana Riverboats | 10,376 | 408,764 | 3,839.5 | 1,105 | 8,204 | 642.4 | 26 | 137 | 430.6 |
| Mississippi Riverboats | 473,901 | 951,805 | 100.8 | 6,951 | 15,612 | 124.6 | 187 | 167 | (10.6) |
| Missouri Riverboats | N/A | 43,880 | N/A | N/A | 1,557 | N/A | N/A | 77 | N/A |
| Total | 7,326,794 | 9,029,984 | 23.2 | 197,818 | 230,878 | 16.7 | $101 | $107 | 5.61 |

[1] Win per unit per day

With approximately 50 percent of the total table game units in 1997, Nevada casinos generated a table game win of approximately $2.7 billion. New Jersey casinos generated approximately $1,2 billion in table game win, despite having only 12 percent of total table game inventory. Mississippi riverboat casinos were a distant third with $500 million in table game win in 1997. In terms of WPUPD, New Jersey's casinos are the most efficient, generating on average $2,176 per table per day. Illinois casinos also posted favorable WPUPD figures of $1,735 per table per day in 1997. The Atlantic City and Illinois markets are similar in their proximity to large population bases and the limited number of casino facilities, which results in high WPUPD figures. Overall, total table game win rose by 5.7 percent in 1997, while the total number of units increased by 5 percent, resulting in a small .23 percent increase in WPUPD.

Aggregate gaming device win increased by 9.2 percent in 1997, led by the secondary markets of Indiana, Missouri, and Iowa, which posted gains of 161.595 percent, 46.94 percent, and 16.01 percent, respectively. During the same period, Indiana, Missouri, and Iowa experienced increases in inventory of 63.9 percent, 77.33 percent and 16.01 percent, respectively. The result was a decrease in WPUPD for Missouri, indicating flat demand at the given level of supply. WPUPD among Indiana and Iowa riverboats rose by 59.61 percent and 12.23 in 1997. The established markets of Nevada and New Jersey increased gaming device inventory in 1994 by 0 percent and 3.75 percent, respectively. New Jersey casinos experienced a slight decrease in WPUPD, indicating a stabilization of demand. Similar to table game WPUPD figures, gaming device WPUPD is strongest in the markets proximate to large population bases with limited inventory. In 1997, New Jersey attained a gaming device WPUPD figure of $221, while Illinois generated a WPUPD of $260. Las Vegas, considered to be a mature, stable market, attained a WPUPD figure of $76, with an inventory of 177,020 gaming devices, or 56 percent of the total gaming devices in the United States. It is this critical mass that separates the Las Vegas market from other gaming jurisdictions, and makes the Las Vegas gaming environment the most competitive in the world.

## [3] Publicly Traded Gaming Corporations

Exhibit 23-4 presents a list of publicly traded gaming corporations and suppliers. The chart divides the gaming companies into large cap and small-cap gaming stocks. The most obvious observation is the consolidation, which has taken place in the casino industry in the past few years.

It appears the industry is heading for more consolidation through mergers and acquisitions by the larger casino corporations. The small-cap gaming stocks appear to be the most likely take over targets in the near future.

As can be seen from Exhibit 23-4, gaming stocks had a good year in 2000 with the exception of gaming equipment stocks, which had a terrific year in a down market.

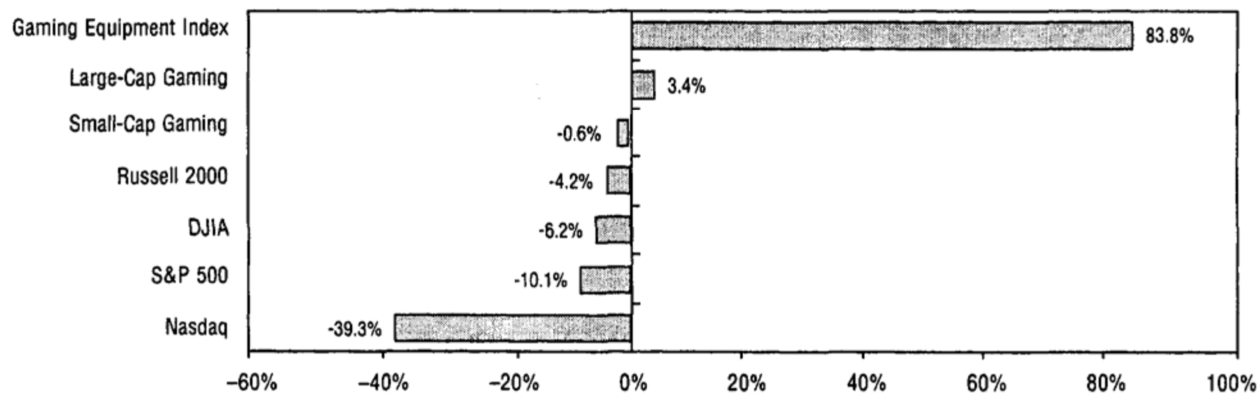
## [4] Consumer Profile and Feeder Markets

Spending on commercial casino gaming was slightly less than spending on basic cable TV and slightly more than spending on coffee or home video rental and sales.

**Exhibit 23-4 Publicly Traded Gaming Corporations and Suppliers**

*Source: Bear, Stearns & Co. Inc.; FactSet Research Systems Inc.*

**2000 Stock Indices Price Performance**




2000 and YTD Gaming Stock Price Performance

| Company | Ticker | 52-Week High-Low | YTD Price Perf. 7/12/01 Price | YTD % Chg. | 2000 Price Perf. 12/29/00 Price | % Chg. |
|---|---|---|---|---|---|---|
| **Large-Cap Gaming Stocks** | | | | | | |
| MGM Grand § | MGG | $39-$23 | $30.55 | 8.4% | $28.19 | 12.0% |
| Harrah's Entertainment | HET | $38-$21 | $30.02 | 13.8% | $26.38 | -0.2% |
| Station Casinos | STN | $19-$12 | $15.01 | 0.5% | $14.94 | -0.1% |
| Park Place Entertainment § | PPE | $15-$9 | $11.20 | -6.2% | $11.94 | 4.5% |
| Mandalay Resort Group | MBG | $28-$18 | $25.81 | 17.7% | $21.94 | 9.0% |
| *BSC Large-Cap Gaming Index % Chg.* | | | | 7.4% | | *3.4%* |
| **Small-Cap Gaming Stocks** | | | | | | |
| Ameristar § | ASCA | $19-$4 | $17.25 | 236.6% | $5.13 | 34.4% |
| Argosy Gaming § | AGY | $29-$13 | $25.86 | 34.8% | $19.19 | 23.3% |
| Aztar Corp. | AZR | $17-$9 | $13.35 | 3.2% | $12.94 | 19.0% |
| Churchill Downs | CHDN | $36-$22 | $26.70 | -10.4% | $29.81 | 32.1% |
| Isle of Capri | ISLE | $17-$6 | $9.70 | -8.7% | $10.63 | -19.4% |
| Boyd Gaming Corp. | BYD | $6-$3 | $5.98 | 74.0% | $3.44 | -40.9% |
| Hollywood Casinos § ^ | HWD | $12-$6 | $6.50 | -29.7% | $9.25 | 114.5% |
| Sun International § | SIH | $29-$18 | $26.76 | 12.7% | $23.75 | 22.6% |
| Penn National Gaming | PENN | $26-$8 | $21.70 | 113.0% | $10.19 | 13.2% |
| Pinnacle Entertainment § | PNK | $23-$7 | $6.95 | -48.5% | $13.50 | -39.8% |
| MTR Graming | MNTG | $14-$4 | $11.45 | 141.1% | $4.75 | 55.1% |
| Trump Hotel & Casinos | DJT | $3-$2 | $2.00 | 6.7% | $1.88 | 44.4% |
| *BSC Small-Cap Gaming Index % Chg.* | | | | 25.3% | | -0.6% |
| **Gaming Equipment Stocks** | | | | | | |
| Intl. Game Technology | IGT | $66-$26 | $58.13 | 21.1% | $48.00 | 136.3% |
| WMS Industries | WMS | $33-$13 | $26.81 | 33.2% | $20.13 | 53.3% |
| Anchor Gaming | SLOT | $67-$23 | $55.75 | 42.9% | $39.00 | 79.6% |
| Alliance Gaming | ALLY | $41-$2 | $32.76 | 271.7% | $8.81 | 224.1% |
| GTECH Holdings | GTK | $39-$15 | $35.76 | 73.9% | $20.56 | -6.5% |
| Shuffle Master | SHFL | $23-$5 | $18.25 | 72.4% | $10.58 | 180.1% |
| *BSC Gaming Equipment Index % Chg.* | | | | 26.8% | | 83.8% |

Exhibit 23-5 shows the demographic portrait of casino players for 1998. The average casino customer has a median household income of $46,000 v. the U.S. median income of $39,000. Also, the average casino customer is better educated than the general U.S. population. Finally, the average casino customer is more likely to be a white collar worker.

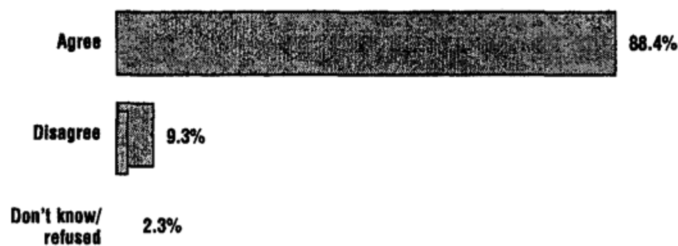
Exhibit 23-6 shows that casino customers spent 22.2 billion dollars in casinos in 1999. The chart compares casino spending to other for forms of discretionary spending patterns. As is clearly shown, Americans spend 358 billion on restaurant meals, making eating out the most popular discretionary spending item among U.S. households.

**Exhibit 23-5 Demographic Portrait of Casino Players, 1999**

*Source: Hart/Luntz*

### Going to Casinos for Fun

"I primarily go to casinos for the fun and excitement."




Nearly 89 percent of casino customers primarily go to casinos for the fun and excitement.

### U.S. CASINO PLAYERS VS U.S. POPULATION, 1999

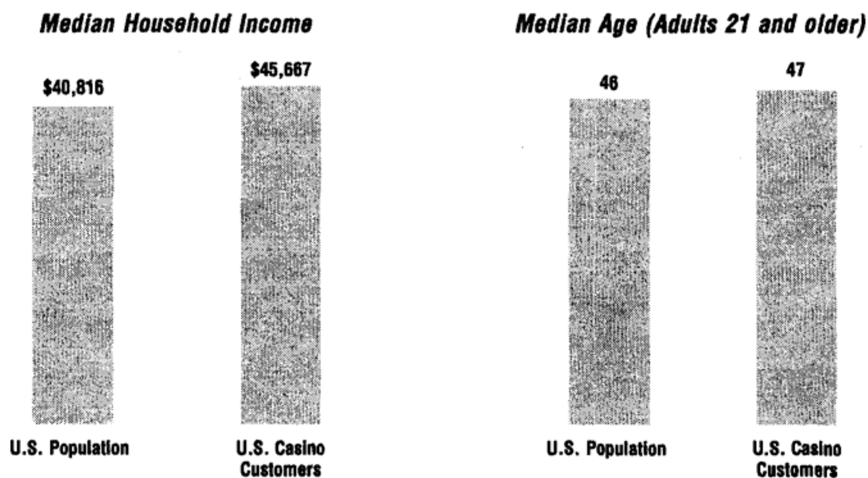
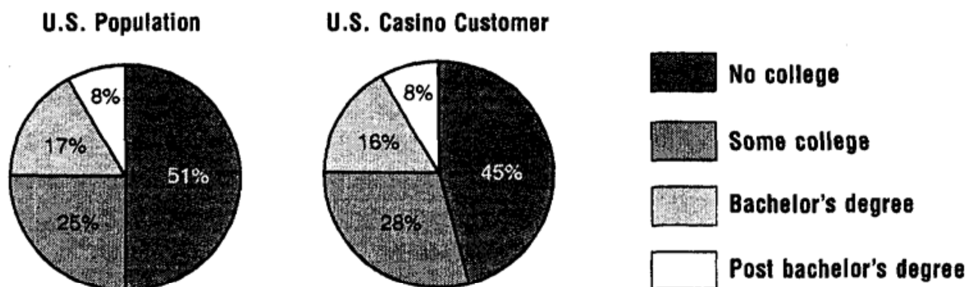


**Exhibit 23-5 Demographic Portrait of Casino Players, 1999 (*Cont'd.*)**

**EDUCATION**




**Employment**

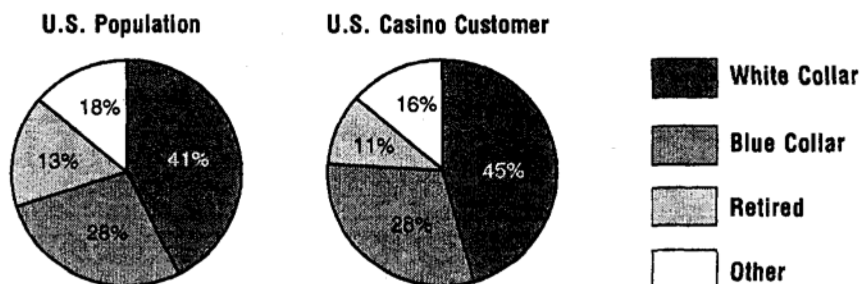
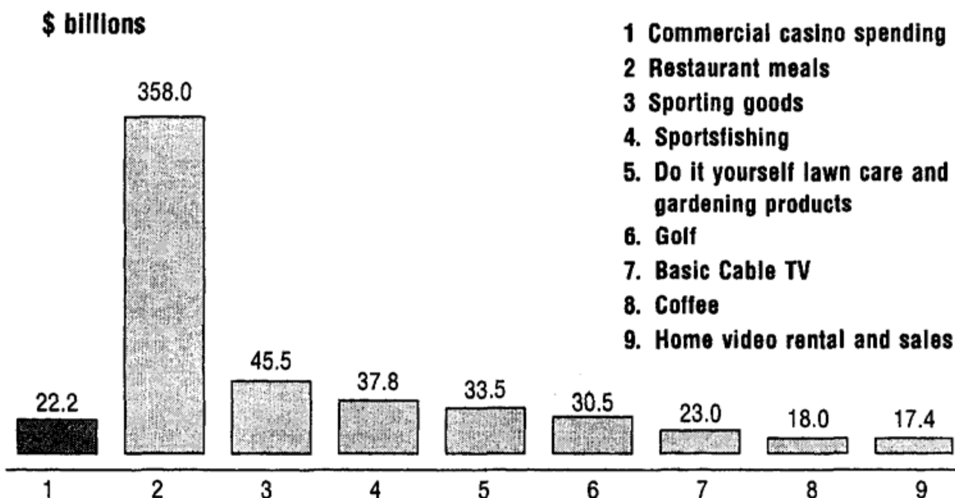



**Exhibit 23-6 Casino Spending vs. Other Forms of Discretionary Spending**

*Sources: 1-Christiansen Capital Advisors, 1999; 2-National Restaurant Association, 1999; 3-Sporting Goods Manufacturers Association, 1999; 4-American Sportfishing Association, 1996; 5-National Gardening Association, 1999; 6-National Golf Foundation, 1998; 7-National Cable Television Association, 1999; 8-National Coffee Association of the USA, 1999; 9-Video Software Dealers Association, 1999*




Casino gaming continues to be among the many mainstream spending choices made by Americans. In 1999, consumers spend less on casino gaming than they did on cable TV, golf, and lawn and garden products, but more than on coffee and video rentals and sales.

## [5] The Future of Gaming

The gaming industry has seen a dramatic slowdown in the expansion of casino gaming. With the exception of Michigan approving three casinos for the city of Detroit, Michigan in 1996, no new markets have been created for casinos. The industry is currently going through a consolidation phase in which the stronger casino operators are buying out the smaller casinos as competition heats up in most markets. Las Vegas has seen a revival with the opening of the Mirage's Bellagio, Circus Circus's Mandalay Bay, and the Venetian. The addition of the Park Place Paris and new Aladdin Casino, total hotel rooms in Las Vegas will top 120,000 rooms. Currently the new properties are attracting new visitors to Las Vegas and the despite the warnings from many analysts, Las Vegas seems to be absorbing the supply of new rooms without sacrificing profit. Nation wide, it appears that market saturation has taken its tow on Mississippi casino industry as more and more smaller casinos are closing because of the increase in building of new and bigger casinos by the major casino companies such as Mirage, Harrah's, Imperial Palace, and Horseshoe, to name a few.

## » 23.02 RIVERBOAT GAMING

The modern era of riverboat gaming in the United States began in April of 1991 with the maiden voyage of the President Riverboat Casino located in Davenport, Iowa. Since that first excursion, riverboat gaming has grown to a more than $3.5 billion industry. Currently, the following six states allow riverboat gaming: Iowa, Illinois, Mississippi, Missouri, Louisiana, and Indiana. The following is a state-by-state overview of riverboat gaming operations.

### [1] Illinois

Riverboat gaming in Illinois was legalized in February 1990, and the first boat became operational in September 1991. Currently, a total of ten gaming licenses are allowed, with nine casinos operating as of December 1997. Recent changes in the law now permit Illinois riverboats to remain dockside and do away with the requirement of cruising. This move is intended to allow the Illinois riverboats to be more competitive with Indiana Riverboats which do not cruise in the Chicago area. Illinois riverboats can offer twenty-one, craps, roulette, baccarat, big six, red dog, sic boe, and gaming devices. Adjusted gross receipts, or win, are taxed at a rate of 25 percent, in addition to a $2 per person admissions tax. This is one of the highest tax rates for any gaming jurisdiction.

### [2] Mississippi

Riverboat gaming in Mississippi was legalized in April 1990; however, the first boat did not open until August 1992. Mississippi, unlike Illinois, has no restrictions on the number of gaming licenses issued. The number of gaming licenses and the selection of qualified applicants are at the discretion of the Mississippi Gaming Commission. Dockside casinos are permitted on navigable waters in counties adjacent to the Mississippi River or the three southernmost counties adjacent to the Mississippi Sound. Currently, dockside gaming has been approved via a local referendum in nine counties: Adams, Hancock, Claiborne, Issaquena, Warren, Harrison, Washington, Tunica, and Coahoma. Riverboat casinos in Mississippi are not required to cruise and can op-

HVS

erate from docks and moorings, resulting in a free flow of pedestrian traffic into and out of the casino twenty-four hours a day. The following table games are permitted within Mississippi riverboat casinos: faro, monte, roulette, keno, fan-tan, twenty-one, seven-and-a-half, big injun, klondike, craps, poker, chuck-a-luck, wheel of fortune, chemin de fer, baccarat, pai gow, beat the banker, panguingui, and gaming devices. Gaming revenues are taxed by the state as well as the counties and local municipalities on a sliding scale. In 1994, the Mississippi Gaming Commission established minimum investment levels for landside developments. All casinos, including those already constructed, must develop a minimum 250-unit hotel equivalent to a Mobil Travel Guide two-star rating and a minimum 500-space parking garage in close proximity to the gaming facility. Alternative developments are allowed at the discretion of the Gaming Commission. Alternative developments must enhance the local entertainment or leisure infrastructure at a cost no less than 25 percent of the cost of the casino. The result of this free market approach to gaming has resulted in a dramatic increase in the number of casinos in Tunica and Gulfport-Biloxi area to become the third largest gaming market in the United States after Las Vegas and Atlantic City.

### [3] Iowa

As mentioned, the modern era of riverboat gaming began in Davenport, Iowa, in April 1991, with the opening of the President Riverboat Casino. As of December, 1995, seven riverboats were in operation, located in Bettendorf, Clinton, Davenport, Dubuque, Fort Madison, and Sioux City. The number of gaming licenses issued is at the discretion of the Iowa Racing and Gaming Commission. Currently, the following games are permitted on Iowa riverboat casinos; big six, roulette, poker, craps, twenty-one, red dog, Caribbean stud, 21 super bucks, and gaming devices. Riverboats are required to make a two-hour cruise on at least 100 days between the months of April and October; once the boats meet this requirement, they may operate from their docks. During the docking period, customers may board and disembark the riverboat casino at any time. In May 1994, Iowa reversed several of its restrictive gaming provisions such as the $5 per hand betting limit and the $250 per day loss limit. The market has rebounded, now that the boats are able to compete directly with Illinois boats located just across the Mississippi river.

### [4] Louisiana

Riverboat gaming in Louisiana was legalized in June 1991. However, the first boat was not operational until October 1993, because of regulatory and political infighting and disorganization. Currently, fifteen gaming licenses are allowed, with twelve casinos operating as of December 1995. According to the Riverboat Gaming Division, boats must cruise, unless the captain deems the conditions to be hazardous, except in Shreveport, where boats are allowed to operate dockside year-round. Louisiana river-boats can offer twenty-one, craps, roulette, mini-baccarat, big six, poker, and gaming devices.

### [5] Missouri

Riverboat gaming in Missouri was legalized in November 1992, with the first boat coming on-line in May 1994. The fate of the Missouri riverboat industry has been much publicized as a result of the ruling by the Missouri Supreme Court outlawing

the use of slot machines on riverboat casinos or elsewhere in the state. The court ruled that games of chance (i.e., slot machines) were unconstitutional and therefore, illegal The situation deteriorated further in April of 1994, when an amendment to the constitution legalizing the games of chance failed to pass by approximately 1,200 votes. However, on November 8, 1994, a referendum to legalize games of chance passed 54 percent to 46 percent. Prior to the referendum, the following games were permitted on Missouri riverboat casinos: poker, craps, twenty-one, Caribbean stud, pai gow poker, Texas hold'em, double down stud poker, and the video representations of these games. Eight riverboats are currently in operation, located in St. Louis, St. Charles, Riverside, Kansas City, and St. Joseph. The number of gaming licenses issued is at the discretion of the Missouri Gaming Commission. Riverboats are required to cruise, unless conditions are such that passenger safety would be jeopardized. Casinos operating along the swift Missouri River in Kansas City have been granted exemptions to allow dockside gaming. However, the casinos must continue to operate "phantom excursions." For continuous dockside operation in other markets, the riverboats must have significant land-based developments resulting in permanent job creation.

## [6] Indiana

Indiana's Riverboat Gaming Law was enacted on June 30, 1993. A total of eleven riverboat gaming licenses have been issued within the state of Indiana. Of the eleven licenses, five are in counties bordering Lake Michigan: two in Gary (Lake County), one in Hammond (Lake County), one in East Chicago (Lake County), and one in Michigan City. An additional five licenses were granted to counties located along the Ohio River. Gaming Commission, the following games are permitted: baccarat, twenty-one, poker, craps, slot machines, video games of chance, roulette, klondike, punchboards, faro, keno, numbers tickets, push cards, jar tickets, pull tabs, and big six. The Indiana Riverboats have surpassed all expectations of profitability. In little over three years of operation, the Indiana market does over $1 billion in gross gaming revenue and is still growing. Especially negatively affected by the Indiana river-boats have been the two Illinois casinos in Joliet.

## [7] Expansion

As evidenced by the significant amount of revenues generated by riverboat casinos, the industry as a whole has proven to be a successful way for states, counties, and local municipalities to increase revenues without directly taxing their respective residents. However, the socioeconomic impact of riverboat gaming is still being debated throughout the country. While several of the areas supporting riverboat casinos have experienced decreases in unemployment levels leading to economic growth, the social cost and redistribution of discretionary income has yet to be fully measured. Given the flow of discretionary income out of non-gaming states and counties, neigh-boring legislatures are anticipated to continue seeking approval from voters to bring casinos into their communities. However, the absence of riverboat gaming referen-dums in key states such as Florida, Texas, Kentucky, Ohio, and Pennsylvania reflects the formidable opposition to gaming. From the referendums that were brought to the voters, it is evident that a successful gaming campaign is dependent on well-organized and clearly communicated legislation emphasizing the following issues: regulation, location, distribution of revenues, restrictions, environmental and socioeconomic impact, and law enforcement.

## » 23.03 NATIVE AMERICAN GAMING

Since the enactment of the Indian Gaming Regulatory Act (IGRA) on October 17, 1988, Native American gaming activity has increased tremendously throughout the United States. Native American gaming venues can now be found across the nation, from northwestern Washington State to southeastern Florida and from Southern California to eastern Connecticut. Gaming activity taking place on Native American land is classified into three distinct categories as defined in the IGRA:

- *Class I gaming.* This includes social games solely for prizes of minimal value or traditional forms of Indian gaming engaged in by individuals.
- *Class II gaming.* This includes all forms of bingo and other games similar to bingo, such as pull-tabs, and punch boards, provided these are played in the same location as bingo games. Class II also includes certain card games authorized, or not prohibited by state law and played in conformity with statewide regulations and specifically excluding any banking card games, such as baccarat, twenty-one, or any electronic facsimile of such games.
- *Class III gaming.* This includes all forms of gaming that are not Class I or II, including slots, casino games, banking card games, horse and dog racing, pari-mutuel wagering, and jai-alai.

Another concept affecting Native American gaming—and the focus of much controversy—is the gaming compact that must be negotiated between the state and the tribe. The compact is defined as an agreement between sovereigns (tribes and states), similar to a treaty. Tribal/state Class III compacts deal with the sovereign powers (e.g., application of laws and jurisdiction and enforcement of laws) of the parties to the compact. Compacts also delineate the type and quantity of games and/or devices permitted within the casino. Guidelines to establish independent gaming commissions are also included in the compacts. Since the enactment of the IGRA, several court battles have been waged between Native American tribes and state governments over what games are to be permitted in Native American casinos, given the existing state laws on gaming.

### [1] The Indian Gaming Regulatory Act (IGRA)

The Indian Gaming Regulatory Act (IGRA) was enacted by Congress on October 17, 1988. According to the IGRA, a principal goal of federal policy is to promote tribal economic development, tribal self-sufficiency, and strong tribal governments. The IGRA was drafted after a congressional committee found that Indian tribes were engaging in gaming activities on Indian lands as a means of generating tribal revenues. Additionally, the study concluded that Indian tribes have the exclusive right to regulate gaming activity on Indian lands if the gaming activity is not specifically prohibited by federal law and is conducted within a state that does not, as a matter of criminal law and public policy, prohibit such gaming activity. It was also concluded that existing federal law did not provide clear standards or regulations for the conduct of gaming on Indian lands.

The purpose of the IGRA is to provide a statutory basis for the operation of gaming by Indian tribes as a means of accomplishing the aforementioned goals. In addition, the IGRA will provide a basis for the regulation of gaming by an Indian tribe to shield it from organized crime and other corrupting influences, to ensure that the tribe is the primary beneficiary of the gaming operation, and to assure that gaming is conducted fairly and honestly by both the operator and players. The IGRA also

established an independent federal regulatory authority for gaming on Indian lands, federal standards for gaming on Indian lands, and the National Indian Gaming Commission. The regulatory authority was deemed necessary to address congressional concerns regarding gaming and to protect such gaming as a means of generating tribal revenue. The IGRA is composed of the following sections;

- Findings
- Declaration of Policy
- Definitions
- National Indian Gaming Commission
- Powers of the Chairman
- Powers of the Commission
- Commission Staffing
- Commission—Access to Information
- Interim Authority to Regulate Gaming
- Tribal Gaming Ordinances
- Management Contracts
- Review of Existing Ordinances and Contracts
- Civil Penalties
- Judicial Review
- Subpoena and Deposition Authority
- Investigative Powers
- Commission Funding
- Authorization of Appropriations
- Gaming on Lands Acquired After Enactment of This Act
- Dissemination of Information
- Severability
- Criminal Penalties
- Conforming Amendment

Of all the sections of the IGRA, the sections dealing with the formation of the National Indian Gaming Commission (NIGC), tribal ordinances, and management contracts have the greatest impact on the feasibility and economic viability of a Native American gaming operation. The formation and purpose of the NIGC is addressed in H 23.03 [2].

The tribal gaming ordinances sets forth a broad overview of Indian gaming requirements and regulations ranging from licensing procedures to background investigations. The following points are outlined within the tribal ordinances section of the IGRA:

- Class I gaming activities are not subject to provisions of the IGRA, while all Class II and Class III gaming operations are.
- An Indian tribe may engage in, or license and regulate, class II and III gaming, as long as the tribe is located within a state that permits such gaming for any purposes by any person or organization.
- With limited exception, the Indian tribe will have the sole proprietary interest and responsibility for the conduct of any gaming activity.

- The net revenues must be used for the purposes of funding tribal government operations and programs; they must provide for the general welfare of the tribe, promote tribal economic development, be donated to charitable organizations, and help fund operations of local government agencies.
- The construction and maintenance of the gaming facility, and the operation of the facility is conducted in a manner that adequately protects the environment and the public health and safety.
- The tribe must have a system for conducting background checks on key managers and employees and must license such officials.
- Tribes may also license an individual or entity to conduct gaming within the limits of applicable state law.

These are the rules for management contracts:

- The permitted fees are up to 30 percent of net revenues with exceptions up to 40 percent.
- The commission must investigate contractors and may disapprove a contract based on such investigation.
- The contract must allow tribal access to daily operations of the game, monthly audits, minimum guaranteed payment to the tribe, and have terms of no more than five years, with exceptions up to seven years.

## [2] National Indian Gaming Commission (NIGC)

According to the IGRA, the National Indian Gaming Commission (NIGC) is to be composed of five people, three of whom must be members of federally recognized tribes. The chairman will be appointed by the President of the United States with advice and consent from the senate. The Department of Justice will conduct background investigations of all appointees. Under the IGRA, the NIGC performs a wide variety of regulatory, enforcement, and advisory functions. The follow items illustrate the breadth of NIGC responsibilities in regulating Indian gaming. The NIGC has the authority to:

- Permanently close tribal games;
- Enforce collection of civil fines;
- Enforce tribal gaming ordinances;
- Monitor all Indian gaming activities;
- Inspect gaming premises;
- Conduct background investigations of employees and contractors;
- Access records, books and other documents and audit accounts;
- Conduct any investigation necessary in connection with regulation of class II gaming;
- Consult with law enforcement officials where appropriate; and
- Request the U.S. Attorney General to conduct necessary criminal investigations.

NIGC funding is derived from tribal assessments and congressional appropriations. Assessments are set on a sliding scale from .5 percent to 2.5 percent of the first $1,500,000 of gross revenues and up to 5 percent of amounts in excess of $1,500,000.

## » 23.04 GAMING SUPPLY AND DEMAND ANALYSIS

The initial step in analyzing supply and demand trends within a given gaming market is to quantify the existing level of gaming inventory, segmented by table games and gaming devices. To quantify gaming supply levels, a detailed review of all competitive gaming facilities is performed. Once the market's supply level and gaming mix are known, an analysis of the demand for gaming facilities is performed.

Unlike traditional economic models of supply and demand, the price variable associated with gaming is largely determined by the consumer. Gaming is an intangible product: what the consumer is purchasing is the "experience" and "excitement" casino gaming offer. The price that the consumer is willing to pay for this experience is known as the "win," and is quantified on a per-unit basis known as the "win per unit per day" (WPUPD). Research indicates that the WPUPD, or the price a market can bear for gaming activity, is highly correlated with the level of available gaming inventory. The actual WPUPD attained by a market, say $250 per gaming device, provides an indication of the marketwide demand for gaming devices. These demand levels within a market can be estimated through an analysis of the actual WPUPD attained by the market versus the market's theoretical maximum WPUPD. The resultant statistic is known as the market's capacity utilization rate. Historical fluctuations in the marketwide capacity utilization rate at various levels of supply can provide insight into the future demand for gaming. Further affecting the demand for gaming facilities in the market are current and projected trends in economic and demographic factors such as population base, employment, disposable income, and visitation. In addition, seasonal fluctuations must be taken into consideration.

Once the various demand trends have been identified, a variety of analytical methodologies may be employed to forecast gaming revenue for an overall market or an individual property. The employment of a specific methodology must take into consideration the reliability and availability of the data to be utilized.

The following procedures are employed in the analysis of gaming supply and demand trends:

1. Analysis of Supply:
    - Identify all local and regional gaming facilities;
    - Quantify the number of existing and proposed gaming facilities by gaming units (i.e., table games and gaming devices) available in the market area;

      and
    - Determine whether additional gaming facilities will enter the market in the foreseeable future.
2. Analysis of Demand:
    - Review the area and neighborhood economic and demographic data to determine the market's overall health and ability to support existing and proposed levels of gaming supply;
    - Examine the local and regional demand sources by market segment to determine potential market mix, demand levels, player gaming habits, and the populace's propensity to gamble; and
    - Review historical marketwide trends in WPUPD and capacity utilization levels to determine the area's potential for growth, stabilization, or saturation.

## [1] Market Segmentation

Demand for gaming can be classified into four primary categories: the local residents, tour and travel groups, leisure visitation, and convention visitation. Each of these gaming demand segments has distinct characteristics that affect the market's potential gaming revenues; these characteristics include gaming frequency, duration of play, gaming budgets, game preferences, and preferred facilities. With the exception of local residents, the demand generally originates from outside the subject property's primary market.

### [a] Local Demand

In emerging riverboat, dockside, and Native American gaming markets, local residents constitute a significant portion of the overall gaming demand. The majority of patronage, an estimated 65 percent to 75 percent, originates within a fifty-mile radius. In such markets as Las Vegas and Atlantic City, which possess a critical mass of gaming, lodging, and entertainment facilities, local demand plays a secondary role to demand from the tour and travel, leisure, and convention segments. However, local patronage is necessary to provide a base level of annual demand, mitigating the effects of seasonality on revenues. In competitive markets, local patrons possess a high degree of loyalty, bas&d on personal service and incentives. Such incentives include complimentary food and beverage service, bonus winnings, complimentary room nights, complimentary travel, and gift items. Gaming frequency among local patrons depends on a number of factors, including the convenience of the casinos, the average age of the populace, and disposable income levels. Typically, local residents can be expected to allot a higher percentage of discretionary income to gaming activities than other demand segments. Locals often possess superior gaming skills and seek tables and devices that offer the highest payouts and best odds. In certain markets, locals tend to be seasonal in an attempt to circumvent the crowds associated with "peak" demand periods of tourist and leisure visitation.

### [b] Tour and Travel Demand

The seasonality of tour and travel demand varies, depending on the type and mode of transportation. Demand generated by the tour and travel segment is primarily a function of an individual property's marketing efforts. While bus tours organized by outside wholesalers and recreational groups tend to be more seasonal, motor-coach tours, gaming junkets, and all-inclusive vacations marketed by the individual properties are booked in the shoulder and off-seasons to offset declining leisure visitation. The costs of marketing to this segment are high, and in some instances negate the potential gain in revenue. The primary goal in attracting tour and travel groups is gaming activity;
rooms and food and beverage outlets tend to be loss leaders. Gaming frequency among tour and travel patrons is high. Traditionally, tour and travel patrons favor gaming devices as opposed to table games. Depending on the type of group and predetermined gaming levels, tour and travel patrons allocate a considerable portion of their total travel budget for gaming activities and tend to make median-sized wagers per hand, or pull.

### [c] Leisure Demand

Leisure visitation tends to be seasonal in nature, with visitors taking advantage of the favorable summer and spring seasons. Traditionally, the leisure segment uses both

table game and gaming devices, showing a higher propensity to play table games than the other demand segments. Gaming propensity and frequency within the leisure segment vary significantly, from "grind players," to "rated players." Further, the gaming budgets of leisure patrons vary considerably, as do their average wagers. While the primary goal in attracting the leisure traveler is gaming activity, food and beverage and retail outlets can also be priced to break even.

## [2] Win per Unit per Day (WPUPD)

The win per unit per day (WPUPD) statistic provides the basis for the analysis and projection of table game and gaming device revenues. WPUPD is calculated by dividing total gaming revenues generated by a particular type of gaming unit by the number of gaming units available. Gaming statistics published in a majority of the gaming markets include the number of gaming units and total win figures by either table games and gaming devices or by individual games and devices (e.g., twenty-one tables, crap tables, five-cent devices, twenty-five-cent devices). The WPUPD provides insight into the efficiency of a market, demand levels, and saturation levels. In the forecast of gaming revenues, a WPUPD estimate is applied to the projected level of supply to arrive at an overall gaming win figure.

Like all other industries, gaming is subject to the laws of supply and demand. In open markets such as Mississippi and Las Vegas, supply can be expected to rise to a level supported by existing demand. During the initial growth phase, WPUPD levels are high, as the limited gaming inventory is insufficient to support high levels of pent-up demand. As new competition enters the market, demand is either dispersed among the competition, or the increase in inventory induces new demand to the market. The latter of the two scenarios will produce a stable WPUPD trend as demand increases at a rate equal to the increase in inventory. However, if demand is held constant or decreases, the result will be a declining WPUPD trend in the face of increasing inventory and competition. In addition, an entire market can be negatively affected by the emergence of a new gaming market proximate to the existing demand base. Through an analysis of the gaming market, an acceptable range of WPUPD levels can be derived and used to forecast marketwide gaming revenue.

Exhibit 23-7 presents an analysis of the hypothetical Cripple Stream gaming market. This analysis will be further used in the forecast of gaming win presented subsequently. Exhibit 23-8 presents an analysis of supply and demand trends in casinos.

The forecast of marketwide gaming win, presented in H 23.05, factors in the historical WPUPD levels attained by the market and the incremental change in WPUPD as inventory levels either increase or decrease. Additional factors affecting WPUPD levels are inflation, population growth, economic expansion, lodging supply, and tourism trends. The WPUPD estimates are then multiplied by the existing and proposed table game and gaming device inventory levels to arrive at a projection of marketwide gaming win.

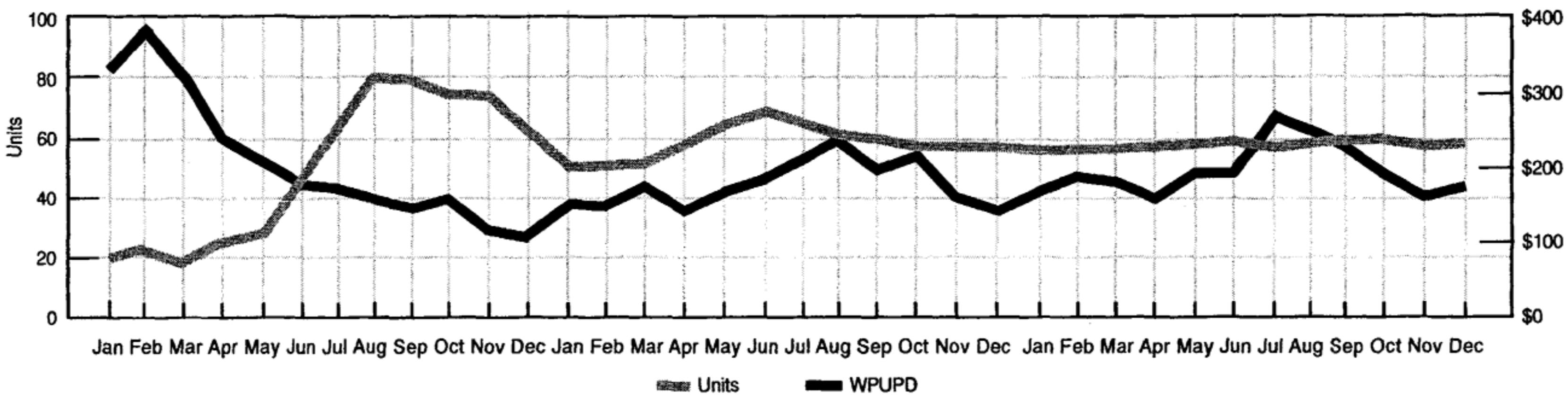
## » 23.05 FORECAST OF GAMING WIN

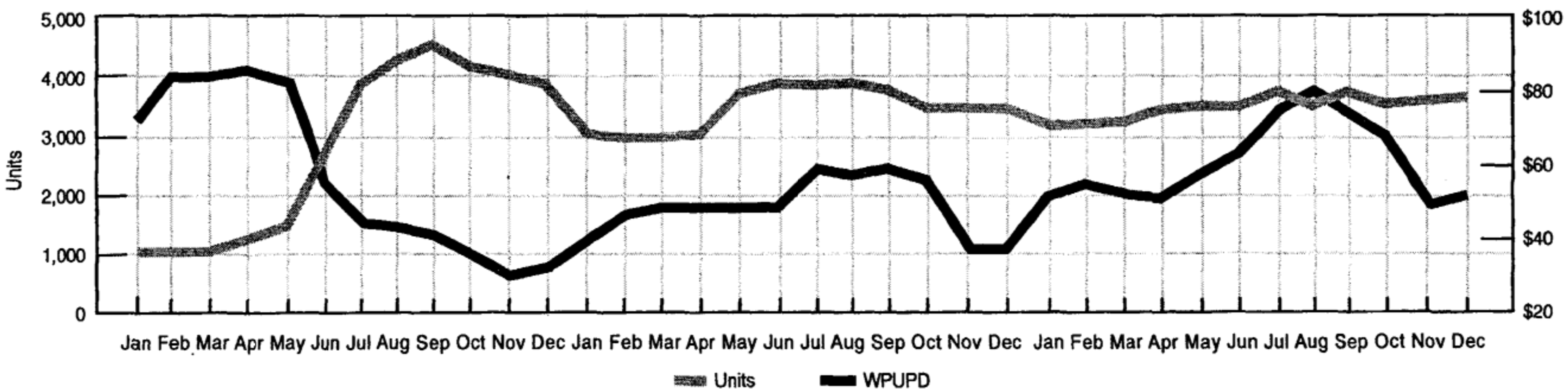
Once the subject market has been defined, and the supply and demand factors analyzed and quantified, the anticipated amount of gaming revenue generated by a specific casino operating within this market can be determined. The compilation of supply and demand data combined with research into the various external factors impacting an individual

## Exhibit 23-7 Analysis of Cripple Stream Gaming Market

| | | Tables and Games | | | Gaming Devices | | | |
|---|---|---|---|---|---|---|---|---|
| Year/Month | No. Casinos | Table WIN | Units | WPUPD | Device WIN | Units | WPUPD | Total WIN |
| **1994** | | | | | | | | |
| January | 13 | $202,164 | 20 | $326 | $2,370,108 | 1,070 | $71 | $2,572,272 |
| February | 13 | 244,790 | 22 | 384 | 2,585,439 | 1,075 | 83 | 2,830,229 |
| March | 13 | 166,869 | 17 | 317 | 2,780,110 | 1,081 | 83 | 2,946,979 |
| April | 13 | 168,129 | 24 | 234 | 3,183,923 | 1,253 | 85 | 3,352,052 |
| May | 17 | 170,403 | 26 | 211 | 3,820,072 | 1,512 | 82 | 3,990,475 |
| June | 23 | 243,750 | 45 | 181 | 4,316,607 | 2,553 | 56 | 4,560,357 |
| July | 29 | 361,144 | 67 | 174 | 5,470,867 | 3,780 | 47 | 5,832,011 |
| August | 31 | 399,472 | 82 | 157 | 5,867,578 | 4,294 | 44 | 6,267,050 |
| September | 33 | 359,055 | 81 | 148 | 5,817,913 | 4,530 | 43 | 6,176,968 |
| October | 33 | 336,909 | 72 | 151 | 5,048,371 | 4,172 | 39 | 5,385,280 |
| November | 33 | 242,033 | 72 | 112 | 3,368,401 | 4,078 | 28 | 3,610,434 |
| December | 28 | 202,393 | 62 | 105 | 3,347,329 | 3,694 | 29 | 3,549,722 |
| **Total/Avg.** | | 3,097,111 | 49 | 172 | 47,976,718 | 2,758 | 48 | 51,073,829 |
| **1995** | | | | | | | | |
| January | 26 | 237,100 | 52 | 147 | 3,733,456 | 3,112 | 39 | 3,970,556 |
| February | 26 | 213,780 | 53 | 144 | 3,907,363 | 3,034 | 46 | 4,121,143 |
| March | 26 | 267,003 | 52 | 166 | 4,662,736 | 3,034 | 50 | 4,929,739 |
| April | 26 | 252,989 | 57 | 148 | 4,600,438 | 3,139 | 49 | 4,853,427 |
| May | 28 | 334,206 | 65 | 166 | 5,623,708 | 3,657 | 50 | 5,957,914 |
| June | 29 | 380,773 | 68 | 187 | 5,611,062 | 3,785 | 49 | 5,991,835 |
| July | 28 | 413,578 | 64 | 208 | 7,189,124 | 3,745 | 62 | 7,602,702 |
| August | 28 | 441,921 | 61 | 234 | 6,936,248 | 3,782 | 59 | 7,378,169 |
| September | 27 | 337,853 | 59 | 191 | 6,719,065 | 3,675 | 61 | 7,056,918 |
| October | 27 | 328,057 | 54 | 196 | 6,195,193 | 3,446 | 58 | 6,523,250 |
| December | 26 | 242,474 | 54 | 145 | 4,055,783 | 3,413 | 38 | 4,298,257 |
| **Total/Avg.** | | 3,711,132 | 58 | 176 | 63,094,871 | 3,437 | 50 | 66,806,003 |
| **1996** | | | | | | | | |
| January | 23 | 277,032 | 53 | 169 | 5,162,703 | 3,214 | 52 | 5,439,735 |
| February | 23 | 274,380 | 53 | 185 | 4,932,181 | 3,229 | 55 | 5,206,561 |
| March | 23 | 300,704 | 53 | 183 | 5,320,333 | 3,257 | 53 | 5,621,037 |
| April | 24 | 277,853 | 55 | 168 | 5,355,477 | 3,398 | 53 | 5,633,330 |
| May | 24 | 335,976 | 56 | 194 | 6,414,613 | 3,462 | 60 | 6,750,589 |
| June | 24 | 334,151 | 58 | 192 | 6,507,027 | 3,465 | 63 | 6,841,178 |
| July | 26 | 458,261 | 56 | 264 | 8,515,328 | 3,673 | 75 | 8,973,589 |
| August | 26 | 439,483 | 57 | 249 | 7,939,595 | 3,337 | 77 | 8,379,078 |
| September | 25 | 391,582 | 58 | 225 | 7,764,571 | 3,610 | 72 | 8,156,153 |
| October | 22 | 352,176 | 58 | 196 | 7,038,869 | 3,400 | 67 | 7,391,045 |
| November | 23 | 288,503 | 56 | 172 | 5,247,191 | 3,498 | 50 | 5,535,694 |
| December | 23 | 307,068 | 57 | 174 | 5,781,639 | 3,545 | 53 | 6,088,707 |
| **Total/Avg.** | | 4,037,169 | 56 | 198 | 75,979,527 | 3,424 | 61 | 80,016,696 |

**Exhibit 23-8 Analysis of Supply and Demand Trends**



property's market share has led to the development of a market penetration model. Using the market derived data in the penetration model results in a forecasting tool that can be applied with a high degree of confidence. The market penetration model uses the following four steps in deriving a forecast of gaming revenue for the subject property.

1. The marketwide existing and proposed level of supply is quantified by table games and gaming devices throughout the projection period. The subject property's proposed level of supply is quantified by table games and gaming devices throughout the projection period. The subject property's fair share of marketwide gaming supply by table games and gaming devices is then calculated.
2. A forecast of marketwide gaming revenue is developed, based on the WPUPD and supply trends. Subjective factors such as latent demand levels, induced demand, and shifting demand patterns have been considered and included in the forecast of WPUPD levels and the resultant projection of marketwide gaming revenue.
3. Market penetration rates attainable by the subject property are projected for table games and gaming devices. The market penetration rates are then multiplied by the subject property's calculated fair share percentages to determine the subject's capture rate. The subject property's capture rate is then multiplied by the forecasted amount of marketwide gaming revenue, equating to the gaming revenue projected to be generated by the subject property.
4. The forecasted gaming win captured by the subject property is reconciled with a WPUPD analysis to check the reasonableness of the revenue projections. Combining the table game and gaming device win equates to an estimate of total gaming revenue.

## [1] Step One—Fair Share

The subject property's fair share is calculated by dividing the subject's gaming inventory by the marketwide gaming inventory. For example, if the subject property has 100 table games and the total number of table games in the market, including the subject property, is 1,000, the subject property's fair share is equal to 10% (100 - 1,000 = 10 percent). Exhibit 23-9 shows projected marketwide gaming inventory and calculated fair share for the hypothetical Cripple Stream casino, as well as for a hypothetical Casino *X*.

## [2] Step Two—Forecasting Marketwide Gaming Revenue

Step two involves the forecasting of marketwide gaming revenue in each year of the projection period. In order to minimize the effect of seasonality, the aggregate table game and gaming device win over a twelve-month period is used in the calculation of base year WPUPD. The base year table game WPUPD estimate is calculated as follows:

Table Game Win/Average Units/365 = WPUPD
$4,037,169/56/365 = $197.51 (rounded to $198)

On the basis of the historical WPUPD trend of the market, the incremental changes in gaming supply, and the anticipated impact of the new supply on the demand trends within the market, future WPUPD levels are estimated. The WPUPD figure is multiplied by the projected level of table game or gaming device inventory to arrive at a forecast of marketwide gaming revenue (see Exhibit 23-10).

**Exhibit 23-9 Projected Marketwide Gaming Inventory and Calculated Fair Share**

| | | | | | | |
|---|---|---|---|---|---|---|
| **Table Games** | | | | | | |
| Gaming Inventory—Cripple Stream | | | | | | |
| Existing Table Games | 55 | 55 | 80 | 80 | 80 | 80 |
| Additions to Supply | 0 | 25 | 0 | 0 | 0 | 0 |
| Total Table Games | 55 | 80 | 80 | 80 | 80 | 80 |
| Percent Change | | 45.5 | 0.0 | 0.0 | 0.0 | 0.0 |
| Casino *X* | | | | | | |
| Existing Table Games | | 25 | 25 | 25 | 25 | 25 |
| Additions to Supply | | 0 | 0 | 0 | 0 | 0 |
| Total Table Games | | 25 | 25 | 25 | 25 | 25 |
| Calculated Fair Share-Table Games | 31,3% | 31.3% | 31.3% | 31,3% | 31.3% | |
| **Gaming Devices** | | | | | | |
| Gaming Inventory—Cripple Stream | | | | | | |
| Existing Gaming Devices | 3.500 | 3,500 | 4,500 | 4,750 | 4,750 | 4,750 |
| Additions to Supply | 0 | 1,000 | 250 | 0 | 0 | 0 |
| Total Gaming Devices | 3,500 | 4,500 | 4,750 | 4,750 | 4,750 | 4,750 |
| Percent Change | | 28.6 | 5.6 | 0.0 | 0.0 | 0.0 |
| Casino *X* | | | | | | |
| Existing Gaming Devices | 1,000 | 1,000 | 1,250 | 1,250 | 1,250 | |
| Additions to Supply | 0 | 250 | 0 | 0 | 0 | |
| Total Gaming Devices | 1,000 | 1,250 | 1,250 | 1,250 | 1,250 | |
| Calculated Fair Share—Gaming Devices | 22.2% | 26.3% | 26.3% | 26.3% | 26.3% | |
| Overall Fair Share | 22.4% | 26.4% | 26.4% | 26.4% | 26.4% | |

## [3] Step Three—Projected Market Penetration Rates

Step three of the analysis includes projections of the subject property's market penetration rates. A penetration rate is defined as the percentage of marketwide gaming revenue the subject property will capture in relation to its fair share. For example, if the subject property's fair share of the marketwide gaming device inventory was 10 percent, and the property penetrates the gaming device segment at 110 percent, the subject would capture approximately 11 percent of marketwide gaming device revenue (1.10 x 0.10 = 0.11). The capture rate is then applied to the aggregate amount of marketwide gaming revenue to derive the subject property's gaming revenue forecast.

The forecast of market penetration rates attainable by the subject property must take into consideration the competitive advantages or disadvantages of the property, including location, visibility, accessibility, management, name recognition, historical operation, physical condition, and marketing (see Exhibit 23-11).

## [4] Step Four—Projecting WPUPD

In step four, the projection of gaming revenue derived via the market penetration analysis is reconciled with a WPUPD analysis. Exhibit 23-12 presents estimated WPUPD projections for the subject property throughout the five-year projection period.

**Exhibit 23-10 Forecast of Marketwide Gaming Revenue—Cripple Stream Market**

| | Base Year | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| **Table Games** | | | | | | |
| Estimated WPUPD | $198 | $175 | $187 | $192 | $196 | $200 |
| Units | 55 | 80 | 80 | 80 | 80 | 80 |
| Total Win | $3,981 | $5,109 | $5,449 | $5,620 | $5,732 | $5,847 |
| Growth Rate | | 28.3% | 6.7% , | 3.1% | 2.0% | 2.0% |
| **Gaming Devices** | | | | | | |
| Estimated WPUPD | $53 | $46 | $45 | $47 | $48 | $49 |
| Units | 3,500 | 4,500 | 4,750 | 4,750 | 4,750 | 4,750 |
| Total Win | $67,381 | $75,994 | $77,542 | $81,285 | $82,911 | $84,569 |
| Growth Rate | | 12.8% | 2.0% | 4.8% | 2.0% | 2.0% |
| **Total Gaming Win** | $71,362 | $81,103 | $82,991 | $86,905 | $88,643 | $90,416 |
| Growth Rate | | 13.7% | 2.3% | 4.7% | 2.0% | 2.0% |
| **Revenue Mix** | | | | | | |
| Table Games | 5.6% | 6.3% | 6.6% | 6.5% | 6.5% | 6.5% |
| Gaming Devices | 94.4% | 93.7% | 93.4% | 93.5% | 93.5% | 93.5% |

**Exhibit 23-11 Projected Penetration Rates and Captured Gaming Revenue**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| **Total Gaming Win** | | | | | |
| Table Games | $5,109 | $5,449 | $5,620 | $5,732 | $5,847 |
| Gaming Devices | $75,994 | $77,542 | $81,285 | $82,911 | $84,569 |
| Total Gaming Win | $81,103 | $82,991 | $86,905 | $88,643 | $90,416 |
| **Estimated Penetration Factors** | | | | | |
| Table Games | 110.0% | 110.0% | 115.0% | 120.0% | 120.0% |
| Gaming Devices | 120.0% | 125.0% | 130.0% | 130.0% | 130.0% |
| Overall | 121.4% | 125.0% | 130,0% | 130.4% | 130.4% |
| **Captured Gaming Win** | | | | | |
| Table Games | $1,760 | $1,870 | $2,020 | $2,150 | $2,190 |
| Gaming Devices | $20,270 | $25,510 | $27,810 | $28,360 | $28,930 |
| Total | $22,030 | $27,380 | $29,830 | $30,510 | $31,120 |
| **Percentage Change** | | | | | |
| Table Games | | 6.3% | 8.0% | 6.4% | 1.9% |
| Gaming Devices | | 25.9% | 9.0% | 2.0% | 2.0% |
| Total | | 24.3% | 8.9% | 2.3% | 2.0% |
| **Revenue Mix** | | | | | |
| Table Games | 8.0% | 6.8% | 6.8% | 7.0% | 7.0% |
| Gaming Devices | 92.0% | 93.2% | 93.2% | 93.0% | 93.0% |

| Exhibit 23-12 Projected WPUPD and Total Gaming Win | | | | | |
|---|---|---|---|---|---|
| | **1997** | **1998** | **1999** | **2000** | **2001** |
| Table Games | | | | | |
| WPUPD | $193 | $205 | $221 | $236 | $240 |
| Units | 25 | 25 | 25 | 25 | 25 |
| Win | $1,760 | $1,870 | $2,020 | $2,150 | $2,190 |
| Gaming Devices | | | | | |
| WPUPD | $56 | $56 | $61 | $62 | $63 |
| Units | 1,000 | 1,250 | 1,250 | 1,250 | 1,250 |
| Win | $20,270 | $25,510 | $27,810 | $28,360 | $28,930 |
| Total Gaming Win | $22,030 | $27,380 | $29,830 | $30,510 | $31,120 |
| Growth Rate | | 24.3% | 8.9% | 2.3% | 2.0% |

## » 23.06 DISTANCE-BASED VISITATION MODEL—RIVERBOAT CASINOS

The current and projected trends in economic and demographic factors such as population base, employment trends, disposable income levels, and visitation statistics have a direct impact on a market's demand for gaming facilities. Forecasting potential casino visitation becomes a function of this economic and demographic data as well as specific information pertaining to the gaming habits and preferences of a particular market's populace. General data on penetration rates and trip frequencies within certain geographical areas have been compiled by the research departments of several leading gaming companies. The compilation of this data has led to the development of a distance-based visitation model, which uses the following four steps in deriving a forecast of marketwide casino visitation.

1. Identify the subject market's capturable base population by using a concentric-circle analysis. The sizes of the concentric circles are typically 0-50 radial miles, 50-100 radial miles, and 100-150 radial miles. In addition to identifying and quantifying the capturable base population, the current level of visitation from outside the 150-mile radius is quantified.
2. Growth rates are applied to the capturable base population figures over the estimated projection period. In addition, an overlap adjustment is applied to the base population estimates within each of the concentric circles to account for regional competition. Similar to the population estimate, a growth rate is applied to the base visitation estimate over the projection period. Finally, the incremental level of visitation generated by the opening of the subject property or other gaming facilities is quantified.
3. Penetration and trip frequency rates are projected for each of the concentric circles, the current visitation levels, and the incremental visitation levels. The rates are then multiplied to derive the gaming incidence factor specific to each concentric circle and visitation segment. The gaming incidence factor is then multiplied by the adjusted base population estimate for each concentric circle and both visitation estimates, equating to the projected number of casino visits within the market.

4. The subject property's fair share, market penetration, and market capture rates are then estimated and applied to the projected number of accommodated casino visits within the market to arrive at the projected number of casino admissions at the subject property.

## [1] Step One—Concentric Circle Analysis

Three concentric circles are plotted around the subject property. The circles represent the primary local market within a 50-mile radius of the subject property, the secondary market from 50 to 100 miles, and the tertiary market from 100 to 150 miles. The primary market includes local residents who tend to have a higher propensity to gamble because of the convenience of the casino facility. For the same reason, the local market also generates a higher average trip frequency figure. The secondary market, while viable, can be subject to regional competition depending on the proximity of the subject property to competitive gaming markets and its relative accessibility from primary transportation routes. An additional factor affecting the secondary market is the marketing campaign employed by management. The tertiary market is composed of "day trippers," who often have a choice between gaming locations of equal distance given the location of the subject property. The tertiary market necessitates the highest overlap adjustment and the lowest penetration and trip frequency estimates.

Exhibit 23-13 delineates the derived base population figures, the capturable adult population, and the current adult visitation level.

**Exhibit 23-13 Estimated Base Population and Visitation Levels (OOOs)**

| Data Type | 0-50 Miles | 50-100 Miles | 100-150 Miles | Total |
|---|---|---|---|---|
| Base Population (000) | 1,057.3 | 1,735.3 | 556.8 | 3,349.4 |
| Percent of Populace Over 21 | 75.0% | 75.0% | 75.0% | 75.0% |
| Capturable Adult Population (000) | 793.0 | 1,301.5 | 417,6 | 2,512.1 |
| Plus: Estimated Adult Visitation | | | | 4,600.0 |
| Total Capturable Adult Population | | | | 7,112.1 |

## [2] Step Two—Forecasting Adjusted Capturable Population and Visitation

On the basis of the area's population statistics, an annual growth rate is applied to the capturable population figures. Similarly, a growth rate is applied to the current visitation levels, reflecting the area's tourism and convention climate. Incremental visitation as a result of the subject casino's opening is projected to decrease by 50 percent in the second year and cease in the third year of the projection period. Overlap adjustments have been applied to each of the concentric circles in order to account for the lost visitation due to the proximity of regional competitive gaming markets. The overlap adjustments are then applied to the capturable population projections to arrive at an adjusted capturable population estimate. Exhibit 23-14 presents the capturable population base, applied growth rates, and overlap adjustments resulting in a forecast of adjusted capturable population and visitation.

**Exhibit 23-14 Base Population and Visitation Levels, Applied Growth Rates, and Overlap Adjustments (000s)**

| | Base Year | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|
| **Capturable Population and Visitation Levels** | | | | | | |
| Capturable Population Growth Rates | | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% |
| 0–50 Miles | 793 | 801 | 805 | 809 | 813 | 817 |
| 50–100 Miles | 1,301 | 1,315 | 1,321 | 1,328 | 1,334 | 1,341 |
| 100–150 Miles | 418 | 422 | 424 | 426 | 428 | 430 |
| Subtotal | 2,512 | 2,537 | 2,550 | 2,563 | 2,576 | 2,588 |
| **Overlap Adjustment** | | | | | | |
| 0–50 Miles | | 0.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| 50–100 Miles | | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| 100–150 Miles | | 0.90 | 0.90 | 0.90 | 0.90 | 0.90 |
| **Adjusted Capturable Population** | | | | | | |
| 0–50 Miles | | 721 | 724 | 728 | 732 | 725 |
| 50–100 Miles | | 789 | 793 | 797 | 801 | 805 |
| 100–150 Miles | | 42 | 42 | 43 | 43 | 43 |
| Subtotal | | 1,552 | 1560 | 1,567 | 1,575 | 1,583 |
| Visitation Growth Rate | | 0.5% | 0.5% | 0.5% | 0.5% | 0.5% |
| Current Visitation | 4,600 | 4,646 | 4,669 | 4,693 | 4,716 | 4,740 |
| Incremental Visitation Growth Rate | | | (50.0%) | (100.0%) | 0.0% | 0.0% |
| Incremental Visitation | | 50 | 25 | 0 | 0 | 0 |
| Total Population and Visitation | 7,112 | 7,234 | 7,244 | 7,256 | 7,292 | 7,328 |

## [3] Step Three—Projecting Casino Visits Within the Market

Step three includes the forecast of penetration rates and trip frequency factors equating to a gaming incidence factor. A penetration rate is defined as the percentage of capturable population in each market segment that is projected to visit a casino at least once annually. Trip frequency is defined as the average number of visits per annum. A penetration rate of 60 percent and a trip frequency of 7.0 equates to a gaming incidence factor of 4.2 (.60 x 7.0 = 4.2). The gaming incidence factor is then applied to the adjusted capturable population and visitation levels to derive the projected number of annual casino visits to the subject's market area.

Based on the various sources, penetration rates range from 50 percent to 70 percent within primary markets, from 25 percent to 50 percent within secondary markets, and from 10 percent to 35 percent within tertiary markets. Trip frequencies range from 3.0 to 7.0 within a 50-mile radius, 1.5 to 4.0 from 50 to 100 miles, and 1.0 to 3.0 from 100 to 150 miles. Exhibit 23-15 presents calculated gaming incidence factors and projected annual casino visits throughout the projection period.

## [4] Step Four—Projecting Casino Admissions

Step four of the analysis includes the calculation of the subject property's fair share, and projection of market penetration rates equating to the overall estimate of casino admissions captured by the property. The subject property's fair share is calculated by

**Exhibit 23-15 Calculation of Gaming Incidence Factor and Projected Annual Casino Visits**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| **Projected Penetration Rates** | | | | | |
| 0-50 Miles | 0.48 | 0.48 | 0,48 | 0.48 | 0.48 |
| 50-100 Miles | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| 100-150 Miles | 0.30 | 0.30 | 0.30 | 0.30 | 0.30 |
| Current Visitation | 0,40 | 0.40 | 0,40 | 0.40 | 0.40 |
| Incremental Visitation | 1.00 | 1.00 | N/A | N/A | N/A |
| **Estimated Trip Frequency** | | | | | |
| 0-50 Miles | 7.00 | 7.00 | 7,00 | 7.00 | 7.00 |
| 50-100 Miles | 4.00 | 4.00 | 4.00 | 4.00 | 4.00 |
| 100-150 Miles | 2.00 | 2.00 | 2.00 | 2.00 | 2.00 |
| Current Visitation | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| Incremental Visitation | 1.00 | 1.00 | N/A | N/A | N/A |
| **Gaming Incidence Factor** | | | | | |
| 0-50 Miles | 3.36 | 3.36 | 3.36 | 3.36 | 3.36 |
| 50-100 Miles | 1,60 | 1.60 | 1.60 | 1.60 | 1.60 |
| 100-150 Miles | 0.60 | 0.60 | 0.60 | 0.60 | 0.60 |
| Current Visitation | 0.40 | 0.40 | 0.40 | 0.40 | 0.40 |
| Incremental Visitation | 1.00 | 1.00 | N/A | N/A | N/A |
| **Projected Annual Casino Admissions—Marketwide (000)** | | | | | |
| 0-50 Miles | 2,422 | 2,434 | 2,446 | 2,459 | 2,471 |
| 50-100 Miles | 1,262 | 1,268 | 1,275 | 1,281 | 1,287 |
| 100-150 Miles | 25 | 25 | 26 | 26 | 26 |
| Current Visitation | 1,858 | 1,868 | 1,877 | 1,887 | 1,896 |
| Incremental Visitation | 50 | 25 | 0 | 0 | 0 |
| Total | 5,618 | 5,621 | 5,624 | 5,652 | 5,680 |
| Growth Rate | | 0.1% | 0.1% | 0.5% | 0.5% |
| **Unaccomodated Demand Adjustment** | | | | | |
| Weekly and Seasonal Fluctuations | 5.0% | 5.0% | 5.0% | 5.0% | 5.0% |
| **Accomodated Casino Admissions** | | | | | |
| 0-50 Miles | 2,301 | 2,312 | 2,324 | 2,336 | 2,347 |
| 50-100 Miles | 1,199 | 1,205 | 1,211 | 1,217 | 1,223 |
| 100-150 Miles | 24 | 24 | 24 | 24 | 25 |
| Current Visitation | 1,766 | 1,774 | 1,783 | 1,792 | 1,801 |
| Incremental Visitation | 50 | 25 | 0 | 0 | 0 |
| Total | 5,339 | 5,341 | 5,342 | 5,369 | 5,396 |

dividing the subject's estimated capacity, expressed as the casino square footage, by the marketwide capacity. For example, if the subject property's casino is 30,000 square feet and the total capacity of the market, including the subject property, is 100,000 admissions per day, the subject property's fair share is equal to 30% (30,000 - 100,000 = 30 percent).

A penetration rate is defined as the percentage of marketwide gaming visitation the subject property will capture in excess of its fair share. For example, if the subject property's fair share of the marketwide capacity was 30 percent, and the property was projected to penetrate the market at 110 percent, the subject would capture approximately 33 percent of marketwide visitation (1.10 X 0.30 = 0.33). The capture rate is then applied to the aggregate amount of marketwide visitation to derive the subject property's admissions forecast.

Penetration into the market reflects a variety of factors including accessibility, available parking, visibility, and proximity to population centers, lodging supply, and tourist attractions. Second, the design and layout of the riverboat complex has a direct impact on visitation. Finally, management's expertise in marketing, customer data base, and name recognition all affect casino visitation.

Exhibit 23-16 presents the subject property's calculated fair share percentages, projected penetration rates, and captured gaming admissions throughout the five-year projection period.

**Exhibit 23-16 Estimated Market Capture and Projected Number of Admissions**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| **Marketwide** | | | | | |
| Existing Capacity | | | | | |
| (Square Footage) | 195,000 | 195,000 | 195,000 | 195,000 | 195,000 |
| Additions to Supply | 0 | 0 | 0 | 0 | 0 |
| Total | 195,000 | 195,000 | 195,000 | 195,000 | 195,000 |
| Percentage Change | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| **RIverboat Casino** | | | | | |
| Existing Capacity | | | | | |
| (Square Footage) | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| Additions to Supply | 0 | 0 | 0 | 0 | 0 |
| Total | 30,000 | 30,000 | 30,000 | 30,000 | 30,000 |
| **Calculated Fair Share** | 15.4% | 15.4% | 15.4% | 15.4% | 15.4% |
| **Estimated Penetration Rate** | 100.0% | 105.0% | 110.0% | 110.0% | 110.0% |
| **Calculated Market Share Rate** | 15.4% | 16.2% | 16.9% | 16.9% | 16.9% |
| **Projected Admissions—RIverboat Casino (000)** | | | | | |
| 0-50 Miles | 354 | 374 | 393 | 395 | 397 |
| 50-100 Miles | 184 | 195 | 205 | 206 | 207 |
| 100-150 Miles | 4 | 4 | 4 | 4 | 4 |
| Current Visitation | 272 | 287 | 302 | 303 | 305 |
| Incremental Visitation | 8 | 4 | 0 | 0 | 0 |
| Total | 821 | 863 | 904 | 909 | 913 |
| Percentage Change | | 5.0 | 4.8 | 0.5 | 0.5 |

## [5] Forecasted Win per Admission

A forecast of aggregate gaming win generated by the market and the subject property can be derived by multiplying the forecasted casino visitation statistics by an estimated win per admission figure. The following is a step-by-step analysis of win per admission levels:

- A survey of comparable facilities operating within similar gaming markets is performed to determine average wagers and average duration of play for both table game and gaming device patrons.
- These estimates are multiplied by the average number of decisions per hour and the weighted house advantage for both table games and gaming devices to determine a respective win per admission figure.
- The estimated table game and gaming device win per admission figures are then weighted by each segment's typical contribution to total gaming revenue. Our analysis of comparable gaming markets indicates that table game revenues contribute approximately 20 percent of total gaming win, while gaming device revenues contribute the remaining 80 percent of total gaming win.
- The two weighted win per admission estimates are summed, equating to an overall win per admission figure.

**Exhibit 23-17 Forecasted Win per Admission**

| Table Game Patron | | Gaming Device Patron | |
|---|---|---|---|
| Average Wager | $10.00 | Average Wager | $0.75 |
| Average Duration of Play (hours) | 3 | Average Duration of Play (hours) | 3 |
| Decision per hour | 55 | Decision per hour | 240 |
| House Advantage | 1.80% | Hold Pecentage | 7.0% |
| Average Win per Admission | $29.70 | Average Win per Admission | $37.80 |
| Percentage of Total Win | 20 | | 80% |
| Weighted Average Win per Admission | $5.94 | | $30.24 |
| Overall Win per Admission | $36.18 | | |

Exhibit 23-17 presents the first-year forecast of overall win per admission. The variables used in the analysis reflect both industry averages and estimates specific to the market. Variables such as decisions per hour and the house advantage are industry standards, while the average wagers and duration of play estimates are based on comparable market activity and discussions with local operators. Estimated average table game wagers reflect the changes in minimum wagers set by the house as a function of peak and off peak demand periods. The duration of play is based on an average excursion times, including embarkation and disembarkation. Average wagers for gaming devices reflect the estimated predominance of reel machines, which allow a maximum drop of three coins per pull. Video poker and progressive video poker machines generally allow a maximum drop of five coins per pull but are anticipated to account for only a moderate portion of the overall device inventory. Gaming devices hold percentages are based on industry averages reflecting the level of competition and marketwide demand

levels. Reflecting a stable supply of gaming inventory, economic, demographic, and inflationary growth within the market, a 1.0 percent average annual growth rate has been applied to win per admission figures throughout the projection period.

Applying the win per admission estimates to the projected gaming admissions captured by the subject property equates to the forecasted gaming revenue anticipated to be generated throughout the five-year period (see Exhibit 23-18).

**Exhibit 23-18 Forecasts of Marketwide Gaming Revenue and Subject Property's Gaming Revenue**

| | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|
| **Forecast of Marketwide Gaming Revenue** | | | | | |
| Forecasted Admissions | 5,617,843 | 5,620,682 | 5,623,660 | 5,651,779 | 5,680,037 |
| Win per Admission | $36.18 | $36,90 | $37,64 | $38.39 | $39.16 |
| Marketwide Gaming Win | $203,253,547 | $207,423,395 | $211,683,976 | 216,997,243 | $222,443,874 |
| Rounded | $203,300,000 | $207,400,000 | $211,700,000 | $217,000,000 | $222,400,000 |
| Growth Rate | | 2.0% | 2.1% | 2.5% | 2.5% |
| **Forecast of Subject Property's Gaming Revenue** | | | | | |
| | **1997** | **1998** | **1999** | **2000** | **2001** |
| Forecasted Admissions | 821,454 | 862,760 | 904,112 | 908,632 | 913,175 |
| Win per Admission | $36.18 | $36.90 | $37.64 | $38.39 | $39.16 |
| Total Forecasted Gaming Win | $29,720,203 | $31,838,965 | $34,032,270 | $34,886,480 | $35,800,000 |
| Growth Rate | | 7.1% | 6.9% | 2.5% | 2.5% |

HVS

CHAPTER 24

# Selecting a Consulting and Appraisal Firm


¶ 24.01 The Impact of FIRREA . . . . . . . . . . . 24-1
¶ 24.02 Basic Requirements . . . . . . . . . . . . . 24-2
¶ 24.03 Initial Selection Process . . . . . . . . . . 24-3
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¶ 24.05 Assignment Proposal . . . . . . . . . . . . 24-4


## » 24.01 THE IMPACT OF FIRREA

The 1990s brought about significant change in the hotel appraisal and consulting industry. During the 1980s, the deregulation of savings and loans led many uninformed lenders to finance commercial real estate projects, including hotels, that were not economically viable. Other commercial lenders followed suit, and the commercial real estate markets became greatly overbuilt. The resultant demise of numerous savings and loans and commercial banks led to the passing of the Financial Institutions Reform and Recovery Enforcement Act (FIRREA), which went into effect in August, 1990. The bill called for stricter regulation of lenders, which in turn helped lead to the capital crunch for commercial real estate from mid-1990 through 1993.

Prior to the enactment of FIRREA, hotel developers interested in obtaining mortgage financing used the following procedure. First they would bring their proposal to a lender, whose 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 thirty to sixty days, the developer would deliver this study to the lender. The study would often have a bias in favor of the developer and his or her project, because the consultant was being directed and paid by the developer. If, after reviewing the study, the lender wanted to proceed, the developer would be told that an appraisal performed by a member (MAI) of the American Institute of Real Estate Appraisers (now known as the Appraisal Institute) was required to justify the amount of the loan. The developer could then hire the appraiser directly. A generalist appraiser who did not understand the hotel industry was often hired to "cap" the forecast of net income set forth in the feasibility analysis. Cost and sales comparison approaches were added to the analysis and the appraisal was complete. Only after another twenty to thirty days had passed and additional fees were paid would the developer have finally satisfied the lender's requests for market and financial analyses and valuation.

Some firms developed the in-house expertise to develop a combined economic study and appraisal that contained all the components of a feasibility study as well as those of an appraisal. This product reduced the cost and time of the process, but no matter how the due diligence was undertaken, the developer was always in control of the process and often pressured the consultants and appraisers to be overly optimistic. One of the most significant changes brought about by the FIRREA legislation was the requirement that any federally insured financial institution had to directly hire the appraiser for the financing of a piece of real estate. The developers and owners looking to build, finance a purchase, or refinance an existing asset were removed as the middleman in the appraisal process. This legislation lifted the pressure to "make a number" that appraisers and consultants previously had to deal with.

FIRREA had many drawbacks, including regulations so strict that lenders became paralyzed in the lending process and were forced to write down any underse-cured loans and to foreclose on borrowers who could not come up with the additional equity to meet regulated loan-to-value requirements. The restrictive lending environment led to a shortage of capital for refinancing and healthy economic activity, and financial institutions and the real estate industry eventually spoke up about the regulation that helped exacerbate the economic downturn of the early 1990s. The interpretation of FIRREA began to loosen up in 1993, and the remnants of the legislation that remain with us today are generally conducive to a healthy and prudent lending environment.

FIRREA also resulted in the requirement that any appraisal performed for a fed-erally insured real estate transaction must be performed by a state-certified appraiser. State certification is the minimum level of qualification that should be expected from professional appraisers. The requirements to become an MAI are significantly greater than those required to become state certified, but the law requires that a federally insured lender must not discriminate against an individual who does not hold a professional designation such as the MAI. Lenders are, however, permitted to retain the most qualified appraiser, which is generally someone holding the MAI designation.

## » 24.02 BASIC REQUIREMENTS

The key to obtaining a report that will fulfill the lender's requirements for both feasibility analysis and appraisal is twofold; (1) select a qualified hotel consulting and appraisal firm, and (2) 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. A market study and appraisal of a lodging facility requires in-depth knowledge of hotel markets and operations; 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. Similarly, the appraiser who works on the project should have a hotel management background 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 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.

As a result, 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.

## » 24.03 INITIAL SELECTION PROCESS

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 or to recommend to a lender for an 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 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.

## » 24.04 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 whether a company is able to conduct a proper market study and appraisal.

- *Does the firm operate on a national level? Does it have strong regional expertise?* Exposure to many types of markets enhances the level of expertise, while regional expertise deepens the knowledge of particular markets. A local firm may be handicapped in its knowledge of various lodging products and how they perform under different market conditions. A national firm with regional expertise often provides the best of both worlds.
- *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 have specialized expertise in hotel-related studies?*
- *Who will be working on the assignment?* Copies should be obtained of the consultants' and appraisers' qualifications, background, and experience. Since a hotel is a highly specialized business venture, it is essential to meet with the appraisers, including the state-certified MAI who will be working on the assignment, to determine whether 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 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. If the most qualified expert is sought out to perform a hotel market study and appraisal, the client will be assured of receiving a high-quality, reputable product.

## » 24.05 ASSIGNMENT PROPOSAL

After a qualified hotel consulting and appraisal firm has been selected, the next step is 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. All the details and issues of the project and assignment should be clarified up front so that the consultant can quote a fair fee for all the work that will be involved and so that the developer will not face any unanticipated fees on the conclusion of the assignment.

While the developer may have already prepared an in-house analysis of the market and the feasibility of a project, he should not expect the consultant to reduce his or her fee quote. Good consultants and appraisers will have to perform their own primary research in performing a market study or appraisal, and any attempt to reduce either the time they spend or the resultant fee may end up causing more trouble than it is worth in the long run.

If the developer is planning to build several hotels, it is a good idea to tell the appraiser before determining the fee. In addition, the fee might be reduced if the developer is willing to wait for the appraisal until a time that is convenient for the appraiser. It is important to remember, however, that 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, because the myriad decisions involved in the development or acquisition of a lodging facility will be 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 (e.g., telephone, postage, and photocopying). It is best, however, to reimburse out-of-pocket travel expenses on the basis of actual receipt 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.

After preliminary discussions regarding the objectives of the assignment, a capable consultant should be able to present a detailed document outlining what steps will be taken to provide the services discussed. The proposal is actually a contract in letter form, outlining the services to be rendered and fees charged. Once the contract has been signed and returned by the developer, the valuation company is usually given forty-five to sixty days to complete the assignment.

A proposal that does not appear to adequately address any of your specific needs or concerns may be an indication that the consultant has not grasped what you are

looking for. This is the time to have another discussion with the consultant or to find an alternate prospect to perform the work. Preparing a formal request for proposal (RFP) containing specifications for the assignment is not recommended in this age of time and fee constraints. Many excellent consultants and appraisers will not respond to an RFP because they do not believe that the potential client has taken the time to narrow the field of competition to truly qualified players. Responding to an RFP can be time consuming, and the good consultants are often too busy to reply.

HVS

APPENDIX 1

# Data Collection Checklist

SUBJECT PROPERTY ______________________

MAILING ADDRESS ______________________

MUNICIPALITY ______________________

COUNTY ______________________

TELEPHONE NUMBER ______________________

REFERENCE NUMBER ______________________

DATE OF STUDY __________

OPENING DATE OF PROJECT __________

## 1. CLIENT DATA

Company Name ______________________

Business Address ______________________

______________________

Telephone Number ______________________

### Financial Records

- ☐ Balance sheets (last three years)
- ☐ Profit and loss statements with supporting statements (last three years)
- ☐ Occupancy and average rate, by month (last three years)
- ☐ Operating budgets and projections
- ☐ All contracts or agreements entered into by client:
  - Union contracts
  - Leases (ground)
  - Management contracts
  - Franchise agreements
  - Title reports
  - Stock agreements
  - Partnership agreements
- ☐ Franchise Reports
  - Occupancy
  - Inspection
  - Reservation
  - Turnaway
  - Denials
- ☐ Capital expenditures (last three years)
- ☐ Capital budget (cost) projections (next three years)
- ☐ Personal and real property tax bills
- ☐ Comparable assessments
- ☐ Cost of furniture, fixtures, and equipment (last three years)
- ☐ Marketing plans
- ☐ Impact study
- ☐ Name of legal owner

### Property Records

- ☐ Architectural plans
- ☐ Floor plans (as built)
- ☐ Plot plans
- ☐ Survey and legal description of property
- ☐ Engineering reports
- ☐ Original purchase data (price, date, terms, contract, closing statement)
- ☐ Agreement of sale, option, or listing
- ☐ Financing documents (mortgage)
- ☐ Past appraisals of subject property
- ☐ Market and feasibility studies of subject property
- ☐ Prospectuses

## Miscellaneous Records

Credit card user surveys
Meeting planners brochure—rate card
Maps

**2. IN-HOUSE DATA BASE**

Client proposal for valuation
Past studies performed in market area
Contacts with local hoteliers
American Hotel and Motel Association Construction Report
Directories

- Official Hotel and Resort Guide
- Hotel Travel Index
- Red Book
- AAA
- Mobil Travel Guide
- American Institute of Real Estate Appraisers Directory
- Hospitality Market Data Exchange
- American Society of Real Estate Counselors Directory
- Society of Real Estate Appraisers Directory

Rate and occupancy data collections
College alumni listing (e.g., Cornell Society of Hotelmen Directory)
Mailing list of clients
Telephone listings—hotels, motels, real estate, apartments
National Real Estate Investor—city data, atlas. encyclopedia
Sales and Marketing Management
Survey of Buying Power
Restaurant Business RAI and RGI
FAA terminal forecasts

**I. FIELD DATA**

**Contacts** *(Name and telephone number)*

General Manager ______________________________

Assistant Resident Manager

Director of Marketing

Director of Sales _________________

Director of Engineering _______________

Front Desk Manager ________________

Controller/Accountant ________________

**Introductions** *(Name and telephone number)*

Other general managers in area _________

Chamber of Commerce ______________

Convention and Visitors Bureau __________

Hotel Association __________________

**Marketing**

Demand generator analysis

- Major businesses and industries in area
- Primary market area in geographic terms (provide map)
- Top twenty major users of subject property
- Major contract business, including term. rate, and number of room-nights

Competition analysis

- Competitive hotels, including occupancy, average rate, and market segmentation
- Market segmentation, by month
- Average length of stay
- Seasonally
  - — weekly
  - — monthly
  - — by segment
- Unaccommodated demand, by segment
- Double occupancy percentage
- Rate resistance by segment
- Rack rate pricing strategy
- Points of origin (feeder markets)
- Mode of arrival (indicate shuttle availability applicable)
- Percentage of reservations from franchise

- Amount of travel agent commissions
- Hotel or extended-stay association

**Subject Property Analysis**

Size, topography, and shape

- Land area
- Excess land (indicate if salable, highest and best use)
- Plot survey
- Optimum frontage-to-depth ratio (corner location)
- Frontages
- Adjoining uses:
  - — North
  - —East
  - — South
  - —West
- Grade, compared to surrounding roads/uses
- Contours, slope, drainage
- Identification of flood zones, if any, and need for flood insurance
- Soil tests
  - — Water table
  - — Percolation tests
  - — Other
- Air rights
- Subsurface rights
- Water rights
- Landscaping
- Easements/restrictions
- Current condition

Access

- North/south roads
- East/west roads
- Direct access pattern (i.e., number of lanes in approach roads, presence of median division, turn restrictions, traffic signals, one-way, curb cuts. limited access)
- Time and distance to:
  - — Airport
  - — Highways and interchanges
  - — Mass transportation
  - — Convention center
  - — Demand generators
  - — Competition

Visibility

- North-south roadways
- East-west roadways
- From demand generators, airport, convention center
- Height and depth
- Slope of land
- Obstructing buildings (all sides)
- Signage
  - — Location
  - — Visibility
  - — Condition
- Views from subject (all sides) including:
  - — Guestrooms
  - — Food and beverage outlets
- Effect of climate, if any

Utilities

- Location
- Capacity
- Provider
- Electricity:
  - — Price/KWH
  - — Normal demand charges
  - — Quantity discounts
  - — Seasonal adjustments
- Natural gas:
  - — Price/therm
  - — Quantity discounts
  - — Seasonal adjustments
- Oil:
  - — Tank size
  - — Price/gallon
  - —Quantity discounts
- Steam
- Water source
- Telephone service
- Sewage
- LPG
- Trash removal
- Storm drainage

Photographic documentation

- Visibility of subject property
- Access to subject properly
- Entrance, with signage
- View of subject property—four sides
- View from subject property—four sides
- Approach roads
- Surrounding land use

## Neighborhood

Boundaries, as indicated by:

- Land use changes
- Transportation arteries

- Bodies of water
- Changes in elevation/topography

Characteristics

- Residential
- Commercial
- Retail
- Industrial
- Rural
- Suburban
- Urban

Buildings

- Style
- Size
- Density
- Vacancy levels
- Rental rates
- Effective age
- Condition

New construction/development

 Street patterns/widths

Nearby parks and recreation areas

Noise or other nuisances

Future trends or potential changes in neighborhood as indicated by uniformity/variance in land uses

## 4. IMPROVEMENTS

### Hotel Description

Architectural plans and description

Year opened

Year of expansion/renovation

Description of expansion/renovation

Number of structures

Location of structures on site

Number of stories in each building

Configuration of each building (e.g., H. L, U)

Total gross building square footage

Total net building square footage

Landscaping and sidewalks

Exterior facade

- Architectural style
- Materials
- Balconies

Future development plans

- Project description
- Costs

Current engineering reports

### Building Layout

Lobby

- Layout and circulation
- Decor
- Size
- Condition
- Ceiling height
- Porte cochere
- Valet stand
- Shuttle bus
- Doors (i.e., automatic, airlock vestibule)
- Bell stand
- Luggage storage
- Concierge desk
- Restrooms
- Phones

Front Desk

- Published rates
- Visibility to incoming guests
- Elevator visibility
- Reservation and registration system

### Other Floors

Layout

Circulation

### Guestrooms (broken down by type)

Total number

Number of connecting rooms

Walking distance

Size

Ceiling height

Number of terraces

Furnishings

- Age
- Last replacement date
- Present condition
- Refurbishment schedule
- Amenities (e.g., extra phone, shoe shine, movies. VCR)

Doors

- Material
- Peephole
- Lock brand
- Type (e.g., 1-key, 2-key, card)

Closets

Wall material (e.g.. plaster, drywall. concrete)

Windows
- Type
- Condition

Sprinklers
Smoke detectors
Accessibility to and equipment (or the handi-capped
No-smoking rooms
Bathrooms
- Condition
- Lighting
- Amenities (e.g.. heat lamp. clothesline, heated towel bar)

### Guest Corridors and Elevator Lobbies

Type (double, single-loaded)
Location (interior or exterior)
Direction
Width
Lighting
Ceiling height
Wallcovering
Floorcovering
Condition
Elevator lobby furnishings
Ice machines
Vending machines
Maid/linen closets

### Food, Beverage, and Room Service Facilities

Seating capacities
Meals served
Hours of operation (including room service)
Menus (obtain copies)
Decors
Furnishings
- Style
- Quality
- Age and condition

Bar
Buffet
Back-of-the-house access from kitchens
Room service facilities
Separate outside access (describe visibility of entrance)
Access to restrooms
Entertainment policy
Point of sale system
Average turnover by meal period
Average check by meal period
Percentage of in-house capture by meal period
Estimate of in-house capture and outside capture
Annual covers
- Breakfast
- Lunch
- Dinner

Room service
Lounge
Banquet room
- Square footage
- Room rental revenue

Food and beverage financial statement (broken down by meal period and outlet)
- Cost of sales
- Total payroll expense
- Total other expenses

### Kitchen(s)

Locations
Access (floors, distance)
- Receiving areas
- Storage areas
- Meeting rooms
- Outlets

Equipment
- Description
- Quality
- Quantity
- Configuration
- Condition

Adequacy of size and layout

### Meeting and Banquet Facilities

Individual rooms
- Name
- Size
- Capacity

Adequacy of mix and breakout rooms
Décor
Condition
Separate entrance/porte cochere
Separate service and public corridors
Proximity to kitchen
Adequacy of meeting support amenities (e.g.. furniture, audio-visual equipment)

Furniture storage area
HVAC/zone control

## Recreational Facilities

Swimming pool
- Shape
- Indoor/outdoor

Tennis courts
- Lighted
- Indoor/outdoor

Golf course
- Number of holes
- Yards per hole
- Annual rounds played
- Fees

Jogging trails
Health/exercise club
- Sauna
- Steambath
- Whirlpool
- Massage
- Exercise classes
- Exercise apparatus
  - —Type
  - — Number

Other facilities (e.g., horseback riding, ice skating, boating, skiing)
Spa
Game room

## Back-of-the-House Layout

Employee entrance (access pattern)
Employee facilities
- Lockers
- Lounge area
- Cafeteria

Security
Timekeeping
Personnel
Purchasing offices
Receiving
- Loading dock .• Guest view
- Lift

Storerooms
Engineering
- Shops
- Storage
- Electrician
- Locksmith
- Carpenter

## Building Systems

Structural
- Foundation
- Framing (e.g., steel, precast concrete, reinforced concrete)
- Walls
- Roof
  - —Age
  - — Condition
  - — Sloped or flat
  - —Material (e.g., asphalt shingle, built-up felt and tar. slate)

Parking
- Number of spaces
- Indoor/outdoor
- Valet
- Cost to guest
- Percentage of non-guest use
- Condition of pavement and striping

## Heating, Ventilation, and Air Conditioning

Heating system
- Type (i.e., hot water, steam, electric)
- Fuel
- Delivery (2-, 3-, 4-pipe. forced air)
- Heat/cool simultaneously
- Boilers
  - — Brand
  - — Model number
  - — Age/condition
- Burners
  - — Brand
  - — Model number
  - — Age/condition
- Water heater
  - — Brand
  - — Model number
  - — Tank size
  - — Age/condition
- Resistance
  - — Brand
  - — Model/capacity
  - — Age/condition

- Heat exchanger
  - — Brand
  - — Model/capacity
  - — Age/condition
- Heat pump
  - — Brand
  - — Model number
  - — Capacity
  - — Age/condition

Cooling system

- Type (e.g , central/chilled water, heat pumps)
- Chiller
  - — Brand
  - — Model number
  - — Age/condition
- Cooling tower
  - — Brand
  - — Model number
  - — Age/condition
- Zones
  - — Guestrooms
  - — Meeting rooms
  - — Public space control

## Energy Management System

Description
Brand and model number
Guestrooms (type of control, eg.. individual)
Meeting/public space (type of control, eg., individual)

## Housekeeping

Offices
Storage areas
Sorting areas
Trash chute
Linen chute
Exhaust tan
Washer

- Brand
- Model number
- Quantity

Dryer

- Brand
- Model number
- Quantity
- Fuel

Guest laundry

- Outside contract
- Self-service

## Fire

Smoke detectors

- Local
- Wired

Heat detectors

- Local
- Wired

Sprinkler system
Fire extinguishers
Pull stations

- Control/communication system
- Brand
- Model number

Annunciator panel
Emergency lighting and battery backup
Exit signage and battery backup
Fire hoses

- Brand
- Model number

Standpipes
Kitchen range hood

- Brand
- Model number
- CO, system

Public address system
Emergency generator

- Brand
- Model number

## Vertical Transportation

Passenger elevators

- Number
- Floors served
- Brand
- Cable or hydraulic
- Cab condition
- Capacity
- Feet per minute
- Automatic/manned
- Control system
- Mechanical or electrical relays
- Computerized load system

Service elevators

- Number

- Floors served
- Brand
- Cable or hydraulic
- Capacity
- Feet per minute
- Control system
- Mechanical or electrical relays
- Computerized load system

Escalators

- Number
- Floors served

Dumbwaiters

- Number
- Floors served

Stairs

- Number
- Location

**Security**

Electronic surveillance equipment

- Number
- Location

Alarm systems

## Telephone System

Brand

Model number

Type of call accounting

Least cost routing

Other special functions

## Lighting

Exterior

- Type (e.g., sodium, fluorescent, incandescent)
- Building signage Interior

## Miscellaneous

Asbestos construction

Urea-formaldehyde foam insulation

Building inspection reports

Health inspection reports

Total deferred maintenance

Total functional obsolescence

**5. ECONOMIC AND DEMOGRAPHIC DATA**

## Market Area

Hotels

- Room counts
- Rates
- Occupancy

SIC employment

Population

- Migration vs. births
- Peak vs. annual
- Age distribution
- Income levels (effective buying income)

Retail sales

Eating and drinking place sales

Office space and occupancy survey/directory
(i.e., absorption trends)

Major businesses

- By employment sector
- National
- Number of employees

Industrial space and occupancy survey/directory
(i.e , absorption trends)

Unemployment percentages

 Housing stats

 Building permits

- Number
- Dollar value

Area maps

Major universities

- Enrollments
- Faculty
- Staff

Major military bases

- Civilian employment
- Type/function

Room/bed lax data

Visitor statistics to area attractions

## Assessed Valuation and Taxes

 Assessor

- Name
- Address
- Telephone number

Purchase tax map

- Size of parcel (acreage, square feet)
- Length of boundaries
- Lot and block number
- Tax ID number

Subject property's assessed value
- Date of assessment
- Value of land
- Value of building

Assessment basis
- Income, cost, market
- Change on sale

Date and frequency of assessment

Tax history
- Past five years
- Current
- Future trends
- Equalization rate
- Assessed values
- Mill rates

Comparable hotel parcels
- Number
- Assessments
  - —Land
  - —Buildings

Land sales

Motel sales

Hotel rates and occupancies

Special and/or future assessments

Tax abatements

Personal property
- Subject property's assessed value
- Comparable hotel assessed value
- Mill rates

**Chamber of Commerce/Economic Development Administration**

Primary contact
- Name
- Address
- Telephone number

Area economic status (e.g., cyclical, growing, declining, high-tech, industrial)

Businesses entering/leaving area

Area attractions
- Historical visitation
- Projected visitation

Area hotels
- Occupancy rates
- Rates

Proposed hotels

Prominent area officials
- Name
- Address
- Telephone number

Area business associations

**Airport Authority**

Passenger traffic
- Past five years
- Projected for five years

Cargo traffic
- Past five years
- Projected for five years

Airlines and number of flights

Physical description of airport

Expansion plans, if any

Cities served (originations)

Restrictions on aircraft size

Number of days closed annually

**Hotel Association**

Primary contact
- Name
- Address
- Telephone number

List of area hotels
- Market segmentation
- Rates
- Occupancies

Total room count
- Current
- Historical

Room/bed tax information

Hotels recently opened or closed

Proposed hotels

**Convention Center and Visitors Bureau**

Primary contact
- Name
- Address
- Telephone number

Physical description
- Size
- Capacity
- Age
- Facilities

Number of conventions
- Historic
- Projected
- Seasonality

Number of conventioneers
- Historic
- Projected
- Seasonality

Average expenditure of conventioneer

Average conventioneer length of stay

Average convention size

Future convention calendar/number of events

Marketing plan

Promotion budget
- Past five years
- Next five years
  - Deficits funding

Nature and types of events (local, state. regional)

Visitor statistics

## Room/Bed/Occupancy Tax

Historical taxes by month
- Past five years
  - Next five years

Identification of tax by property (occupancy and rate)

Tax rate
- Historical rates
- Rate changes

Definition of taxable property

Change in number of taxable hotel rooms

### Zoning/Building/Planning Department

Primary contact
- Name
- Address
- Telephone number

Proposed hotel development
- Plans
- Related facilities
- Name of developer, hotel company
- Estimated completion date

Hotels under construction
- Status of each project
- Approval process

Zoning of subject property
- Current
- Historical
- Zoning map
- Zoning regulations
- Conforming use
- Height restrictions
- Lot coverage
- Size restrictions
- Floor area ratio
- Setback restrictions
- Parking requirements
- Sign restrictions
- Moratoriums on building and utilities usage

Environmental impact study requirements

Zoning for surrounding land
- Present
- Future

Flood plain areas

Zoning trends for area

Potential for/probability of zoning changes

Building permits
- Five-year history
- Number
- Dollar value

### Economic Development Administration or Planning Department: City, County, and Surrounding Area

Contacts
- Name
- Address
- Telephone number

Existing hotels
- Occupancy
- Rate

New construction
- Hotels
- Expansions
- Renovations

County (of subject property)

City (of subject property)

Surrounding municipalities

Master (renewal) plan for development

Pertinent studies
- Land use map
- Economic/demographic data
- Transportation

Directions of growth (e.g., industrial, commercial, redevelopment)

Availability of public funds/tax incentives for hotels

DATA COLLECTION CHECKLIST

### Highway/Transportation Department

Primary contact
- Name
- Address
- Telephone number

Origination and destination maps

Traffic flow/count maps

Future changes
- Road improvements
- Traffic rerouting roadway changes (eg., left turn lanes, lights, curb cuts, medians, turn restrictions, additional lanes)

Traffic counts
- Historic
- Current
- Toll receipts

### Commercial Real Estate Firm/Board/ Brokers/Developers/Relocation Services

- ☐ Apartments that accommodate extended stay demand (less than six months)
- ☐ Relocation director/coordinator
- ☐ Retail space inventory
  - Commercial
  - Office
  - Industrial
  - Retail
- ☐ Historic absorption/anticipated growth
- ☐ New projects/expansions/renovations
  - Developer
  - Location
  - Size (square feet)
  - Opening date
  - Major committed tenants
  - Projected occupancy
  - Projected tenant mix
- ☐ Geographic patterns of growth
  - Office space
  - Industrial
  - Retail
  - Residential
  - Source of tenants

### Land Appraisers, Counselors, Bankers

- ☐ Land and hotel sales
- ☐ Occupancy and average rate/market segmentation
- ☐ Proposed hotels
  - Additions
  - Expansions
- ☐ Economic and demographic data

Land use
- ☐ Land value

Property tax rate trends

### Newspapers

- ☐ Advertising/research department
  - Demographic data
  - Economic data
- ☐ Real estate department
  - Articles concerning recently announced commercial/hotel properties
  - Articles concerning recent hotel or land sales

### Rental Car Agencies

- ☐ Number of cars rented
  - Monthly
  - Annually
- ☐ Average length of rentals
- ☐ Renters' points of origin
- ☐ Major companies renting cars

## Generators of Visitation

- ☐ Major companies
- ☐ Office and industrial parks
- ☐ Scenic areas
- ☐ Hospitals
  - Local
  - Regional
  - National specialty
- ☐ Military installations
- ☐ Colleges and universities
- ☐ Amusement parks
- ☐ Resort facilities
- ☐ Governmental offices
- ☐ Residential developments
- ☐ Racetracks
- ☐ Sports stadiums
- ☐ Historic attractions
- ☐ Retail shopping
- ☐ Theaters
- ☐ Museums
- ☐ World and state fairs
- ☐ Sporting events
- ☐ Historic events

National and slate parks
Courts of law
County seats and state capitals

## Generators of Visitation (specifics by type)

Description
Proximity to subject property
Types of visitors (i.e. commercial, meeting/convention. leisure)
Visitor counts

- Admission charge
- Recent changes

Origin of visitors

- Percentage local (from within 200-mile radius)
- Percentage requiring accommodations

Seasonally of visitation

### Competitive Restaurants and Lounges

Name and address
Photograph
Capacity
Year opened
Meals served
Hours of operation
Affiliation
Owner
Renovation/expansion plans
Seasonality

- Weekly
- Monthly

Type of menu
Type of service
Types of patrons

- Age group
- Income

Decor/theme
Entertainment policy
Competitors
Average check
Covers/turnover
Annual sales
Reputation
Location/proximity to subject property

## Competitive Hotels

Name/address
Photograph (entrance with sign)
Brochure/meeting planner/sates or business card
Number of rooms/room square footage
Building configuration
Year opened
Franchise/management company/owner
Unionized
Properly for sale
Percentage of reservations from system
Renovation/expansion plans
Seasonality

- Weekly
- Monthly
- By segment

Segmentation
Competitors
Occupancy

- Historical
- Current trends

Average rate

- Historical
- Current trends

Market segmentation

- Historical
- Current trends

Published rates
Proposed hotels
Additions
Renovations
Major customers
Amenities—description
Current property condition
Location/distance from:

- Subject property
- Demand generators

Access and visibility
Corridors

- Exterior
- Interior
- Both

Neighborhood

- Food
- Beverage
- Entertainment

Frequent traveler program
Actual number of extended-stay room-nights
Relocation and corporate rates
Rooms or suites with kitchen facilities and types of facilities

## Extended Stay Competition

Name/address
Photograph (entrance with sign)
Brochure/sales or business card
Number of rooms/square footage
Building configuration
Year opened
Management/ownership
Minimum stay (six months or less)
Furnished
- Furniture
- Linen
- China
- Utensils

Full kitchen
Number of units
Breakdown of units
- Studio
- One-bedroom
- Multiple bedroom

Rates by unit size
- 1-6 days
- 7-29 days
- 30-60 days
- Over 60 days

Maid service
- Daily
- Weekly

Telephone service
- 24-hour switchboard
- Wake-up calls
- Messages
- Free local calls

Utilities included
Amenities
- Pool
- Meeting space
- Other

Renovation/expansion plans
Seasonably
Occupancy/average rate
- Historic (past five years)
- Future (next five years)
- Segmentation

Competition
- Occupancy
- Average rate
- Trend
- Segmentation

Proposed direct competition
Major customers
Condition of property
Location/distance from:
- Subject property
- Demand generators

Neighborhood
- Food
- Beverage
- Entertainment

Access/visibility

## Liquor License Laws

Application process
- Location
- Time
- Cost
- Limitations

Restrictions
- Ratio of liquor to food
- Open to public
- Required unit of sale

Types of licenses

# APPENDIX 1A

# Sample Form: Purchase of a Hotel

This Purchase Agreement is entered into on the date hereinafter set forth by and between ........... (the "Purchaser"), and .................. (the "Seller").

WITNESSETH:

**ARTICLE 1**

**1.1 Property** Subject to the terms and provisions hereof, the Seller covenants and agrees to sell to the Purchaser, and the Purchaser covenants and agrees to purchase from the Seller that property described on the attached Exhibit A (the "Subject Properties") and commonly known as .................. ("Hotel").

**1.2 Other Interests** Contemporaneously with the conveyance of the Subject Properties, and subject to the terms hereof, the Seller covenants and agrees to transfer to the Purchaser, and the Purchaser covenants and agrees to accept from the Seller (and to assume the obligations of the Seller) all right, title, and interest of the Seller in and to the following:

**(a)** All commercial leases providing for rights of possession in or to the Subject Properties (the "Commercial Leases");

**(b)** All third-party contracts covering the management or operation of the Subject Properties (except the existing management arrangements with ...........,...) and all furniture, fixtures, and equipment leases to Seller and used in the operation of the Subject Properties, to the extent transferable ("Third Party Contracts"),

Purchaser shall have the opportunity to review and approve or disapprove of the Commercial Leases and Third-Party Contracts, copies of which shall be supplied to Purchaser within ....,..........(.....,,) days of this date. Such review period shall extend for ............... (.......) days after receipt thereof by Purchaser. In the event any Commercial Leases or Third-Party Contracts are objectionable to Purchaser, this Agreement shall be terminable by Purchaser by written notice to such effect provided to Seller prior to the expiration of such ....... -day period, otherwise Purchaser shall be deemed to have approved such Commercial Leases and Third-Party Contracts.

**ARTICLE 2**

**2.1 Purchase Price** The total consideration for the conveyance of the Subject Properties by the Seller to the Purchaser shall be as follows:

**(a)** ............... dollars shall be payable in cash at closing, subject however to Sections 2.1(b) and 2.1 (c) of this Agreement:

**(b)** The assumption and promise to pay the unpaid principal balance and accrued interest, according to the terms of that certain ............. dollar-promissory note dated .................. 19 ...., payable to the order of................. *[lender]* (the "First Mortgage") together with all instruments evidencing or securing the payment thereof, including without limitation, the Mortgage, Security Agreement, and Assignment of Leases and Rents dated .................. 19..... between Seller and ................ *[lender].* Copies of the First Mortgage and the Mortgage securing the payment thereof have been provided to Purchaser prior to the date hereof, the receipt of which is hereby acknowledged by Purchaser and are hereby approved as acceptable to Purchaser. Purchaser agrees to take all action required by the holder of the First Mortgage as a condition of obtaining consent to the transaction contemplated by this Agreement (if required), provided that Purchaser shall not be required to pay any fee as a condition of obtaining such consent, other than as set forth in Section 2.1(c). In the event Purchaser fails or refuses to comply with or supply such information as required by the holder of the First Mortgage within .......,....,..(.....,,) days after the date such request is made in writing to Purchaser, Purchaser shall be deemed to be in default of this Agreement. Purchaser agrees to indemnify and hold Seller harmless from and against all claims, demands, and liabilities arising out of the First Mortgage, to the extent Seller is liable for any amounts due thereon; and

**(c)** Purchaser shall deliver to Wells Fargo Realty Advisors, Inc. (the "First Mortgagee") a letter of credit in the amount of....... dollars (the "Letter of Credit") as additional security for the First Mortgage, and Seller shall be released from all liability on the First Mortgage at Closing. Failure of Purchaser to provide to Seller proof satisfactory to Seller of the availability of such Letter of Credit on on before the expiration of .............. (......) days after the date hereof shall constitute a default of this Agreement and entitle Seller to terminate this Agreement and retain the Earnest Money.

The Purchase Price shall be allocated prior to Closing between the various components of the Subject Properties in a manner mutually acceptable to Seller and Purchaser.

## ARTICLE 3

**3.1 Seller's Agreements** Within .............(......) days following the date hereof Seller shall furnish the following to the Purchaser, which shall be returned to Seller in the event Closing does not occur.

**(a)** Any plans and specifications regarding the Subject Properties which Seller may have in its possession;

**(b)** Any surveys, field notes, and plats Seller may have in its possession regarding the Subject Properties, which survey shall be updated if required by Purchaser at its sole cost and expense;

**(c)** A current Commitment for Title Insurance (the "Commitment") covering the Subject Properties in the standard ALTA form issued by a title insurance underwriter mutually acceptable to Seller and Purchaser (the "Title Company"),

**3.2 Operating Agreements** Purchaser shall assume and agree to honor all agreements and contracts which are provided to Purchaser for review in accordance with Section 1.2 and any other agreements and contracts entered into in the ordinary course of business regarding the operation and maintenance of the Subject Properties which are terminable without penalty upon notice of ................. (.......) days or less.

**3.3 Sale or Modification** Between the date hereof and the date of Closing or termination of this Agreement, the Seller covenants and agrees that without the prior written consent of the Purchaser, which consent shall not be unreasonably withheld, it will not:

(a) Make any structural modifications to the Subject Properties, except to the extent required to comply with this Agreement and except as reasonably required in connection with any emergency or casualty; or

(b) Sell or otherwise dispose of any portion of the Subject Properties (except in the ordinary course of business), unless replaced with Items of equal or better quality.

**3.4 Remedies** In the event of a breach by the Seller of its covenants or agreements contained in this Article, the sole right or remedy of the Purchaser for such breach shall be the recovery of actual damages therefor, and in no event shall the Purchaser be entitled to rescission or to exemplary or punitive damages, nor shall the Purchaser be entitled to delay Closing or terminate this Agreement by virtue thereof,

**ARTICLE 4**

**4.1 Seller's Obligations** At Closing, the Seller covenants and agrees to deliver the following instruments and documents to the Purchaser:

**(a)** A duly executed and acknowledged deed with warranties limited only to the grantors acts, conveying good and indefeasible title to the Subject Properties to the Purchaser, subject only to those matters permitted herein, the liens securing the First Mortgage and the liens securing the promissory note described in Section 8.2(c);

**(b)** A Bill of Sale transferring all personal property constituting the Subject Properties to Purchaser;

**(c)** An Assignment of Leases and Third-Party Contracts, transferring all Commercial Leases and Third-Party Contracts regarding the Subject Properties (to the extent transferable);

**(d)** Such other documents as may reasonably be required by the Title Company in order to evidence the authority of those executing the various documents on behalf of the Seller;

**(e)** The proceeds of any insurance policies paid for unrepaired damages;

**(f)** A certificate of the Secretary of State of.............. that the Certificate of Articles of Limited
Partnership is on file and has not been revoked or terminated; and

**(g)** A complete schedule of all accounts receivable and accounts payable as of the Closing Date.

**4.2 Purchaser's Obligations** The Purchaser covenants and agrees to pay to the Seller, at Closing, the cash consideration (together with or net of any adjustments as provided in Article 10 hereof) and to execute, acknowledge, and deliver to Seller counterparts of the Bill of Sale, the Assignment of Leases and Third-Party Contracts and the Letter of Credit. Purchaser shall also deliver to Seller an opinion of counsel for Purchaser that Purchaser is a validly formed corporation according to the laws of its state of incorporation, is in good standing, has the full power and authority to perform and act as required by this Agreement and the person(s) executing the closing documents on behalf of the Purchaser has the full power and authority to so act. A certificate of the applicable public official to the good standing of the Purchaser shall be delivered to Seller at the Closing.

**4.3 Documents** On the date of Closing, and following Closing, the Seller shall deliver to the Purchaser, on the site of the Subject Properties, the following:

**(a)** executed originals of all Commercial Leases in the possession of the Seller pertaining to leases with such tenants;

**(b)** executed originals (or copies if originals are not in the possession of Seller) of all Third-Party Contracts assigned to the Purchaser;

**(c)** to the extent in possession of Seller; keys to each room, and all guest records relating to present and future guests;

**(d)** possession of the Subject Properties, subject to rights of tenants under Commercial Leases, hotel guests and other matters permitted herein; and

**(e)** all marketing, personnel records, and any other files and records used in the operation of and located on the Subject Properties, other than as otherwise provided in this Agreement.

**ARTICLE 5 5.1 Representations'** Seller makes the following

representations:

**(a)** This Agreement has been duly and validly authorized, executed, and delivered by Seller and no other action is requisite to the valid and binding execution, delivery, and performance of this Agreement by Seller. This representation shall survive for a period of .................. (......) days after the Closing.

**(b)** Except as otherwise disclosed on the attached Exhibit B, to Seller's knowledge and belief, there are no actions, suits, or proceedings pending against, threatened, or affecting the Property or the Hotel operating on the Subject Properties in law or equity.

**(c)** During the period Seller operated the Hotel, all required licenses and permits necessary for the operation of the Hotel by Seller were in full force and effect on the date of the Closing (except Buyer will be responsible for procuring its own liquor license and transfer of such licenses and permits);

**(d)** The financial information furnished and to be furnished to Purchaser by Seller relating to the Subject Properties fairly presents those facts and circumstances reflected therein as of the effective date of such financial information;

**(e)** Seller is the owner of good and indefeasible fee simple title to the Subject Properties, subject only to those matters described or permitted herein;

**(f)** There are no union contracts covering any of the employees employed at the Subject Properties; and

**(g)** As of the date Seller acquired the Subject Properties, its use was permitted under applicable zoning laws and, to the best of Seller's knowledge, there has been no change in the applicable zoning classification; and

**(h)** Seller has not entered into any Commercial Leases or Third-Party Contracts except those delivered to Purchaser under Section 1.2 herein or except those terminable without penalty on notice of.....,.......,, (......) days or less.

**ARTICLE 6**

**6.1 Earnest Money** Contemporaneously with the execution and delivery of this Agreement, the Purchaser has deposited with ................Title Insurance Company ........... *[address], ............... [city], ............... [state],* the sum of..... dollars. Closing shall be held on or before ............... (.....) days after the date hereof or such earlier date as is mutually agreed upon. Upon Closing, all Earnest Money shall be applied toward part payment of the cash portion of consideration specified herein. In the event this Agreement is not closed for any reason, then the Earnest Money shall be disbursed in the manner provided in Article 7.

**ARTICLE 7**

**7.1 Seller's Remedies** In the event that all covenants and agreements to be performed by the Seller prior to Closing are fully performed by the Seller or if such performance is not completed due to

the default or failure by the Purchaser, and all conditions precedent set forth in Article 8 hereof have been satisfied or waived, and the transaction contracted for in this Agreement is not consummated due to default on the part of the Purchaser on or before the date of Closing, then the Seller shall retain the Earnest Money as liquidated damages for the Purchaser's default hereunder. The foregoing provisions of this Section shall not affect the indemnity and confidentiality obligations of Purchaser (or any liability to Seller for any breach by Purchaser of any of such obligations) contained herein.

**7.2 Title Objections** Purchaser shall have ............. (......) days after receipt of a copy of the Title Commitment in which to notify Seller of any objection to the title of Seller to the Subject Properties disclosed therein. Standard exceptions contained in the Title Commitment, any exceptions which do not have a material adverse effect on the operation of the Subject Property as a hotel and all liens against the Subject Properties which are to be assumed by Purchaser, which may be discharged out of the cash payable to the Seller at Closing or are otherwise permitted herein, shall not constitute objections to title. Purchaser shall be deemed to have waived any objections to title disclosed in the Title Commitment for which no such notice is given to Seller with such ......day period. In the event the Purchaser timely objects to the title to the Subject Properties, then the Seller shall have the right, but not the obligation, for a period of............... (......) days hereafter, to cure such objections and to show title herein required in the Seller, and if the Closing would otherwise occur within such ........day period, the date of Closing shall be extended until the end of such .......day period. If the Seller elects not to cure such objections, or fails to cure such objections within such .......day period, then

**(a)** the Purchaser may, at its election, waive any objections to title and proceed with the Closing of the transaction contracted for herein (in which event such objections to title shall be deemed approved), all with prejudice to the Purchaser's rights against the Seller for damages by reason of such default or breach; or

**(b)** the Purchaser, as its sole exclusive remedy (Purchaser hereby waiving all other rights and remedies in connection with such failure of title, including any right to specific performance hereof), may terminate this Agreement, and shall then be entitled to the return of the Purchaser's Earnest Money, in which event this Agreement shall be thereafter terminated. The obligations of the Seller to deliver good and indefeasible title shall be satisfied upon delivery of the Deed and the Title Policy.

**7.3 Purchaser's Remedies** In the event that the transaction contracted for in this Agreement is not consummated on the date of Closing due to default on the part of the Seller, excepting only a default as provided in Section 7.2, then the Purchaser may elect as its sole and exclusive remedies:

**(a)** to terminate this Agreement, in which event the Purchaser's Earnest Money shall be refunded; or

**(b)** in the event Seller intentionally defaults in its obligations to perform, and Purchaser is ready, willing, and able to perform and has waived all conditions to Closing, enforce specific performance.

**ARTICLE 8**

**8.1 Purchaser's Conditions** The obligation of Purchaser to consummate the transaction contemplated hereby is subject to the satisfaction (or waiver in writing by Purchaser) or each of the following conditions precedent:

**(a)** Within ............ (......) days after the date hereof, Purchaser shall have received from ................ Hotel Company a commitment to issue a new franchise or transfer the existing franchise to operate the Subject Properties as a ............... Hotel, subject to such requirements and conditions as .................. Hotel Company may impose. Purchaser shall apply for a new franchise or transfer of the existing franchise within ......,.........(......) days of the date hereof and shall be responsible for all costs incurred in connection with ob-

taining such franchise. Seller agrees to assist and cooperate with Purchaser in obtaining such franchise, at the sole cost and expense of Purchaser.

**(b)** Within ....,......,,(....) days from the date hereof, Purchaser shall make an application with the First Mortgagee for consent to the transfer and conveyance of the Subject Properties subject to the First Mortgage upon such terms as may be acceptable to Purchaser. That the First Mortgage may require Purchaser to deliver a letter of credit in an amount not to exceed .......dollars shall not be a requirement unacceptable to Purchaser. In the event Purchaser has not obtained such consent from the First Mortgagee within .............. (.....) days after the date hereof, this Agreement shall automatically terminate without any further action by Seller unless Seller elects otherwise. Should Seller elect not to terminate this Agreement and Buyer has not terminated this Agreement on or before the expiration of ............... (....) days after the date hereof, Buyer's Earnest Money shall be deemed to be "at risk" and shall be non-refundable (except in the event of default by Seller).

**(c)** Purchaser shall have had the opportunity to review and approve the Commercial Lease and Third-Party Contracts as provided in Section 1.2(b).

**(d)** Notwithstanding anything in this Agreement to the contrary, Purchaser shall have no right to obtain a refund of the Earnest Money after the expiration of..............(.......) days after the date hereof except in the event of a default by Seller and, after the expiration of such .......day period, Purchaser shall be deemed to have waived any conditions to Closing (except failure by Seller to perform).

**8.2 Seller's Conditions** Seller's obligations to consummate the transaction contemplated hereby are subject to the satisfaction (or waiver in writing by Seller) of each of the following conditions precedent:

**(a)** On or before the Closing Date, Seller shall have received from ............. Hotel Company a full release, effective as of the Closing Date, of all of Seller's obligations and liabilities under the terms of the existing franchise agreement between Seller and ................ Hotel Company.

**(b)** On or before the Closing Date, Seller shall have obtained consent from the First Mortgagee for the transfer and conveyance of the Subject Properties to Purchaser subject to the First Mortgage without cost to Seller and without change in the terms of the First Mortgage, unless otherwise agreed by Seller. The First Mortgagee shall release Seller and ............. *[name]* and liability under the First Mortgage, any other indebtedness secured by the Subject Properties and release any property other than the Subject Properties from security for the First Mortgage. Seller shall apply to the First Mortgage for said consent and release within ....days after the date hereof.

**(c)** Purchaser shall accept the Subject Properties subject to the liens and security interests securing that certain ..... dollar-promissory note dated ............... 19 ..,.., payable to the order of ................. Hotel Company and Purchaser shall indemnify and hold Seller harmless from and against any and all claims and damages in connection with such indebtedness .............. *[name]* and Seller shall be released from all liability in connection with said indebtedness or Purchaser shall provide adequate security to Seller to protect against any loss.

**(d)** Purchaser shall supply to Seller satisfactory evidence of a commitment for the Letter of Credit to be delivered as provided in Section 2.1(c) within .............. (.....) days after the date hereof. Failure to do so shall constitute a default in this Agreement by Purchaser and entitle Seller to retain the Earnest Money.

**ARTICLE 9**

**9.1 Inspection** The Seller agrees that, prior to Closing, the Purchaser, personally or through its authorized agent or representatives, shall be entitled to enter upon the Subject Properties at all reasonable times with notice to Seller and only in the presence of a duly authorized representative of Seller. Purchaser agrees that this right shall not be exercised in such a manner as to interfere with the normal business or operations of Seller. All information, plans, and specifications shall be made available on the site of the Subject Properties and shall be kept confidential by the Purchaser.

**ARTICLE 10**

**10.1 Adjustments** The Seller shall pay all expenses incurred or accrued in connection with the operation of the Subject Properties through ........ A.M. on the date of Closing. The Purchaser shall pay all expenses incurred in connection with the ownership or operation of the Subject Properties from and after........ A.M. on the date of Closing. The parties shall use reasonable efforts to obtain final bills from all utility companies, and to terminate all expenses, as of...... A.M. on the date of Closing. To the extent that any such item cannot be terminated at such time and on such date, the item shall be prorated between the Seller and the Purchaser at such time as a final bill is received. Notwithstanding anything contained in this Section, however, all hazards against which insurance is provided shall be the responsibility of the Seller until 12:01 A.M. on the date of Closing, and the responsibility of the Purchaser from and after 12:01 A.M. on the date of Closing.

**10.2 Closing Costs** The Purchaser shall pay the escrow fee charged by the Title Company, all charges and fees relating to filing of documents or instruments executed and delivered pursuant to this Agreement (including transfer taxes and documentary or stamp taxes), the premium for the Title Policy, and all costs and expenses contracted for by the Purchaser. The Seller shall pay all costs and expenses contracted for by the Seller. All items to be prorated between the Purchaser and the Seller, as well as all other charges and credits reflected on the closing statements of the parties, shall be based on the best information available to the parties at the time of Closing. In the event, following Closing, either party discovers that any item paid, prorated, charged, or credited, pursuant to the provisions of this Article (including, without limitations, ad valoreum taxes) was erroneous, or was based on an inaccurate estimate, then such party shall notify the other party of such error and an appropriate adjustment shall be made between the parties so that any such item will have been correctly and accurately prorated, charged, or credited between the parties. Any such amount shall be due and payable .................. (.....) days following demand for payment thereof accompanied by such documents as may be reasonably required to establish the accuracy of such adjustment. In the event of any dispute as to amounts owed, the matter may be settled by resorting to arbitration under the rules of the American Arbitration Association upon ..............(......) days prior written notice by one party to the other. The costs of such proceeding shall be borne by the losing party.

**10.3 Payment of Liabilities** Attached hereto as an exhibit is a schedule of the current assets and current liabilities of the Seller as of.......... 19... Seller will transfer to Purchaser at closing the current assets as of the Closing Date. Purchaser agrees to assume the current liabilities as of the Closing Date. If, as of the Closing Date, the excess of the current liabilities over current assets is more than the excess of current liabilities over current assets as of the above date, then any change in the excess shall be a credit to Purchaser and a charge to Seller. If, as of the Closing Date, the excess of the current liabilities over current assets is less than the excess of current liabilities over current assets as of the above date then any reduction shall be a credit to Seller and a charge to Purchaser. Any amounts due under this Section shall be payable at Closing.

Purchaser hereby agrees to pay at Closing that portion of the current liabilities which include accrued employee wages and salaries, and accrued federal, state, and local payroll taxes. Purchaser further agrees to guarantee to Seller the full and complete payment of the current liabilities, and to the extent such current liabilities are not paid in full at Closing, Purchaser shall deliver to Seller adequate security to insure Purchaser's performance, which security shall be in the form of a letter of credit or escrow deposit in such form and amount as may be reasonably accepted by Seller.

**10.4 Employees** Seller shall not solicit for employment any of the employees at the Subject Properties after the date of Closing without first providing Purchaser with notice and obtaining its prior consent.

**ARTICLE 11**

**11.1 Insurance** The Seller covenants and agrees to maintain in full force and effect until 12:01 A.M. on the date of Closing all insurance policies currently in effect. For purposes of transfer of title, Closing shall be considered to occur at 12:01 A.M. on the date of Closing, even though actual execution, delivery, and exchange of documents of Closing shall occur at a different time.

**11.2 Casualty** The Purchaser shall assume the responsibility for all insurance coverage on the improvements at 12:01 A.M. on the date of Closing. In the event the Subject Properties should be damaged by any casualty prior to the above time on the date of Closing, then notice of such damage shall be given to the Purchaser by the Seller, and if the cost of repairing such damage, as estimated by an architect retained by Seller and Purchaser, the cost of which shall be shared equally between Seller and Purchaser, is:

**(a)** Less than ........ dollars, then the Seller shall repair such damage as promptly as is reasonably possible, restoring the damaged property at least to its condition immediately prior to such damage.

**(b)** More than ......... dollars but less than ......... dollars, and if such casualty is covered by insurance carried by Seller, then (i) the Purchaser shall be obligated to close in accordance with the provisions hereof; (ii) the Seller shall assign to the Purchaser, at Closing (or pay to the Purchaser if such proceeds have been collected) all insurance proceeds payable for such damage, which insurance proceeds together with the amount of the deductible, shall not be less than the cost to repair such damage, as determined by an architect retained by Seller for such purpose; (iii) the consideration set forth in Section 2.1 hereof shall be reduced by the amount of the deductible under Seller's insurance policies applicable to such casualty; and (iv) the Purchaser shall have the entire right and authority to negotiate for and agree to any adjustments for such damage with insurance carriers;

**(c)** More than ........ dollars, then the Purchaser may elect to terminate this Agreement upon notice given to the Seller within ................ (.......) days following receipt by the Purchaser from the Seller of notice of such damage; and if the Purchaser does not elect to terminate this Agreement, the Seller shall assign to the Purchaser (or pay to the Purchaser if such proceeds have been collected), at Closing, all insurance proceeds payable for such damage and the sale shall be closed without the Seller's repairing such damage.

**(d)** Seller agrees to carry business interruption insurance in the event of loss of revenue caused by Casualty and, in the event of assignment of insurance proceeds to Purchaser pursuant to (b) or (c) above, any business interruption insurance proceeds applicable to the period after Closing shall be paid to Purchaser.

**ARTICLE 12**

**12.1 Commissions** In the event any claim or demand is made by any real estate agent claiming by, through, or under an agreement with any party hereto, the contracting party shall indemnify and hold the other harmless from and against any such claim or demand and all expenses related thereto, including, without limitation, court costs and attorney fees.

**12.2 Seller's Indemnity** Subject to the provisions of Section 12.3 hereof, the Seller agrees to indemnify and hold the Purchaser harmless from and against any and all liabilities, claims, demands, and expenses, of any kind or nature (except those items which by this Agreement specifically become the obligation of the Purchaser) arising or accruing prior to ..........A.M. on the date of Closing and which are related to the
Seller's ownership, maintenance, or operation of the Subject Properties and all expenses related thereto.

**12.3 Purchaser's Indemnity** The Purchaser agrees to indemnify and hold the Seller harmless from and against any and all liabilities, claims, demands, and expenses, of any kind or nature (except those items which by this Agreement specifically remain the obligation of the Seller) arising or accruing subsequent to ...........A.M. on the date of Closing and which are in any way related to the ownership, maintenance, or operation of the Subject Properties, and all expenses related thereto; including, without limitation, court costs and attorney fees. The Purchaser also agrees to indemnify and hold the Seller harmless from and against any and all liabilities, claims, demands, and expenses of any kind or nature, for any damage to property, or any injury to or death of persons, resulting from any entry onto the Subject Properties by Purchaser or any of its agents, architects, engineers, auditors, planners, or other representatives, or any inspections, surveys, audits, or tests conducted by any of the foregoing, and all expenses related thereto; including, without limitation, court costs and attorney fees.

**12.4 Survival** It is expressly stipulated, covenanted, and agreed that the provisions of this Article shall survive Closing.

**ARTICLE 13**

**13.1 Notices** All notices, demands, or other communications of any type given by the Seller to the Purchaser or by the Purchaser to the Seller, whether required by this Agreement or in any way related to the transaction contracted for herein, shall be given in accordance with the provisions of this Article. All notices shall be in writing and delivered to the person to whom the notice is directed by personal delivery, commercial messenger service, or by U.S. Mail, as a Registered or Certified item, Return Receipt Requested. Notices shall be effective on the earlier to occur of (i) actual receipt by the party to whom such notice is addressed or (ii), in the case of notices sent by U.S. Mail, ............... (.......) days after deposited in a Post Office or other official depository under the care or custody of the U.S. Postal Service. All notices shall be enclosed in a wrapper prepaid or with proper postage affixed, addressed, if to the Purchaser, to its address in the United States as indicated on the signature page hereof. Either party hereto may change the address for notice specified above to any other address within the continental United States by giving the other party ................ (.......) days advance written notice of such changes of address.

**ARTICLE 14**

**14.1 Continuing Liability** Any covenant or agreement herein of either party to this Agreement which contemplates performance after the time of Closing, shall not be deemed to be merged into or waived by the instruments of Closing, but shall expressly survive Closing and shall be binding upon the party obligated thereby.

**14.2 Assignment** This Agreement may not be assigned by the Purchaser, except with the prior written consent of the Seller, which prior written consent shall not be unreasonably withheld. Consent to assignment to an affiliate, subsidiary, or related entity of Purchaser shall not be withheld. Any representations or warranties of Seller shall be personal to Purchaser and nontransferable or available for reliance by any third-party beneficiary Such representations and warranties shall survive for a period of............. (......) months after the date of Closing.

**14.3 Construction and Interpretation** This Agreement shall be construed and interpreted in accordance with the laws of the State of................... and the English language. Where required for proper interpretation, words in the singular shall include the plural, the masculine gender shall include the neuter and the feminine, and vice versa. The terms "heirs, executors, administrators, and assigns" shall include successors, legal representatives, and assigns. The descriptive headings of the several Articles and Sections contained in this Agreement are inserted for convenience only and shall not control or affect the meaning or construction of any of the provisions hereof.

**14.4 Amendment and Waiver** This Agreement may not be modified or amended, except by an agreement in writing signed by the Seller and the Purchaser. The parties may waive any of the conditions contained herein or any of the obligations of the other party hereunder, but any such waiver shall be effective only if in writing and signed by the party waiving such conditions or obligations.

**14.5 Attorney Fees** In the event it becomes necessary for either party hereto to file a suite to enforce this Agreement or any provisions contained herein, the party prevailing in such action shall be entitled to recover, in addition to all other remedies or damages provided for herein, reasonable attorney fees.

**14.6 Consent to Jurisdiction** For purposes of enforcing the obligations of Purchaser under this Agreement only, Purchaser hereby consents to the jurisdiction of the courts of the State of ............... and of the United States, and agrees that any suit against Purchaser arising out of this
Agreement may be brought in any appropriate .................. *[state]* or United States court,

**14.7 Notices and Press Releases** Purchaser and Seller covenant and agree with each other not to make public or give notice of the execution of this Agreement or of the transaction contemplated herein prior to the Closing except for disclosure to parties necessary in connection with the Closing or in connection with post-Closing work to be done by the Purchaser and unless any such notice or publicly be in writing and be approved in writing by both Seller and Purchaser. Recognizing that Seller may suffer damages arising out of the loss of business or the loss of employees should any notice or publicity be given with respect to this Agreement or the transactions contemplated herein, and in the event Purchaser violates the covenants herein, Purchaser agrees to indemnify and hold Seller harmless from any such loss or damage. In the event the Purchaser deals with work to be performed after Closing, the Purchaser shall use his best efforts to prevent any such disclosures by said third parties.

**14.8 Licenses and Permits** Purchaser shall be solely responsible for obtaining such governmental permits, licenses, certificates, and approvals as shall be necessary for Purchaser's use of the Subject Properties (including, without limitation, any liquor licenses), and the failure of Purchaser to obtain any such item prior to Closing shall not delay the Closing or affect the obligation of the Purchaser hereunder to purchase the Subject Properties from the Seller at the Closing. Seller shall not be required to perform any obligations under this Agreement which would be in violation of applicable law, including without limitation, transfer of liquor licenses in violation of applicable licensing laws, provided however Seller agrees to cooperate with and assist Purchaser in obtaining such licenses and permits (at no cost to Seller).

**14.9 Approvals** Purchaser shall be solely responsible for obtaining any approvals required for the assignment of any contracts, leases, or other agreements which affect the Subject Properties from all such parties who may have reserved the right of prior approval to such assignment and assumption.

**14.10 Effective Date** All references in the Agreement to the terms "Effective Date," "date hereof" or similar references shall be deemed to refer to the earliest date upon which all of the following have occurred: (a) execution of this Agreement by Purchaser; (b) execution of this Agreement by Seller;
and (c) receipt by .................. Title Insurance Company of the Earnest Money.

**14.11 Multiple Originals** Numerous copies of this Agreement have been executed by the parties hereto. Each such executed copy shall have the full force and effect of an original executed instrument.
IN WITNESS WHEREOF, etc. **Courtesy of D.J. Brats,**

**Mississippi Grand, Tunica, Miss.**

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APPENDIX 2

# Sample Clauses for Hotel Purchase and Sale Agreement

This appendix is a compilation of clauses from a number of actual purchase and sale agreements, which have been selected to cover a broad range of subjects. To facilitate their use, they have been arranged topically in 17 different categories. In many instances, the clauses are supplemented with alternative or optional language.


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## Category 1 REAL AND PERSONAL PROPERTY BEING SOLD

Seller agrees to sell and convey the Hotel to Purchaser and Purchaser agrees to purchase the Hotel from Seller, for the Purchase price and upon the terms and conditions herein set forth, which Hotel consists of the following property:

### 1.1 Land

The approximately 5.1-acre tract of land described in Exhibit A *[omitted}* attached hereto and made a part hereof together with all rights, easements, and interests appurtenant thereto, including, but not limited to, any streets or other public ways adjacent to said real property and any water or mineral rights owned by or leased to Seller (all of such property being hereinafter referred to as the "Land").

### 1.2 Improvements

All improvements located on the land, including eighteen (18) two-story buildings, each of which contains six (6) studio suites (one-bedroom) and two (2) penthouse suites (two bedrooms on two levels), together with parking spaces for approximately 149 cars, and any and all amenities and other improvements located on the land, including, without limitation, the administrative building (which houses the guest lobby and registration area, administrative areas, meeting area and complimentary service area. swimming pool, whirlpool, and other recreational facilities (all such improvements being hereinafter referred to as the "Improvements"). The land and all of the Improvements thereon are hereinafter sometimes referred to collectively as the "Real Property."

### 1.3 Personal Property

All personal property presently owned by Seller and located on or in the Real Property or used in connection with the operation and maintenance of the Hotel, including, without

limitation, all of Seller's fixtures, furniture, machinery, vehicles, equipment, linens, kitchen and bar equipment and supplies (including cleaning supplies and materials, whether in sealed or broken packages), building materials, supplies, merchandise inventories, hardware, carpeting, draperies, wall coverings, quest supplies, signs, and all other personal property used in connection with the operation of the Hotel (all o( such personal properly being hereinafter referred to as the "Persona! Property ): provided, however, that the Personal Property does not include Seller's food and beverage inventories To the extent any items of Personal Properly are subject to operating lenses or executory contracts that are assignable, Seller shall convey such properly subject to such operating leases or executory contracts. Within fifteen (15) days after *Vie* Contract Dale. Seller's most recent inventory (the "Personal Property Inventory") of all of the Personal Property (and executory contracts and operating leases relating thereto) shall be delivered lo Purchaser. On the Closing Dale, such Personal Property Inventory shall be supplemented in accordance with the terms and provisions hereof. Such Personal Property Inventory and the supplement thereto shall, upon delivery to Purchaser as aforesaid, be and constitute a part of this Agreement, to the same extent as if fully set forth herein.

***[Alternate Clause]*** All china, glassware, and silverware; uniforms: engineering, maintenance, and housekeeping supplies, including soap. cleaning materials, and matches; draperies, material, and carpeting; stationery and printing; and other supplies of all kinds with a use, and including such resupplies as shall occur and be made in a normal course of business.

The quantities of Personal Property and Inventory in the Property shall permit the Property to be operated at a normal level

***[Alternate Clause]*** Exhibit H *[omitted]* hereto sets forth a true and complete list of all furniture and equipment located in. at, or about the Properly or otherwise used in connection with the operation thereof. All Personal Property to be transferred to Purchaser pursuant hereto is or at Closing will be owned by Seller free and clear of any and all liens, encumbrances, security interests, or hypothecations.

**Category 2 BUSINESS ASSETS BEING SOLD**

In recognition of the fact that Ihe value of the business as specified herein is dependent upon the business being a going concern. Seller hereby agrees to transfer to Purchaser at the Closing the following items:

## 2.1 Governmental Permits

All of the Seller's right, title, and interest in and to all hotel licenses and other governmental permits, approvals, and licenses used in the operation of the Hotel, but only if such assignment is permitted by the terms thereof.

***[Alternate Clause]*** All licenses, franchises, and permits used in or related to the ownership, occupancy, or operation of any part of the Real Properly.

***[Alternate Clause]*** All rights of the Partnership and all licenses and permits to the extent assignable, including, but without limitation, the license or licenses to sell alcoholic beverages on or in connection with the conduct of any business on the Real Property.

### 2.2 Operating Contracts

All operating leases, executory contracts, service contracts, and repair agreements with respect to the Real Property and the Personal Property, but only if assignment is permitted

by (he terms thereof. Seller hereby represents and warrants to Purchaser that true and correct copies of each of the governmental permits and operating contracts are set forth in Exhibit B (omitted).

***[Alternate Clause}*** All service, maintenance, union, employment, and other contracts respecting the maintenance or operation of the property.

**2.3 Other Miscellaneous and Intangible Personal Property**

All other contract rights, leases, concessions, receipts, trademarks, logos, copyrights, and other items of .intangible personal property relating to the operation of the Property.

***{Alternate Clause]*** Seller shall grant to Purchaser the right to use the existing name of ______ at the subject property only and subject to reasonable and customary conditions (or a period of five (5) years, for a payment of Ten Dollars ($10.00) per year.

***[Alternate Clause]*** To the extent owned by Seller and permitted to be transferred under the Franchise Agreement or otherwise, the trade name of —————. and goodwill relating thereto, together with the telephone exchange numbers.

***[Optional Clause]*** All customer lists and records owned or possessed by Seller pertaining to the transaction of business at the Hotel, together with the architectural plans.

***[Optional Clause]*** All other intangible property not described above owned by Seller and used or useful in connection with the ownership and operation of the Hotel, including, without limitation, contract rights, guarantees, warranties, and goodwill, but only to the extent that such are assignable by their own terms or under law.

***[Optional Clause]*** All current sales records and information with respect to the hotel, including, without restriction, all sales files and all sales "leads" that would be used in the normal course of business of the hotel.

## 2.4 Franchise Agreement

Purchaser shall have determined that the Partnership has entered into a Franchise Agreement with the Franchisor, and such Franchise Agreement can be transferred to Purchaser at closing.

**Category 3 CLOSING**

The consummation of the Purchase and sale of the Hotel as contemplated herein shall take place at the escrow offices of the Title Insurer at ——————. ——————, on —————, 19_, on or before the close of business, or at such other time as the parties may agree upon in writing. The Closing shall be effected through a closing escrow with the Title Insurer in accordance with the terms and provisions of this Agreement. Seller shall deliver possession of the Hotel to Purchaser at closing.

***[Alternate Clause]*** The closing of title hereunder in respect of the Hotels and payment of the consideration thereof shall occur on or before sixty (60) days after the signing of this Agreement, subject only to the provisions relating to the extension of time to close. The Closing shall occur in _____, _____. at a place to be mutually agreed upon by the parties hereto.

***[Alternate Clause]*** At Closing, the balance of the purchase proceeds shall be delivered to Seller in the manner provided and title to the Property, together with all other documents to be delivered by Seller to Buyer, shall be delivered and conveyed to Buyer. Legal possession and physical occupancy of the Premises shall be given to Buyer at 12:01 P.M. on the date of Closing.

## Category 4 PURCHASE PRICE

### 4.1 General Terms

The purchase price ("Purchase Price") for the Properly, subject to the adjustments **as** provided in this Agreement, shall be Ten Million. Nine Hundred Twenty-live Thousand Dollars ($10,925,000) and shall be payable in the manner set forth herein.

***[Alternate Clause]***The Purchase Price shall be paid in cash at Closing by wire transfer, with credit (or the Deposit specified above and subject to the Prorations and Adjustments referred to herein.

***[Alternate Clause]*** Purchaser shall pay to Seller or, if the dosing be an escrow closing, to the Escrow Agent on behalf of the Seller the sum of $____, which sum shall be paid by certified check or bank draft to the order of the Seller (or the Escrow Agent, as the case may be) at the closing.

### 4.2 Mortgage Assumption

Seven Million, Eight Hundred Fifty-five Thousand Dollars ($7.855,000) shall be paid by the assumption by Purchaser of the First Mortgage Notes currently encumbering part of the Property.

### 4.3 Purchase Money Financing

Seller will provide purchase money financing in the amount of One Million, Three Hundred Thousand Dollars ($1,300,000). Such loan will bear interest at the rate of eleven percent (11%) per annum and will require payment of interest and principal based on a thirty (30) year amortization period, with a balloon payment of remaining principal and interest at the end of the 15th year. Seller agrees that such purchase money financing shall be subordinate to First Mortgage financing obtained by Purchaser in an amount not to exceed Three Million, Five Hundred Thousand Dollars ($3.500,000). II is provided, however, that the lender will agree to promptly notify Seller of any default or late payment by Purchaser and will further agree to allow a reasonable time (or Seller to make such payments and to assume the loan. It is further provided that such default on the first mortgage shall be deemed a default in Purchaser's second mortgage to Seller, and Purchaser shall quietly surrender possession of the properties to Seller.

### 4.4 Allocation of Purchase Price

The Purchase Price shall be allocated among the assets acquired by the Purchaser as follows:

Land $ 800,000 Building<br>
6,080,000 Personal Property<br>
1.670,000 Inventory 50,000<br>
Hotel Names 50,000 Permits<br>
50,000 Hotel Contracts 50.000<br>
Miscellaneous Hotel Assets 50.000 Total<br>
$8.800,000

***[Alternate Clause]***Prior to the closing date, Purchaser shall determine the allocation of purchase price as among Land, Building, fixtures, machinery, equipment, furniture, inventory, and goodwill and shall deliver to Seller notice as to such allocation at least five (5) days prior to the Closing Date. At Closing, Purchaser and Seller shall execute an agreement in form and

terms mutually satisfactory whereby Purchaser and Seller confirm such allocation of purchase price.

## Category 5 EARNEST MONEY

### 5.1 General Terms

An earnest money deposit in the amount of Two Hundred Fifty Thousand Dollars ($250,000) by wire transfer shall be deposited with Purchaser's Title Insurer upon execution of this Agreement. If the transaction contemplated hereby is consummated in accordance with the terms and provisions of this Agreement, the Deposit shall be applied to the cash payment at Closing. The Deposit shall be promptly returned to Purchaser in the event that Seller defaults on any of the terms, covenants, or conditions of this Agreement.

***[Alternate Clause]*** Upon the execution and delivery of this agreement. Purchaser shall pay to ______ (the "Escrowee Agent"), $——— (the "Deposit"), which Deposit shall be held by the Escrowee Agent until closing. All interest on the Deposit shall be payable to Purchaser. Upon closing of the transaction contemplated herein, the Deposit together with all interest thereon shall be paid by the Escrow Agent to the Purchaser. In the event that this transaction shall fail to close, the disposition of the Deposit shall be governed by the provisions of Section 19 hereof.

***{Alternate Clause]*** An Earnest Money Deposit in the amount of One Hundred Thousand Dollars ($100,000) by wire transfer shall be deposited with Escrow Agent by Purchaser upon execution hereof and receipt by Purchaser of a fully executed copy of this Agreement. Following the expiration of the Inspection Period, an additional Earnest Money Deposit in the amount of One Hundred Fifty Thousand Dollars ($150,000) by wire transfer shall be deposited with Escrow Agent by Purchaser. Such Earnest Money Deposit shall be refundable in the event that Seller defaults in any of the terms, covenants, or conditions of this agreement.

### 5.2 Purchaser's Default

In the event the Closing fails to occur due to the default of Purchaser, Seller shall deliver a written notice of termination to Purchaser and shall retain the Earnest Money Deposit as liquidated damages, it being understood that Seller's actual damages in the event of such default are dilficull to ascertain, owing to changing economic and market conditions and the amount of time that the Hotel may be off the market, and that the Earnest Money represents the parties' best current estimate of such damages. Seller shall have no other remedy for any default by Purchaser.

***[Alternate Clause]*** If the Transaction is not consummated, and Seller is not in default under the terms of this Agreement, the Earnest Money Deposit shall be retained by the Seller.

***[Alternate Clause]*** If Purchaser fails to perform its obligations under this Agreement within the times specified. the deposits paid by Purchaser aforesaid may be retained by and (or the account of Seller as liquidated damages, as full settlement of any claims; whereupon all parties shall be relieved of all obligations under this Agreement; or Seller, at its option, may proceed at law or in equity to enforce its legal rights under this Agreement, including specific performance.

### 5.3 Seller's Default

In the event the Closing fails to occur due to the default of Seller, Purchaser, as its sole and exclusive remedy, may elect to obtain specific performance of the express terms and

conditions set forth in this Agreement (so long as such specific performance does not involve seeking judgment for money against Seller or any partner o( Seller).

***[Alternate Clause]*** It Seller fails, neglects, or refuses to perform this Agreement, other than rendering title marketable (unless Seller has no obligation to correct any title defect or matter unacceptable to Purchaser), the Purchaser may seek specific performance or elect to receive the return of its deposits, in which event this Agreement shall be terminated and the parties released of any further obligation hereunder.

**5.3.1 Termination of Agreement.** Purchaser may terminate this Agreement by written notice to Seller, in which event Seller shall return the Earnest Money, so long as Purchaser's written notice terminates all of the Purchaser's interest in the Hotel and this Agreement; provided, however, that failure of the Purchaser to give the Seller such notice shall not be constructed to expand the Purchaser's remedies in any manner.

***[Alternate Clause]*** Purchaser may terminate this Agreement by written notice delivered to Seller on or before the Closing Date, in which event Purchaser shall be entitled to the return of the Earnest Money Deposit.

## Category 6 DUE DILIGENCE

### 6.1 Inspection Period

For a period of sixty (60) days from and after the Seller Authorization, Purchaser and its employees, agents, and representatives shall be entitled to physically inspect and con-duel an engineering study of the Premises and examine records of the Hotel as described hereunder.

**6.1.1 Physical Inspection.** Purchaser may enter upon the Real Property, on al least 24 hours' notice to Seller's resident manager at the Hotel, to perform such inspections and tests of the Hotel including, without limitation, all leased areas and structural and mechanical systems within the Improvements, as Purchaser shall, in its sole discretion, deem appropriate.

**6.1.2 Engineering Study.** Purchaser, within the time period provided herein, may obtain an independent engineering firm to conduct a thorough review of the Premises. If such engineering firm determines that (he Premises have any major structural, electrical, or mechanical deficiencies (including those deficiencies that violate local building codes), Purchaser shall immediately notify Seller and Seller may correct such deficiencies prior to Closing. If such major deficiencies are found to exist, Purchaser shall have the right to either cancel this Agreement and immediately receive back all amounts paid by it or proceed to Closing and accept the property "as is," Purchaser waiving any adjustment of purchase price.

If the Seller fails to perform the above conditions or if any of the above conditions are not satisfied, then Purchaser shall have the right to terminate (his Agreement and the Earnest Money Deposit shall promptly be returned to Purchaser and hereafter neither party shall have any liability or be under any obligation to the other

Purchaser shall obtain an independent engineering firm to conduct a thorough review of the premises. Seller will correct any major structural, electrical, and mechanical deficiencies (including those deficiencies that violate local building codes) found on the premises prior to closing, or the Purchase Price will be adjusted to cover such costs.

**6.1.3 Examine Records.** Purchaser may examine and copy any and all books and records maintained by Seller or its agents relating to receipts and expenditures pertaining to the ownership and operation of the Hotel for the three (3) most recent full calendar years and the current calendar year.

***[Alternate Clause]*** Purchaser's auditors may examine the books, records, and financial statements relating to the operation of the Hotel for the past three years, and such books, records, and financial statements must be in auditable condition and acceptable to Purchaser's auditors.

## 6.2 Confidentiality

Purchaser hereby expressly agrees that neither it nor its agents or representatives shall discuss any aspect of the physical or financial condition of the Hotel or any aspect of Hotel operations with anyone employed at the Hotel except in the presence of and with the approval of Seller's resident manager.

## 6.3 Seller Held Harmless

Purchaser shall hold Seller harmless and shall indemnify and defend Seller and its successors and assigns against any loss, damage, claim, cost, liability, or expense, including reasonable attorney fees, resulting from (a) any intentional act of Purchaser or its agents, representatives, or assigns during or in connection with its inspection of the Real Property, the Hotel, the Records, and other matters that adversely affect Seller's relations with the employees at the Hotel or business operation at the Hotel, or (b) any physical damage caused by Purchaser or its agents, representatives, or assigns during or in connection with its inspection of the Real Property, the Hotel, the Records, and other matters. Purchaser's indemnity in the preceding sentence shall survive termination of this Agreement or Closing of the sale contemplated herein.

## 6.4 Termination of Agreement

On or before the expiration o( the Inspection Period, if Purchaser, in its sole discretion, determines that the results of any inspection, test, or examination are unacceptable or unsatisfactory for purchase or operation of the Hotel in the Manner contemplated by Purchaser, Purchaser may terminate this Agreement by written notice to Seller specifying the reason(s) (or the termination. Upon receipt of such notice, this Agreement shall automatically terminate, Seller shall return the Earnest Money to Purchaser, and neither party shall have any further rights, obligations, or liability to the other hereunder.

***[Alternate Clause]*** Should Purchaser not be satisfied for any reason with respect to any aspect of the Real Property, Personal Property, or any other matter whatsoever. Purchaser shall have the unconditional right to cancel this Agreement by written notice to Seller prior to 12:00 A.M. (midnight) on the sixtieth (60th) day following the effective date of this Agreement. In the event that Purchaser cancels this Agreement pursuant to this paragraph, then Purchaser shall be entitled to an immediate return of Purchaser's deposit, whereupon this Agreement shall be deemed cancelled and the parties released of all further obligations hereunder.

### S.5 Affirmation of Agreement

Failure of Purchaser to send any notice to Seller within the required time period shall be conclusively deemed to constitute affirmance of this Agreement and waiver ol the right to terminate.

## Category 7 TERMS OF PURCHASE FINANCING

The purchaser will often include the condition that the completion of the purchase agreement is contingent on the procurement of financing.

### 7.1 Agreement Not Contingent on Loan Commitment

Simultaneously with the Closing, but not as a condition to the Closing and not as a condition to Purchaser's obligations under this Agreement, Purchaser shall have the right, i( Purchaser so desires, to obtain, at its sole cost and expense, a loan. to be secured by a first lien against the Real Property and Personal Property.

### *[Alternate Clause] 7.2* Agreement Contingent on Loan Commitment

For a period of ninety (90) days from and after the Seller Authorization, Purchaser shall use reasonable efforts to procure a firm written commitment from a lender to make a fully nonrecourse acquisition loan to Purchaser, the proceeds of which loan shall be utilized by Purchaser in order to consummate its acquisition of the Hotel, on the following terms:

1. *Principal amount*—No less than Seven Million, Seven Hundred Sixty-Five Thousand and no/100ths Dollars;
2. *Interest rate—No* greater than ten and one-half percent (lO[1]^) per annum;
3. *Amortization schedule*—thirty (30) years; and
4. *Other terms*— Any other terms that Purchaser deems acceptable.

### 7.3 Failure to Procure Loan Commitment

In the event that Purchaser fails to procure the Loan Commitment, Purchaser shall have the right to terminate this Agreement by delivering notice of such election thai shall specify the reason(s) (or the termination to Seller. Upon receipt of such notice, this Agreement shall automatically terminate. Seller shall retain the Earnest Money as Liquidated damages (it being understood that Seller's actual damages in such event are difficult to ascertain owing to changing economic and market conditions and the amount of time the Hotel may be off the market), and neither party shall have any further rights, obligations, or liability to the other hereunder.

***[Alternate Clause]*** Seller agrees that if said commitment is not obtained by Purchaser as described above, then. at Purchaser's election, it may terminate this Agreement, which shall then be void and without recourse to either party, and the Earnest Money Deposit shall be returned to Purchaser, or Purchaser may elect to proceed to close the purchase of the Property, such election to be made by written notice to Seller not later than sixty (60) days from execution and delivery of this document.

***[Alternate Clause]*** If Purchaser is unable to obtain the first mortgage funding by the Closing, Purchaser shall have the right to extend the Closing (or 30 days (or a maximum of two times. Each time Purchaser wishes to extend Closing, Purchaser will (a) send written notice to Seller stating such intention five (5) days prior to the scheduled Closing, and (b) deposit with the Escrow Agent an additional deposit in the amount of One Hundred Thousand Dollars ($100,000). Any deposits made under this, paragraph will be considered part of the Deposit and credited toward the Purchase Price.

## Category 8 TITLE COMMITMENT AND SURVEY

### 8.1 Title Commitment

Purchaser, at Purchaser's sole expense, shall be responsible for obtaining a title insurance commitment for a title insurance policy from a title insurance company (hereinafter "Purchaser's Title Insurer") in such amount and in favor of such persons as Purchaser desires. Purchaser shall have a period of ten (10) days from the date of this Agreement in which to conduct a title search of Property encumbrances or defects of title rendering title of the Property unmarketable. Marketability of title hereunder shall be determined in accordance with the standards of title of the Local Bar. Seller shall have an additional twenty (20) days (but not later than the date of Closing) from the date of receipt of such written notice to remove the specified encumbrances or detects. If, at the expiration of such twenty (20)-day period or the day of Closing, Seller is able to convey good and marketable title, transfer of title shall occur at the Closing. If, at the expiration of said twenty (20)-day period or the day of Closing period, Seller shall then be unable to convey good and marketable title free and clear of all such encumbrances and detects, then Purchaser shall have the option either of accepting such title as Seller can convey or of rescinding this Agreement; and it Purchaser shall elect to rescind, Seller shall refund the Earnest Money Deposit to Purchaser, whereupon all rights and liabilities of the parties hereto by reason of this Agreement shall be deemed at an end.

**8.1.1 Title to Real Property.** No later than fifteen (15) days after the Contract Date, Seller will deliver to Purchaser, at Seller's sole cost and expense, a title commitment, dated on or after the Contract Date. issued by the Title Insurance Company committing to issue to Purchaser an American Land Title Association (ALTA) owner's policy of title insurance in the amount of the Purchase Price, showing fee simple title to the Real Property in Seller, subject only to the exceptions listed on Exhibit D *[omitted]* and true and correct copies of all documents, whether recorded or unrecorded, referred to in the Title Commitment.

**8.1.2 Title to Site.** Promptly after the effective Date, Purchaser shall obtain evidence of title to the Site, at Purchaser's cost and expense, by the issuance of a title insurance binder or commitment through a major national title insurance company selected by Purchaser. The Title Commitment shall set forth the state of title to the Site together with all exceptions or conditions to such title, including, but without limitation to, all easements, restrictions, rights-of-way, covenants, reservations, and all other encumbrances affecting the Site that would appear in an owner's title policy.

**8.1.3 Title to Personal Property.** At Closing, Seller shall warrant that the Partnership has good and sufficient title to the Personal Property, subject to the encumbrances created by Security Agreements in the Loan Documents.

**8.1.4 Contract Rights.** Purchaser shall have determined that the Partnership has good title to the Contract Rights in accordance with the requirements hereof.

***[Alternate Clause}*** At Closing, Seller shall warrant to Purchaser that the Partnership has good sufficient title to the Contract Rights and Accounts, that Seller has no knowledge of any defect or unmerchantable title thereto, and that Seller has not created or suffered any lien, encumbrances, attachment, security interest, or other outstanding interest or right that would diminish, affect, or reduce title thereto subject to the encumbrance created by Security Agreements in the Loan Documents.

**8.1.5 Defects of Title—Cure.** Seller shall have an additional thirty (30) days from the date of receipt of such written notice to remove the specified encumbrances or defects If. at the expiration of such thirty (30) -day period. Seller is able to convey good and marketable title, transfer of title shall occur at the Closing as provided for in this Agreement

***]Alternate Clause]*** Seller shall, at its sole cost, cause the standard printed exceptions contained in the Title Commitment to be removed or insured over as of the Closing. Seller shall, al its sole cost, cause the title policy to be issued in accordance with the Title Commitment to be issued, as of the Closing Date, to cover the recording of the Deed.

***[Alternate Clause]*** In the event Purchaser objects to any matters of records as disclosed by the Abstract of Title, Purchaser shall notify Seller of the items of which Purchaser disapproves. Seller then shall have the right (or a period of thirty (30) days to cure or remove such matters ol records that have been objected to by Purchaser, provided, however, that Seller shall have no obligation to do so.

**8.1.6 Defects of Title—Termination.** If, at the expiration of said thirty (30) -day period, Seller shall then be unable to convey good or marketable title free and clear of all such encumbrances and defects. Purchaser, nevertheless, may elect to accept such title as Seller may be able to convey, with a credit against the monies payable al the Closing equal to the reasonably estimated costs to cure the same up to Twenty Thousand Dollars ($20,000), but without any other credit or liability on the part of Seller. If Purchaser shall not so elect, Purchaser may terminate this Agreement and Seller will immediately refund (he Deposit.

***[Alternate Clause]*** In the event Seller fails or refuses to cure or remove alt of such items as hereinbefore provided within said thirty (30) -day cure period, Purchaser's only remedy will be to terminate this Agreement, whereupon the Title Company is hereby authorized to return to Purchaser all deposits that have been theretofore paid or deposited by Purchaser in connection with this Agreement, and the parties hereto shall be released from all further obligations hereunder. In the alternative, if Purchaser shall fail lo cancel this Agreement as provided, Purchaser shall accept title in its existing condition, and Purchaser shall be deemed to have waived any objections to such title that have not been cured or removed, except as to warranties contained in the documents of conveyance.

**8.2 UCC Search**

Purchaser, at Purchaser's sole expense, shall be responsible for obtaining a UCC search of the records of ____ County, State of ———— and (he Secretary of State of ____ pertaining to Seller and Property. The results of this search shall not disclose any lien or encumbrance that cannot be discharged at the Closing. Seller warrants to discharge any other such lien or encumbrance at Closing.

## 8.3 As-Built Survey

No later than fifteen (15) days after the Contract Date, Seller will deliver to Purchaser, at Seller's sole cost and expense, a print of an as-built survey of the Hotel (the "Survey"), prepared by the planners and engineers. Prior to Closing, the Survey will be updated, will be certified by said surveyor to have been prepared in accordance with minimum detail requirements of the ALTA land survey standards, and will be recertified to Purchaser and Purchaser's lender(s). In the event the Survey shows any encroachment over a lot line, a prohibited encroachment over any easement, or any other matter that, in Purchaser's reasonable opinion, does (or could, in the future) materially interfere with the use. operation, or financing of the Real Property, such matter shall be considered a "Defect" hereunder.

**8.4 Site Survey**

Promptly alter the Effective Dale, Seller shall cause a boundary survey o( the Site to be made by a licensed land surveyor selected by Seller. The Survey shall provide a legal description of the boundaries of the Site and shall identify all easements, restrictions, and rights-of-way benefiting or burdening the Site by reference to the applicable recorded documents creating same. The costs and expenses of the Survey shall be paid by Purchaser.

**8.5 Review of Title Commitment and Survey**

Purchaser shall have thirty (30) days after receipt of the latter of (a) the Title Commitment and (b) the Survey to deliver, in writing to Seller, Purchaser's objections to title. Purchaser's failure to object to any item on the Title Commitment or Survey within the thirty (30) -day time limitation imposed hereby shall be deemed to be approval of same by Purchaser.

***[Alternate Clause]*** In the event that any or all of the Title Commitment, Survey, or Lien Searches disclose any claim, lien, encumbrance, encroachment, or other matter that is objectionable to Purchaser, then Purchaser shall, within fifteen (15) days of receipt of the instrument containing the Defect, notify Seller in writing of any objections. Failure of Purchaser to so notify Seller in writing within such time period shall be conclusively deemed to be approval by Purchaser of all items in the Title Commitment, Survey, or Lien Searches, as applicable. If Purchaser timely notifies Seller of any objections, Seller may, but shall not be obligated to, prior to Closing, cause such Defects to be removed or insured over prior to Closing; Purchaser may, at its sole option, either (a) terminate this Agreement by written notice to Seller, in which event the Earnest Money shall be returned to Purchaser, and neither party shall have any further liability to the other, or (b) proceed to close and accept title to the Hotel subject to such objectionable items, in which event the obligations of the parties hereunder shall not be affected by reason of such matters, the sale contemplated hereunder shall be consummated without reduction of the Purchase Price, and Purchaser shall have no further right to terminate this Agreement because of such Defects. If Seller causes the Defects to be removed or insured over, Purchaser shall be obligated to proceed with Closing.

## Category 9 SELLER'S DELIVERIES

### 9.1 Financial Statements

Seller wilt provide the Purchaser with copies of year-end financial statements for the Hotel (the "Operating Statements") for the three (3) most recent full calendar years prior to Closing and, to the extent available, the current year. The year-end statements shall be certified by an independent certified public accountant as having been prepared in accordance with generally accepted accounting principles.

***[Alternate Clause]*** Seller will provide Purchaser with copies of monthly operating statements for the Property (or each month for the last two (2) years, each statement to include the occupied rooms for that period, accompanied by a written statement signed by the President of the Seller certifying that such statements are true and correct to the best of his/her knowledge after reasonable investigation.

***[Alternate Clause]*** The Seller will provide to Purchaser, on or before the twentieth (20th) day of each month, a Profit and Loss Statement with detailed departmental schedules, actual occupancy per-

centage, and average room rate (or the preceding month from the dale hereto until the Closing.

## 9.2 Plans

Seller will provide Purchaser with copies of all engineering and architectural plans and specifications, drawings, soil reports, studies, and surveys relating to the construction o( the Hotel in Seller's possession or control.

## 9.3 Taxes

Seller will provide Purchaser with copies of the bill or bills issued (or the three (3) most recent years for which bills have been issued (or all real estate taxes and personal property taxes and with copies of any and all notices pertaining to real estate taxes or assessments applicable to the Hotel.

### 9.4 Contracts

Seller will provide Purchaser with copies o( all brokerage, commission, management, leasing, maintenance, repair, service, pest control, and supply contracts (including without limitation janitorial, elevator, scavenger, laundry, and landscaping agreements) and any other contracts or agreements relating to or affecting the Hotel that will be binding upon the Hotel or Purchaser subsequent to Closing, all as amended.

Contemporaneously with the execution hereof, Seller shall provide Purchaser with copies of all notes, mortgages, leases, contracts, licenses, commitments, trademarks, trade names, copyrights, and engagements of Seller with respect to the Property and the business conducted thereon or any part thereof and, within ten (10) days after receipt of such documents. Purchaser shall advise Seller in writing of which of such Contracts Purchaser at its sole discretion will agree to assume and perform from and after Closing, providing, however, that if Purchaser shall not agree to assume any one of the Contracts that shall be material in nature. Seller shall have the right to cancel this Agreement within five (5) days after such notification from Purchaser, and in such event Purchaser's deposit shall be returned to Purchaser with all interest earned thereon. At Closing, Seller shall furnish to Purchaser assignments, in form and content satisfactory to Purchaser's counsel, conveying and assigning such of the Contracts as Purchaser has agreed to assume and perform. Such assignments of Contracts shall contain all third party consents as may be required in order to validly assign same to Purchaser and shall require Purchaser to assume all obligations under such Contracts that may arise thereunder from and after the Closing (except as otherwise herein provided) and to indemnify Seller with respect thereto.

### 9.5 Licenses

Seller shall provide Purchaser with copies of all licenses of Seller for the benefit of the Hotel or of third parties burdening the Hotel.

### 9.6 Leases

Seller shall provide Purchaser with copies of all contracts, leases, and agreements for the Property,

### 9.7 Insurance Policy

Seller shall provide Purchaser with copies of existing insurance policies covering the Property.

***[Alternate Clause]*** Seller shall, contemporaneously with the execution hereof, provide Purchaser with a schedule setting forth all the insurance policies owned by Seller with respect to the Property and indicating the carrier or carriers of such insurance, the type of coverage afforded by each such policy, the annual premium, and the duration of the policy. Purchaser acknowledges that it will cause its own insurance to be placed on the Property at Closing.

### 9.8 Historical Capital Expenditure Budgets

Seller shall provide Purchaser with a summary of all capital expenditures made by Seller during last three (3) years, which summary may be delivered up to thirty (30) days after the execution of this agreement.

#### 9.9 Franchise Reports

Seller shall provide Purchaser with copies of all inspection reports, deficiency letters, improvement requirements, and similar communications received by Seller from the Franchisor under the Franchise Agreement during the past twenty-four (24) calendar months.

#### 9.10 Miscellaneous Hotel Assets

Seller shall provide Purchaser with a complete listing of all miscellaneous Hotel assets.

### 9.11 Reduction Certificate

Seller shall provide Purchaser with any estoppel letters from any mortgagees as to mortgages encumbering the Real Property and/or Personal Property, to be furnished not less than twenty (20) days prior to closing.

#### 9.12 Rent Roll

Seller shall provide Purchaser with a Rent Roll for the property, certified to be true and correct by the Seller, setting forth the name and address of each tenant, monthly rent, amount of security or other deposits, status of rental payments, options if any. term of lease, and rent prepayments.

#### 9.13 Payroll Summary

Seller shall provide Purchaser with a summary of Seller's payroll for employees.

***[Alternate Clause]*** Contemporaneously with the execution hereof, to the extent available to Seller, Seller shall provide Purchaser with a list of all employees presently employed by Seller or by the manager of the hotel with respect to the Property, indicating, in each case, the name of each such employee, the position occupied by such employee, such employee's rate of compensation and any agreement relating to any increase thereof or bonus to be paid to such employee, term of employment, contract agreement, if any, and any other relevant information with respect to such employee.

### 9.14 Inventory of Personal Property

The inventory of Personal Properly of the Hotel shall be delivered to Purchaser within twenty (20) days

### 9.15 Affidavit From Partners of Sellers

Within thirty (30) days, an affidavit from the partners of Seller shall be provided to Purchaser setting forth who the partners are and the identity of the person or persons authorized to execute the documents required by this Agreement to effectuate the closing.

## Category 10 SELLER'S REPRESENTATIONS, WARRANTIES, AND COVENANTS

### 10.1 Due Authorization

The performance of this Agreement and the transactions contemplated hereunder by Seller and each general partner of Seller have been duly authorized by all necessary action on the part of Seller and by each of its partners, and this Agreement is binding on and enforceable against Seller and each general partner of Seller in accordance with its terms. Seller shall, on or prior to the Closing Date, furnish Purchaser with certified resolutions, in form and substance satisfactory to Purchaser, evidencing that Seller and each general partner of Seller have been duly authorized to enter into and perform this Agreement and the transactions contemplated hereunder. No further consent of any shareholder, creditor, investor, judicial or administrative bonds. Governmental Authority, or other party to such execution, delivery, and performance is required.

***[Alternate Clause]*** Seller has informed Purchaser, and Purchaser hereby acknowledges and agrees, that, notwithstanding the executions of this Agreement by ____ as the general partners of Seller, this Agreement shall not be or become binding upon Seller unless and until the terms and conditions of the transaction contemplated by this Agreement have been approved by the Board of Directors of the general partners. If both partners of Seller have not obtained authorization within (en (10) days after the Contract Date and given written notice thereof to Purchaser, this Agreement shall be automatically terminated and be null and void, and the parties shall have no further rights or obligations unto the other hereunder.

### 10.2 Authority and Capacity

Any person signing below warrants that. unless a representative capacity is set forth in connection with his signature, he is acting for himself alone. Seller warrants that Seller is the owner of the Property in fee simple and has the right and power to enter into (his offer and to carry out the terms hereof. All persons signing as Seller agree to execute Seller's deed required hereunder.

### 10.3 Foreign Entity Status

At the closing. Seller shall deliver to Purchaser such documents as may be required by the Internal Revenue Service pursuant to Section 1445 of the Internal Revenue Code of 1954, as amended, or the regulations issued pursuant thereto certifying as to the non-foreign status of the Seller. In the event that Seller fails or refuses to deliver such certificate to the Purchaser and the Title Company at the closing, Seller authorizes the Title Company to withhold from the cash portion of the purchase price to be delivered to Seller at closing an amount equal to ten percent (10%) of the purchase price. All such sums withheld by

the Title Company shall be remitted to the Internal Revenue Service within the period prescribed by law. Notwithstanding the foregoing, it the Seller has received a Withholding Certificate from the Internal Revenue Service pursuant to applicable laws and regulations, the Title Company shall withhold from the cash portion of the purchase price payable at the closing only the amount required by the Withholding Certificate, with all such funds so withheld or paid to be remitted to the Internal Revenue Service within the period prescribed by applicable law

## 10.4 No Conflicts by Consummation of Agreement

To the best knowledge of Seller, neither the execution of this Agreement nor the consummation of the transactions contemplated hereby will (a) result in a breach of, default under, acceleration of, or imposition of any lien or encumbrance against the Hotel under any agreement to which Seller is a party or by which Seller or the Real Property are bound or (b) violate any restriction, court order, judgment, law, regulation, charter, bylaw, instrument, or agreement to which Seller or the Real Property (or any portion thereof) are subject.

### 10.5 No Undisclosed Interest

All of the Real Property described in Exhibit A *[omitted] as* being conveyed hereby in connection with the hotel is contiguous. Seller neither owns nor leases nor has any other interest in any real property adjoining, adjacent, or otherwise connected with the operation of the Property and no such real property is being conveyed to Purchaser pursuant to the terms of this Agreement.

## 10.6 No Untrue Statement

The representations and warranties of Seller contained herein were true in all material respects when made and are true in all material respects with its obligations and agreements hereunder and Seller shall have delivered to Purchaser a certificate dated the Closing Date signed by the President of the Seller to that effect and indicating any changes.

***[Alternate Clause]*** No Exhibit hereto or document specified hereunder furnished or to be furnished pursuant to this Agreement to Purchaser contains or will contain any untrue statement of a material (act.

***[Alternate Clause]*** Seller shall notify Purchaser promptly if Seller becomes aware of any transaction or occurrence prior to (he Closing Dale which would make any of the covenants, representations, and warranties of Seller contained herein not true in any material respect with the same force and effect as if made on and as of the date on which Seller becomes aware of such transaction or occurrence.

***[Alternate Clause]*** Seller hereby represents and warrants to Purchaser as to the truth and accuracy of each of the matters set forth on Schedule C *[omitted]* annexed hereto, which representations and warranties shall survive the execution hereof (and any investigation made by the Purchaser) and the Closing for a period of two (2) years after the Closing.

### 10.7 Further Assurances

The parties hereto agree to execute, acknowledge, deliver, and record such certificates, amendments, instruments, and documents and to take such other action as may be necessary to carry out the intent and purposes of this Agreement.

***[Alternate Clause]*** All action required pursuant lo this Agreement that is necessary to effectuate the transaction contemplated herein will be taken promptly and in good faith by Seller, and Seller shall furnish Purchaser with such documents or further assurances as Purchaser may reasonably require.

### 10.8 Actual Knowledge

Notwithstanding anything in this Agreement to the contrary, Seller shall have no liability whatsoever with regard to any matter of which the Purchaser had actual knowledge prior to the Closing. For purposes of this Agreement, "actual knowledge" shall include anything in a written report or document of any sort given to Purchaser in connection with the transaction contemplated in this Agreement or in a written report prepared for Purchaser by any inspector, engineer, auditor, or any other party; or anything known by an inspector, engineer, auditor, or other person reviewing any aspect of the Real Property, the Hotel, the Records, or the general business operations of the Hotel on behalf of Purchaser, whether or not said person disclosed the information to Purchaser or any of the foregoing named persons. By executing this Agreement, the Purchaser waives any such claim; by Closing, the Purchaser shall be deemed to have waived any such claim; and the Purchaser shall not be entitled to "reserve" any claims at Closing of which it has actual knowledge.

### 10.9 No Further Entrance Into Binding Agreements

Seller will not enter into any new Hotel Contracts or agreements of any kind (whether written or oral) affecting the Properly that by their terms require the payment of or receipt by Seller of more than Five Hundred Dollars ($500) annually, or cancel, modify, or renew any existing Hotel Contracts without notifying Purchaser by written notice. If Purchaser does not approve of any such agreement, within five (5) days of receiving notice from Seller of such agreement, Purchaser may terminate this contract and receive back the Deposit, and thereafter neither party shall have any further obligation to the other.

***[Alternate Clause]*** Seller agrees that from and after the date hereof and pending transfer of title to Purchaser, Seller will not enter into any lease or agreement for the rental of any portion of the Premises, other than in the ordinary course of business.

***[Alternate Clause]*** Seller will not enter into any negotiations with any third party with respect to the sale of the Property unless and until this agreement shall have been terminated in accordance with the provisions hereof.

### 10.10 Continued Operation

Seller shall continue to operate and manage the Hotel, maintaining present services (including pest control); shall maintain the Hotel in good repair and working order; shall keep on hand sufficient materials, supplies, equipment, and other personal property for the operation and management of the Hotel; and shall maintain in full force and effect and make all payments, and perform, when due. all of Seller's obligations under the Operating Contracts, the Governmental Permits, and all mortgages, restrictions, and other agreements affecting or relating to the Hotel and otherwise in accordance with applicable laws, ordinances, rules, and regulations affecting or relating to the Hotel. Seller shall deliver the Hotel at Closing in substantially the same condition as on the dale Purchaser waives or is deemed to waive its rights to terminate this Agreement, reasonable wear and tear excepted. Except as otherwise provided herein. Seller shall terminate, as of the Closing Date, those of the Operating Contracts that by their terms are not assignable. None of the

Personal Property or fixtures shall be removed from the Real Property unless replaced by personal property or fixtures of equal or greater utility and value.

**10.10.1 Repairs and Maintenance.** All repairs and replacements necessary to maintain the Property in its current condition will be made in the regular course of business up to the Closing Date at the expense of Seller.

**10.10.2 Marketing.** The Hotel will continue to be operated, promoted, advertised, and marketed substantially in accordance with the present standards of operation, promotion, advertising, and marketing.

**10.10.3 Business Relationships.** Seller shall preserve intact the normal business and organization of the Hotel and the normal business relationships of the Hotel with all wholesalers, suppliers, contractors, and other parties with whom the Property maintains a business relationship, and Seller shall maintain normal relations with the present employees of the Property.

**10.10.4 Inventory.** Each and every guestroom and function room in the hotel located on the Property and all public rooms therein are and shall on the Closing Date be no less fully equipped and furnished that they were on ______, 19— and each and every item of equipment and furniture therein or used in connection with the operation of the business thereon is included within the Property, except with respect to leased equipment.

***[Alternate Clause]*** Until the date hereof and from the date hereof to the Closing Date, each of Seller and manager of the hotel has not and shall have not removed any item of inventory from the Property, other than items of inventory that have been consumed on the Property in the normal course of business.

***[Alternate Clause]*** The book values of food and beverage inventories on the Property at the Closing Date shall be not less than the book values of such inventories maintained by the Property in the comparable month in the preceding year.

**10.10.5 No Sale of Hotel.** Until the date hereof and from the date hereof to the Closing Date, neither Seller nor the manager of the hotel has nor shall have sold, leased, mortgaged, pledged, or otherwise encumbered or disposed of any part of the Property, except in the ordinary and usual conduct and course of business.

**10.10.6 Taxes.** Seller is current in the payment of all taxes affecting the Property or operation thereof and Seller shall continue to make timely payments of all such taxes.

**10.10.7 Insurance.** Seller carries insurance upon or in connection with the Property of the kind and in the amounts as required by the first mortgage, and said insurance is in full force and effect on the date hereof and no notices of cancellation or suspension have been received with respect thereto.

***[Alternate Clause]*** Seller will maintain in effect through the Closing Date all policies of casualty and liability insurance or similar policies of insurance, with limits of coverage not less than those required by the First Mortgagee.

## 10.11 Licenses and Permits

All required Certificates of Occupancy, underwriter's certificates, zoning, building, housing, safety, tire, health, environmental, liquor, and similar governmental approvals and all

permits and licenses necessary to operate the Hotel in the manner in which it is presently being operated have been issued and are valid and in lull force and elfect. and none of the foregoing is in the nature of a conditional use permit variance or other special approval.

***[Alternate Clause]*** Seller owns and holds all licenses, permits, certificates, concessions, franchises, rights, approvals, and other authorizations, all unencumbered and subject to no challenge or revocation, as are required to carry out and conduct the business carried out and conducted at the Property and each and every aspect thereof and to own. use, and operate the business thereon carried on and conducted; and all such rights and privileges will pass to Purchaser at Closing without creating the right of termination or revocation on the part of any third party granting such right and privilege, except with respect to those licenses, permits, certificates, concessions, franchises, and approvals as expressly noted. With respect to the Property and its use and operation. Seller is not obligated or under any liability to make any payments by way of royalties or fees or otherwise pursuant to any license, royalty, franchise, or other agreement to any owner of. licensor of, or claimant to a patent, trademark, trade name, copyright, or other intangible asset with respect to the use thereof or in connection with the conduct of its business or otherwise.

***[Alternate Clause]*** Exhibit C *[omitted]* identifies and will on the Closing Date identify all Permits used in connection with the operation of the Property, and is complete and correct. Seller has received no written notice from the issuing agency to the effect that a default has occurred in (he due observance of any condition to any Permit, and the Seller has not received any written notification from any governmental body to the effect that there is lacking any license, franchise, or permit needed in connection with the operation of the Property and any related business thereof. All Permits are transferable to Purchaser.

***[Alternate Clause]*** Seller has unencumbered title to any and all licenses and permits necessary for the customary operation of the Hotel as required by any governmental authority having jurisdiction over the Premises, and such licenses and permits are freely transferable to Purchaser; and the Hotel is properly zoned (or its present use as a first-class hotel.

***[Alternate Clause]*** Seller has valid transferable permits and/or leases as the case may be for all signs used in connection with the advertising, location, or directions to the Property.

***[Alternate Clause]*** To the best o( Seller's knowledge, all permits and licenses necessary for the operation of the Property for its current use have been obtained and will be in effect as of the date of closing.

***[Alternate Clause]*** Seller will execute and, where necessary. Purchaser will join in the execution of all applications and instruments required in connection with the transfer of the Permits in order to transfer the benefits of the Permits (o Purchaser on the Date of the Closing. Seller shall preserve in force all existing Permits and shall timely file proper applications for renewal of any Permit expiring prior to the Closing Date. If any such Permit shall be suspended or revoked. Seller shall promptly so notify Purchaser and shall take all measures necessary to cause the reinstatement of such Permit without any additional limitation or condition.

***[Optional Clause]*** The Seller holds valid licenses under the State of ____ Alcoholic Control Law permitting the sale of alcoholic beverages for on-premises consumption and all permits as **are** required in order for Seller to sell alcoholic beverages on the Property in the places and in the manner in which Seller has heretofore sold such alcoholic beverages.

***[Optional Clause]*** All curb cut and street opening licenses or permits required for vehicular access to and from any portion of the Property to any adjoining public street, highway, or road have been obtained and, where required, paid for in full by Seller and are in full force and effect.

**10.12 Contracts**

There are no contracts, leases, or other agreements affecting the Property other than those to be delivered at the Closing. Such contracts, leases, or agreements are not in default by either party thereto and are freely transferable to Purchaser.

***[Alternate Clause]*** There are no contracts, verbal or written, with any employees or unions, nor any service contracts, maintenance contracts, or any other contracts or agreements in connection with the operation of the Real Property or Personal Property, and there are no actions pending or, to Seller's knowledge, threatened between Seller, as landlord, and any tenant on the Real Property, to reduce any of their rentals.

***[Alternate Clause]*** With respect to the Property, the Seller is not engaged in any labor or other material controversy with any of its employees, and the Seller is not a party to any labor agreement, management contract, employment contract, expense program, or pension, retirement, profit sharing or other benefit plan, program, or arrangement, or to any executive or key personnel incentive or other special compensation or agreement or to other contracts or agreements with employees, including union and incentive contracts or agreements, other than those referred to in Exhibit 3 *[omitted}* annexed hereto; and with respect to each employee of Seller or of the manager of the hotel with respect to the Property, all amounts owing to the date of Closing shall be paid to each such employee on the date of closing, including, without restriction, all salaries, wages, fringe benefits, contributions to pension plans, and accrued vacation pay.

**10.13 Franchise Agreement**

Annexed hereto is all of the documentation constituting the Franchise Agreement, true and complete copies of which documentation have been heretofore delivered to Purchaser. The Franchise Agreement has not been modified, amended, supplemented, or changed in any manner and the Franchise Agreement is valid, binding, and in full force and effect. As of the date hereof, no defaults on the part of Seller or any other party thereto exist under the Franchise Agreement; all royalty and other payments under the Franchise Agreement, including, without limitation, fixed payments and percentage payments, have been paid to date; and Seller shall deliver to Purchaser at the Closing and thereafter all reports, statements, and financial information necessary or appropriate to enable Seller to calculate percentage royalties and other sums payable to the franchisor, as the case may be, and otherwise to file required financial and other statements pursuant to the Franchise Agreement.

***[Optional Clause]*** On or before the Closing Date, Purchaser will have obtained any required consents or approvals to enable Purchaser to assume the existing license or Franchise Agreement. Purchaser shall use diligence and its best efforts to obtain the approval from the franchisor (or the assumption of the existing Franchise Agreement.

***[Optional Clause]*** There are no outstanding requirements or recommendations by the franchisor of the Franchise Agreement or by any insurance company issuing a policy with respect to the Property and/or Personal Property or by any board of fire underwriters or by any other bodies exercising similar functions requiring or recommending any repair or ameliorative work to be done in, at, or about the Hotel.

**10.14 Employee-Related Representations**

No employee of Seller or of the Property has the right to occupy any dwelling space on the Properly or has a dwelling provided for it by the Property.

***[Alternate Clause]*** There are no employment agreements with any of the employees.

***[Alternate Clause]*** There are no labor disputes pending or threatened, and Seller has no knowledge or reason to believe such disputes are threatened.

***[Alternate Clause]*** Until the date hereof and from the date hereof to the Closing Date, each of Seller and the manager of the hotel has not and shall not have incurred any increase in salaries, wages, or other forms of compensation payable to or to become payable to any employee of the Seller with respect to the Property.

**10.15 No Outstanding Litigation or Outstanding Conflicts**

Seller represents and warrants that as of the Effective Dale, there are no suits, arbitration proceedings, other proceedings, or governmental investigations pending against it or, to the knowledge of Seller, threatened that adversely and materially affect its right or ability to enter into this Agreement or to consummate the sale of the Hotel in accordance with the terms of this Agreement, or that materially affect the Hotel.

***[Alternate Clause]*** To the best of Seller's knowledge, there is no violation of any law. ordinance, or regulation and no existing litigation, known potential or threatened litigation, investigation, or other proceeding with respect to any aspect of the real or Personal Property being purchased under this Agreement, and if there were, any such litigation would be covered by insurance In the event that a lien, claim, or cause of action should arise after the closing resulting or attributable to any of Seller's activities upon the property prior to the closing, the Seller shall, at its sole cost and expense, cause any such lien to be discharged and defend against any such claim or cause of action, and Seller shall hold Purchaser harmless therefrom, including, but not necessarily limited to. charges incurred for the retention of such attorneys or other persons as may be required If any matters referred to in this paragraph become known to Seller after the effective date of this Agreement and prior to closing, Seller shall notify Purchaser of same.

***[Alternate Clause]*** There is no violation of applicable laws, ordinances, or regulations, inclusive of those of administrative boards or agencies and other public authorities, relating to the Property and the business thereon conducted, and the Seller is not in default (or having failed to file lax returns or statements required to be filed under the laws of any federal, stale, municipal, or other jurisdiction with respect to the Properly and the business conducted thereon by Seller, and the Seller has paid or shall pay on or prior to the Closing all taxes, whether income, sales, use, real estate, or otherwise, owing to date with respect to the Property or its ownership or operation thereof and the business conducted thereon, and Purchaser will assume no liability with respect to any period up to and including the Closing Date or otherwise with respect to any such taxes, except for such real estate taxes that may be adjusted at Closing.

## 10.16 Eminent Domain/Condemnation Actions

Seller represents and warrants (hat as of the Effective Date, there are no pending con-demnation actions of any nature with respect to the Hotel that would materially impair the Hotel's economic viability, and Seller has not received any notice of any such threatened or contemplated condemnation actions.

### A. MISCELLANEOUS REPRESENTATIONS, WARRANTIES, AND COVENANTS

**10.17 Title Matters**

Seller has good and marketable title to the Personal Property and all Personal Property has been fully paid for.

*[Alternate Clause]* Seller makes no warranty of title as to the Site or the Improvements, except that Seller represents and warrants that it has refrained from any action that might impair Purchaser's title and will continue to do so.

### 10.18 General Encumbrance

There are no instruments or agreements that in any way encumber or affect the Property, and Seller has neither done nor (ailed to do anything nor suffered anything to be done as a result of which the Property or any part thereof has been or will be encumbered or title thereto has been or will be affected in any way.

**10.19 Mortgage**

To the best of Seller's knowledge, all mortgages and liens encumbering the Real Property and Ground Lease are in good standing, and Seller shall keep all of such mortgages and the Ground Lease in good standing through the date of closing.

***[Alternate Clause]*** There are no attachments, executions, assignments for the benefit of creditors, or voluntary or involuntary proceedings in bankruptcy pending against Seller or contemplated by Seller, and to the knowledge of Seller no such action has been threatened against it.

**10.20 Zoning**

Except as required by law. Seller shall not seek or consent to any amendment to any Permit that would alter the existing permissible uses of the Hotel or any part thereof.

***[Alternate Clause]*** Seller has not made nor shall Seller make any applications before any zoning board or commission seeking to modify or change the present zoning of the Real Property constituting the Property.

**10.21 Operating Liabilities**

All Liabilities for sales taxes, unemployment compensation contributions, and assessments incurred by Seller in connection with the operation of the Real Property through the date of actual closing hereunder shall, unless otherwise provided herein to the contrary. be paid prior to or at closing.

**10.22 Asbestos**

There is now and there shall be on the Closing Date no asbestos or other noxious or environmentally hazardous substance on or about the Property.

**10.23 Payment for Labor, Goods, and Services**

Seller has paid or will pay in full before or after Closing all bills and invoices tor labor, goods, material, and services of any kind relating to the Hotel or any portion thereof, and utility charges relating to the period prior to closing.

**10.24 Hotel Names**

Exhibit B [omitted] identifies the Hotel Names that are included in this sale and Seller is currently using no others in connection with the operation of the Property.

### 10.25 Break-Even Guarantee

From the date of Closing and for twelve (12) months thereafter, the Seller shall guarantee that gross operating expenses shall be sufficient to cover all debt service on the Seven Million, Six Hundred Thousand ($7,600,000) Dollar loan and One Hundred Sixty-two Thousand Dollars ($162.000) of credit fees The Seller's guarantee will be personally guaranteed by _

## B. SPECIAL CASES

#### 10.26 Completion of Hotel

Seller agrees that it will undertake and complete the Hotel for the purposes and in the manner intended hereby and in accordance with the plans and specifications therefore that have been prepared by or on behalf of Seller and are attached as Exhibit D [omitted] hereto, and that it will cause such improvements to be made to His Real Properly **as are** necessary for the operation thereof in the manner herein provided

***[Alternate Clause]*** Seller shall obtain all necessary approvals from any and all governmental agencies requisite to the completion of the Hotel and in compliance with all state and local laws, ordinances, and regulations applicable thereto. Upon completion of the Hotel, Seller shall obtain all required permits and authorization from appropriate authorities, if any **be** required, authorizing the operation and uses of the Hotel for the purposes contemplated hereby.

***[Alternate Clause]*** Seller covenants that it will take such action and institute such proceedings as shall be necessary to cause and require all contractors and material suppliers to complete their contracts diligently in accordance with the terms of the contracts, including, without limitation, the correcting of any defective work.

### 10.27 Limitations on Seller's Representations, Warranties, and Covenants

Purchaser acknowledges and agrees that except as otherwise expressly set forth in this Agreement, (a) Purchaser is acquiring the Hotel "as is" and (b) neither Seller nor the Broker nor any other agent of Seller has made, and Purchaser is not relying upon, any representation or warranty, express or implied, with regard to the Hotel or otherwise in connection with the size, value, physical condition, or financial condition of the Hotel or its suitability for development resale or any particular use.

#### 10.28 Survival of Contract

Notwithstanding anything to the contrary contained in this Agreement, after Closing, Purchaser shall have no cause of action against the Seller with respect to the breach of any representation, warranty, or agreement contained herein.

***[Alternate Clause]*** All warranties and representations made in this Agreement shall survive the Closing.

### 10.29 Default and Termination

11 Seller defaults at any of the terms, covenants, or conditions of this Agreement or if any of the above conditions are not satisfied, then Purchaser shall have the right to terminate this Agreement by written notice to Seller listing the condition that was not satisfied and the return of the Deposit to Purchaser.

*[Alternate Clause}* II, at any lime prior to the Closing. Purchaser discovers that any of the representations or warranties of Seller are not true or that any of the agreements of Seller have not been complied with or that any of the conditions precedent to Closing are not satisfied, then Purchaser shall notify Seller and Seller may, but shall not be obligated to. cure same. If Seller is unwilling or unable to cure any such matters, Seller shall forthwith give notice of such fact to Purchaser and Purchaser shall, as its sole and exclusive remedy in such event, make an election in writing, which must be received by Seller within ten (10) days after receipt by Purchaser of Seller's Election Not to Cure, to terminate this Agreement, in which event the Earnest Money shall be returned to Purchaser by Seller after its receipt of Purchaser's election, and the parties hereto shall be fully released from any further liability or obligation hereunder. In the event that Purchaser has not received Seller's Election Not to Cure within ten (10) days after Seller's receipt of the notification from Purchaser, Seller shall be deemed conclusively to have elected to cure.

*[Alternate Clause]* In the event that Seller is unable to deliver title in accordance with the terms of this agreement or is unable to perform or comply with any other condition or obligation on the part of Seller to be performed under this Agreement, or in the event that any representation or warranty made by Seller hereunder shall be untrue as of the Closing Date, in each such case for reasons beyond Seller's control, then Purchaser shall have the option (a) to close and waive objection to any such defect or (b) to terminate this agreement at any lime prior to Closing or at Closing, by notice in writing to Seller, whereupon the Deposit and all interest earned thereon shall be returned to Purchaser and whereupon neither party shall be further obligated hereunder. In the event that the transaction contemplated hereby fails to close owing to any reason that is not beyond Seller's control, then Purchaser shall have the right, at its option, to obtain specific performance or to obtain money damages and to terminate this Agreement. Notwithstanding the foregoing, to the extent that there exists a state of fact underlying any representation or warranty made by Seller hereunder, which state of fact shall cause any representation or warranty to be untrue or incorrect as of the Closing, Purchaser shall not be entitled to elect to terminate this Agreement as aforesaid if (i) this state of fact shall be susceptible of correction by the payment of money, (ii) Seller elects to take such steps as are necessary for the correction of such state of fact subject to the reasonable approval by Purchaser of the steps to be taken, and (iii) such steps are taken and such state of fact if corrected within fifteen (15) days from the date initially established (or the Closing.

In the event that this transaction fails to close due to Purchaser's unexcused default, then Seller shall be entitled to payment of the Deposit as liquidated damages, and this Agreement shall be terminated and neither party shall be further obligated hereunder.

## Category 11 REPRESENTATIONS AND WARRANTIES OF PURCHASER

### 11.1 General Terms

in order to induce Seller to sell the Motel and to consummate the other transactions contemplated hereby. Purchaser hereby represents and warrants to Seller that the following are true statements **as** of the date hereof and agrees that the following shall be true statements as of the Closing, subject to the proposition that, prior to Closing, the truth of the following is a condition to Closing only, with no liability of Purchaser whatsoever.

### 11.2 Due Organization

Purchaser is duly organized, validly existing, and in good standing under the laws of the state of its formation, and will on the Closing Date, be qualified to do business in the State of ——-——, and has all requisite power and authority to execute this Agreement and

the documents referred to herein to be executed by Purchaser. Prior to the closing. Purchaser shall have taken all actions required for the consummation of the transaction contemplated by this Agreement or any document delivered or to be delivered in connection with this Agreement.

***[Alternate Clause]*** Purchaser represents and warrants that it is a corporation duly organized, validly existing, and in good standing under the laws o( (he Slate of _____, is qualified to do business in the State o( _____, and is authorized to enter into the transactions contemplated by this Agreement. At Closing, if this Agreement has been assigned to a limited partnership, said limited partnership will be duly organized, validly existing, in good standing under the laws of the State of _____, qualified to do business in the Slate of ______, and authorized to enter into the transactions contemplated by this Agreement.

**11.3 No Conflict**

Neither the execution, delivery, and performance of this Agreement or any other agreement contemplated hereunder nor the carrying out by the Purchaser of the transactions contemplated hereby or thereby will conflict with, result in a breach of, constitute a default under, or accelerate (he maturity of (a) any applicable provisions of the Purchaser's charier or by-laws or other governing instrument, (b) any applicable legal requirements, or (c) any other agreement, indenture, or instrument to which the Purchaser is a party or by which the Purchaser is or may be bound or affected No consent o( any third party is required in order (or the Purchaser to enter into this Agreement or any other agreement contemplated hereunder or for the Purchaser to carry out the transactions contemplated hereby or thereby.

## 11.4 No Pending Litigation

The Individuals and the entity comprised by the Purchaser represent and warrant that as of the Effective Date. there are no suits, arbitration proceedings, other proceedings, or governmental investigations that are pending against them or to their knowledge threatened that adversely and materially affect their right or ability to enter into this Agreement or to consummate the purchase of the Hotel in accordance with the terms of this Agreement.

## 11.5 Purchaser Authorizations

Within thirty (30) days from the effective date of this Agreement. Purchaser shall furnish to Seller evidence acceptable to Seller, authorizing the consummation by Purchaser of the purchase and sale transaction contemplated hereby and the execution and delivery of the closing documents on behalf of the Purchaser. The foregoing shall also be required as to any person or entity to which Purchaser may assign this Agreement. No assignment of this Agreement by Purchaser will relieve Guarantors of their obligation hereunder. Simultaneously with the provision of such information as required by (his paragraph, Purchaser shall also provide to Seller a certificate of current good standing of the Purchaser in the State of incorporation of Purchaser.

## 11.6 Truth of Representations

Purchaser hereby represents and warrants to Seller as to the truth and accuracy of each of the matters set forth on Schedule D *[omitted]* annexed hereto, which representations and warranties shall survive the execution hereof and the Closing (or a period of two (2) years after the Closing.

## Category 12 PRORATIONS AND ADJUSTMENTS

### 12.1 General Accounts Receivable and Accounts Payable

It is understood and agreed by and between the parties that any and all accounts receivable arising out of Seller's operation of the Hotel prior to the Closing shall remain the property of Seller and are not part of the property being transferred under this Agreement. In the event Purchaser shall receive payments on said accounts receivable due Seller after Closing, Purchaser agrees to promptly remit same to Seller. All accounts receivable arising out of the operation of said Hotel from and after the date of Closing shall belong to Purchaser, Further, it is understood and agreed to between the parties that Purchaser assumes no responsibility or liability for any accounts payable, obligations, or indebtedness of Seller of the Hotel, except those obligations assumed by Purchaser hereunder, and Seller shall hold Purchaser harmless and indemnify Purchaser from any claim by any party relating to any accounts payable, obligation, or indebtedness of any nature that was incurred prior to the Closing.

#### 12.2 Liabilities Not Assumed

The purchase and sale of the Hotel shall be a transfer of assets only, and no liabilities or obligations of the Seller, whether incurred prior to or after the date hereof, shall be assigned by Seller or assumed by Purchaser, with the exception of the following: (a) any liability to provide hotel accommodations and services pursuant to confirmed reservations subsequent to the Closing Date: (b) any liability under the service contracts and equipment leases that is attributable to the period after the Closing Date; and (c) all accounts payable, trade payables, wages, vacation pay, and other accrued operating expenses incurred in the ordinary course of operating the hotel (not including real estate or personal properly taxes, which shall be prorated as of the Closing Date). Except as specifically provided herein, Purchaser shall not be responsible for any liabilities arising from acts or omissions of Seller prior to the Closing Dale, even though the claim with respect thereto may be brought after the Closing Date.

***[Alternate Clause}*** Purchaser is not assuming any of the liabilities of Seller accrued prior to or on the Closing Date unless Otherwise specifically provided in this Agreement, which liabilities are and shall remain after the Closing Date the obligation of Seller.

#### 12.3 Utilities

Seller shall be responsible for all water, sewer, and all other utility charges through the date prior to Closing hereunder, and Seller will use its best efforts to have meters for such utility services read on the date of the closing and thereafter Purchaser shall be responsible tor such utility services in its own name commencing with the closing date and thereafter. Seller agrees not to terminate utility services without giving Purchaser at least three (3) days' notice. Purchaser shall, prior to closing, post such utility deposits as required by the applicable utilities to assume the utility services and prevent interruption of service.

***[Alternate Clause}*** Rents, if any, and water, sewer, gas, and electric charges as per meter readings taken not more than twenty-four hours prior to Closing shall be prorated and adjusted as of the date immediately prior to Closing.

### 12.4 Real Estate and Personal Property

Real estate taxes, personal property taxes, and no prepayable assessments shall be prorated to the date of delivery of possession, using the last available tax bill. Accrued general real estate, personal property, and ad valorem taxes for the current year shall be

prorated on the basis of actual bills therefore, if available prior to closing. If such bills are not available, then such taxes shall be prorated on the basis of one hundred ten percent (110%) of the most currently available information (or the Real Property and promptly re-prorated upon the issuance of final bills therefore (and any amounts due from one party by reason of such re-proration to the other shall be paid in cash at that time). Prior to or at Closing, Seller shall pay or have paid all such bills that are due and payable prior to or on the Closing Date and shall furnish evidence of such payment to Purchaser and the Title Insurer.

***[Alternate Clause]*** At Closing, the real estate ad valorem taxes and the personal property taxes shall be prorated between the Seller and the Purchaser on the basis of the tax bill rendered lor the year before the year in which the Closing occurs il said tax bill for the year in which the Closing occurs has not been rendered. At such time as the actual tax bills lor the Real Property and Personal Property for the tax year during which the Closing is held are available, then taxes shall be re-prorated between the parties based upon the Closing Date. All tax prorations shall be made, taking into account the maximum discount permitted by law. The obligation to re-prorate taxes as set forth herein shall survive the closing.

## 12.5 Sales Taxes

There shall be no apportionment with respect to sales tax or occupancy taxes charged to guests occupying rooms at the Property subject to such taxes. After the Closing, Seller shall file final sales and occupancy tax returns with the appropriate taxing authority and pay to the appropriate taxing authority sales and occupancy taxes charged to guests and others during the period of time prior to the Cut-Off Time.

## 12.6 Payroll

Seller will pay all employees for all services performed through 12 P.M. (noon) of the date of Closing, together with all contributions to welfare, pension, fringe benefit, and other such programs required to be made on their behalf, and the employer's share of payroll taxes, social security, unemployment compensation taxes, and disability insurance incident to such salaries, wages, or other benefits. The accrual for vacation and sick day pay and bonuses shall be based upon individual calculations for each employee in conformity with (a) union contracts, when applicable, and (b) past practices as to vacations and sick days allowed and bonuses paid to non-union employees.

## 12.7 Interest

Interest, accrued or prepaid, shall be apportioned as of the date of Closing.

## 12.8 Association Dues

Trade association dues. travel agency commissions, trade subscription, and commissions of credit referral organizations, if any. shall be prorated as of the Closing Date.

***[Alternate Clause]*** American Express, Diners Club, Carte Blanche. VISA, Mastercard. Citicorp Credit Service, net receivables, and payments or net receivables of other credit organizations, if any, shall be apportioned and the amount due to Seller shall be paid lo Seller by Purchaser if and when collected by Purchaser. Seller agrees to reimburse Purchaser promptly for any refunds Purchaser is required to make with respect to any payment theretofore made to Seller.

## 12.9 Telephone Charges

Purchaser and Seller shall obtain and determine all telephone charges applicable to the telephone system in use at the Hotel, and Seller shall execute any and all forms required in order to transfer (he existing telephone numbers, and any and all rights thereto, to Purchaser.

### 12.10 Room Rents

Seller shall be credited with all room rents from guests in residence on the night immediately prior to the date of Closing.

***[Alternate Clause]*** Purchaser shall be credited with all room rents from guests in residence on the night immediately prior to the date of Closing.

***[Alternate Clause]*** At 12:01 A.M. on the Closing Dale. Purchaser and Seller, or their designated agents and representatives, shall prepare and enter into the cash register a separate "folio" for every hotel guest then residing at the Hotel as disclosed by the guest ledger maintained by Seller (which guest ledger shall be subject to verification by Purchaser) and shall prepare a separate listing or inventory of same. As Purchaser receives payment in response to the accounts set forth on such Guest Inventory, Purchaser shall, within seven (7) days after receipt of such payment, pay to Seller that portion of each such payment representing guest charges attributable to the period prior to the Closing Date, net of all applicable collection charges, including, but not limited to. any applicable credit card commissions or other similar charges. Purchaser shall receive credit for one half ([1]^) of the guest charges attributable to guests residing at the Hotel at 12:01 A.M. on the Closing Date for the previous night's lodging.

## 12.11 Prepaid Rent and Deposits

All prepaid rent, room rental deposits, and all other deposits for advanced reservations or future rentals are to be turned over to Purchaser at Closing. All prepaid amounts under Hotel Contracts shall be adjusted.

***[Alternate Clause]*** On the Closing Date. Seller shall provide Purchaser with a complete schedule (the "Reservation Schedule") of post-closing confirmed guest reservations, which Reservation Schedule shall list (a) the party for whose benefit the reservation was made; (b) the amount of prepaid room rent thereunder; (c) the amount of any room rental deposits; and (d) the amount of any other deposits made lor advance reservations, banquets, and/or future services to be provided after the Closing Date. Seller shall pay to Purchaser the amount of all deposits held in connection with such confirmed reservations at the rate or price previously agreed to by Seller.

## 12.12 Vending Machines

All revenues from vending machines and commissions, i( any, payable by the telephone company in respect of public telephones in the Property and long distance telephone calls made from the property shall accrue to the benefit of Purchaser after the Closing.

### 12.13 Inventory

There shall be no apportionment for inventory of consumable items or any linens, china, silverware, or supplies, the value of which are included in the Purchase Price.

***[Alternate Clause}*** On the Closing Date, Seller and Purchaser shall take a further inventory of the Personal Property for (he purpose of assuring the accuracy of the Personal Property Inventory, and

any items of Personal Property that shall have been added or removed since the date of the Personal Property Inventory shall be disclosed in a written supplement to the Personal Property Inventory and furnished to Purchaser at Closing. Any additional items of Personal Property disclosed in said supplement shall be conveyed to Purchaser at Closing in the manner herein provided.

**12.14 Working Capital**

Purchaser shall pay Seller amounts of all house funds and petty cash funds at the Premises as of 12 P.M. (noon) of the date of the closing. All such amounts shall be verified jointly by representatives of Seller and Purchaser.

***[Alternate Clause]*** Seller shall insure that there is Seventy-five Thousand Dollars ($75,000) of working Capital deposited in the Hotel's working capital account as of 12 P.M. (noon) of the date of Closing.

***[Alternate Clause]*** Purchaser shall pay lo Seller an amount equal to the sum of all cash maintained in all cash registers in use at the Hotel as of 12:01 A.M. on the Closing Dale. That cash shall be counted jointly by representatives of Seller and Purchaser.

***[Alternate Clause]*** Promptly after the Closing Date, Seller shall determine, subject to Purchaser's review and approval, the dollar amount of the Working Capital of the Hotel as of the Closing Date. If said dollar amount is less than Five Hundred Fifty Thousand Dollars ($550,000), Seller shall pay any such deficiency to Purchaser. If said dollar amount is greater than Five Hundred Fifty Thousand Dollars ($550,000), Seller shall be entitled to withdraw and retain any such excess from the Hotel operating accounts.

### 12.15 Other Adjustments

Charges due under the Assigned Contracts (defined hereinafter) shall be prorated as of the Closing Date. All other items that are customarily adjusted in transactions similar to the transactions contemplated hereunder shall also be prorated as of the Closing Date.

**12.16 Disputes**

Any and all disputes as to the adjustments pursuant to this section shall be resolved by an audit. The losing party shall pay all of the costs of such auditing expense. The provisions of this section shall survive the Closing.

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**Category 13 CLOSING DOCUMENTS AND PROCEDURE**

Not later than fifteen (15) days prior to the Closing, the parties shall deliver copies of certain documents, set forth below, to the other parties as specified: the original of said documents shall be executed and delivered at the Closing together with such other documents as are contemplated by this Agreement.

**A. SELLER'S RESPONSIBILITIES**

### 13.1 Title Deed

Limited warranty deed in recordable form, executed by Seller, conveying the Real Property to Purchaser free and clear of all claims, liens, and encumbrances except tor the Permitted Exceptions and items approved or deemed to be approved by Purchaser.

***[Alternate Clause}*** By general warranty deed, which deed, when tiled for record, shall convey to Purchaser and Warrant good and marketable title to the property, in tee simple absolute, free and clear o( all liens and encumbrances, except the underlying mortgages, described herein, taxes and assessments not yet due and payable, zoning ordinances and regulations acceptable to Purchaser, and such other "title exceptions," the Permitted Exceptions as well as additional title explanations, as shall have been approved in writing by Purchaser prior to the Closing.

### 13.2 Bill of Sale

A warranty assignment and bill of sale. executed by Seller, assigning, conveying, and warranting to the Purchaser title to the Personal Property, free and clear of all encumbrances, other than the Permitted Exceptions and items approved or deemed to be approved by Purchaser, and assignments of title to any vehicles owned by Seller included in the Personal Property, together with the original certificates of title thereof.

***[Alternate Clause]*** By Seller to Purchaser, a Bill of Sale in the form customarily used in the county in which the Personal Property is situated, conveying the Personal Property, with warranty ot title.

***[Altetnate Clause]*** The personal property, which shall be inventoried prior to Closing to the approval of Purchaser. shall be conveyed by a good and sufficient Bill of Sale with warranty of title by Seller as required by Purchaser. Purchaser agrees to accept the Personal Property estate in its present physical condition, Purchaser acknowledges that Seller has made no representations or warranties of any kind or nature, express or implied, with respect to the aforesaid Personal Property and Improvements except as herein set forth.

### 13.3 Assignment of Governmental Permits

To the extent any Governmental Permits are assignable, an assignment, executed by Seller, to Purchaser of all of Seller's right, title, and interest in and to the Governmental Permits, together with executed copies, applications, forms, and other documents as may be necessary to fully effectuate to the transfer of the same to Purchaser as herein contemplated.

**13.3.1** Liquor **Permit.** Among the permits and licenses to be assigned and transferred with respect to the operation of the Property and the conduct of the Seller's business is the liquor permit issued to the Seller by the _____ Department of Liquor Control. At the Closing, Seller shall cause to be executed and delivered to Purchaser or Purchaser's nominee an instrument in form reasonably satisfactory to Purchaser that assigns, conveys, and transfers to Transferee all of Seller's rights and interests in, under, and to the Liquor Permit.

### 13.4 Assignment of Intangible Personal Property

An assignment to Purchaser of all right, title, and interest of Seller and its agents in and to the Intangible Personal Property, executed by Seller.

### 13.5 Assignment of Operating Contracts

An assignment executed by Seller, to Purchaser of those of the Operating Contracts that are assignable, in which Seller agrees to indemnify, protect, defend, and hold Purchaser harmless from and against any and all claims, damages, losses, costs, and expenses (including attorney fees) that arise in connection with the Operating Contracts and relate to the time period prior to Closing

### 13.6 Original Documents

To the extent not previously delivered to Purchaser, original copies of the Operating Contracts and Governmental Permits.

### 13.7 Keys

All keys used in connection with the Properly, tagged for identification

### 13.8 Title Policy

The Title Policy (for a "marked-up" Title Commitment) issued by the Title Insurer, dated as of the Closing Date. in such amounts and containing such endorsements and other terms as are required herein.

***[Alternate Clause]*** At the Closing, there shall be issued to Purchaser by the Title Company an owner's policy of title insurance on ALTA Owner's Policy Form _ (the "Title Policy") in the amount of the Purchase Price. The Title Policy shall insure good, marketable, and indefeasible fee simple title to the Site, and to any beneficial easements and/or restrictions appurtenant to the Site, and shall contain as exceptions to title only the Permitted Exceptions and such additional matters as shall be approved by Purchaser. The costs and expenses of the Title Policy shall be paid by Purchaser.

### 13.9 Resolutions

A certified resolution authorizing Seller to enter into and perform this Agreement and to perform Seller's obligations hereunder.

***[Alternate Clause]*** At Closing, a certificate of the Seller signed by a Senior officer, dated the Closing Date, certifying that all of the representations and warranties of the Seller contained in this Agreement are true and correct on and as of the Closing Date with the same force and effect as if made on and as pt the Closing Date.

### 13.10 Closing Statement

A counterpart, executed by Seller, of a closing statement conforming to the proration and other relevant provisions of this Agreement.

### 13.11 Records

To the extent not previously delivered to Purchaser, original copies of all records (including, without limitation, all guest ledgers) pertaining to the Hotel.

### 13.12 Certificate of Non-Foreign Status

The Certificate of Non-Foreign Status in the form attached hereto as Exhibit C *{omitted].*

### 13.13 Affidavits

Affidavits reasonably required by Purchaser and/or the Title Company to establish the authority and capacity of Seller to consummate the transaction described herein.

**13.13.1 No-Lien Affidavit.** By Seller to Purchaser, a Seller's No-Lien affidavit that is customary in form and content in the county in which the Properly is located.

### 13.14 Tenant Notice

By Seller to Purchaser, a form letter to tenants advising them of the sale of the Lessee's interest under the Ground Lease, advising that future rent payment shall be paid to the Purchaser.

### 13.15 Warranty Assignment

By Seller to Purchaser, a general assignment to Purchaser of all warranties that exist as to equipment, Personal Property, or structural components o( the building that have not expired by lapse of time

### 13.16 Lease Assignment

By Seller to Purchaser, an assignment of any leases to Purchaser.

### 13.17 Rent Roll

By Seller to Purchaser, a rent roll, certified to be true and correct by Seller, setting forth the name and address of each tenant, monthly rental, amount of security or other deposits, status of rental payment, options (if any), term of lease, and rent prepayments.

### 13.18 Hotel Name

An assignment by Seller to Purchaser, to the extent of the Seller's rights therein, without warranty, to the name "______" and the current telephone numbers of the
_____ (if same are transferable to the Purchaser).

### 13.19 Other Documents

Such other documents and instruments as are contemplated hereunder or as may reasonably be required by Purchaser, its counsel, or the Title Insurer and necessary to consummate this transaction and to otherwise effect the agreements of the parties hereto.

## B. PURCHASER'S RESPONSIBILITIES

At Closing, Purchaser shall deliver to Seller:

### 13.20 Purchase Price

The full Purchase Price, plus or minus prorations and other adjustments hereunder, in the amount and in the manner provided pursuant to this agreement.

### 13.21 Assumption of Ground Lease

By Purchaser to Seller, the consent and agreements of the Lessor to the assignment of the Lessee's interest under the Ground Lease and other matters as required by this Agreement.

### 13.22 Closing Statement

A counterpart, executed by Purchaser, of a closing statement conforming to the proration and other relevant provisions of this Agreement.

### 13.23 Assumption of Operating Contracts

An assumption executed by Purchaser in which Purchaser agrees to assume the Operating Contracts assigned to it by Seller, together with the agreement of Purchaser to indemnify, protect, defend, and hold Seller harmless from and against any and all claims, damages, losses, costs, and expenses (including attorney fees) that arise in connection with the assigned Operating Contract and relate to (he time period from and after Closing.

### 13.24 Resolutions

Certified resolution authorizing Purchaser to enter into and perform this Agreement and to perform Purchaser's obligations hereunder.

***[Alternate Clause]*** By Purchaser to Seller, evidence reasonably acceptable each to the other authorizing the consummation of this Agreement and the execution and delivery of all of the Closing documents by the applicable party, and the authority of the applicable party to execute and deliver the closing documents.

### 13.25 Affidavits

Affidavits reasonably required by Seller and/or the Title Company to establish the authority or capacity of Purchaser to consummate the transaction described herein.

### 13.26 Franchise Transfer

By Purchaser to Seller, the consent o( Franchisor to the transfer of the existing Franchise Agreement from Seller to Purchaser and agreement by such Franchisor as to such other mailers required by this Agreement.

### 13.27 Other Documents

Such other documents and instruments as are contemplated hereunder or as may reasonably be required by Seller, its counsel, or the Title Insurer and necessary to consummate this transaction and to otherwise effect the agreements of the parties hereto.

### 13.28 Seller's Escrowee Instructions

Seller's instructions to Escrowee regarding the recording and release to Purchaser of the Deed and the other documents described herein.

### 13.29 Purchaser's Escrowee Instructions

Purchaser's instructions to Escrowee authorizing the disbursement of the Purchase Price to Seller and the delivery of the documents listed above to Seller, conditioned on Escrowee simultaneously informing Purchaser that it is prepared to issue the Title Policy with respect to the Hotel, in the total amount of the Purchase Price, subject only to the Permitted Exceptions.

### 13.30 Escrowee Actions

Wire transfer to Seller of the Purchase Price and delivery to Seller of the documents described hereinabove:

Causing the Deed (together with all other documents that are to be recorded) to be recorded in the jurisdiction in which the Hotel is located.

Issuance (or contractual obligation of itself to issue) the Title Policy to Purchaser.

Carrying out all of the remaining instructions given by Purchaser and Seller to Escrowee.

## Category 14 CLOSING EXPENSES

### 14.1 Closing Expenses

Seller shall pay the cost of the Title Policy, the Survey, one half of all escrow fees, and recording relating to the instruments of conveyance contemplated herein. Purchaser shall pay any real estate transfer taxes, intangible fee, or tax, and one half of all escrow tees.

***[Alternate Clause]*** Seller shall pay such Closing costs including, but not limited to, transfer, stamp, or documentary taxes Purchaser shall pay for the costs of title insurance policies and Escrow fees.

***[Alternate Clause]*** All costs relating to the Closing, other than fees payable to Purchaser's and Seller's respective legal counsel, and including, but without restriction, the cost of the title insurance policy and any transfer taxes shall be paid by Seller, and recording lees and sales taxes shall be paid by Purchaser; each of Purchaser and Seller shall be responsible (or fees payable to their respective legal counsel.

### 14.2 Real Estate Brokerage Fees

Real Estate Broker fees will be provided for in a separate agreement between Seller and Broker. Purchaser shall have no liability for any real estate brokerage commission in connection with the acquisition of the Property.

***[Alternate Clause]*** Seller and Purchaser represent and warrant each to the other that no broker was involved in the negotiations leading to the execution of this Agreement or brought it about either directly or indirectly.

***[Alternate Clause]*** Seller and Purchaser each warrant to the other that each has dealt with no broker, salesman, finder, or consultant with respect to this Agreement or the sale contemplated herein except the Broker. All sums due Broker shall be paid in full by Seller. Except as provided above, each shall indemnify, protect, defend, and hold the other harmless from and against all claims, losses, costs, expenses, and damages (including attorney fees) resulting from a breach of the foregoing warranty.

## Category 15 EMINENT DOMAIN AND RISK OF LOSS

### 15.1 Eminent Domain

In the event of the institution of any proceedings, judicial, administrative, or otherwise, relating to the taking of a portion of the Real Property by eminent domain, or condemnation, prior to closing, the Seller shall have the first right to terminate this Agreement, which right shall be exercised within fifteen (15) days after notice of condemnation or proposed taking is received by Seller, whereupon all deposits heretofore paid by the Purchaser shall be returned to the Purchaser, and the parties shall be released from any further obligations hereunder. In the event that the Seller does not elect to cancel this Agreement, then the Purchaser shall have the option, to be exercised within ten (10) days after (he aforesaid fifteen (15) -day period, of canceling this Agreement, in which event all deposits theretofore paid by the Purchaser shall be returned to the Purchaser and the parties shall be released of all further obligations hereunder, or the Purchaser shall elect to close this

transaction, in which event there shall be no reduction in the Purchase Price, except that Purchaser shall be entitled to receive the award as a result of such taking, except that Seller shall be entitled to such portion of the award for its damages between the date of the taking and the dale of the Closing, assuming the taking occurred prior to the Closing, in which event the award shall be prorated.

**15.2 Risk of Loss**

Risk ol loss to the Real Properly or Personal Property or any portion thereof until the Closing shall be borne by Seller. In the event of damage to or destruction of the Real Property or Personal Property or any portion thereof by fire or other casualty prior to Closing, Seller shall have the option of repairing the damage or of rescinding this Agreement, in which event the deposits theretofore paid by Purchaser shall be returned to Purchaser and the parties shall be released and relieved of all further obligations hereunder.

***[Alternate Clause]*** If the Premises or any part thereof shall be damaged or destroyed by fire or other casualty prior lo the Closing, and such damage shall not have been repaired or reconstructed prior to Closing in a good and workmanlike manner to the reasonable satisfaction of Purchaser, Purchaser may, at its option, (a) receive the proceeds of any insurance payable in connection therewith, under Seller's insurance policy or policies, and thereupon remain obligated to perform this Agreement, or (b) terminate this Agreement and receive back any funds previously paid or deposited. Upon termination of this Agreement by Purchaser pursuant to this section, neither party shall thereafter be under any further liability to the other. Seller agrees to advise Purchaser of the present insurance coverage upon the property, to keep said policy or policies in full force and effect through the Closing Date. and to advise Purchaser promptly of any damage to the Premises by any loss or casualty.

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**Category 16 ASSIGNMENT, SUCCESSORS, AND HEIRS**

Purchaser may assign this Agreement and the Purchaser's rights thereunder to any person or entity at any time.

***[Alternate Clause]*** Purchaser may assign this Agreement and the Purchaser's rights thereunder to any person or entity at any time; however, such assignment shall not release Purchaser from any personal guarantees or recourse liabilities given by Purchaser to Seller unless Seller consents to such release in writing, which consent shall not be unreasonably withheld.

***[Alternate Clause]*** This Agreement may not be assigned prior to the Closing Date by either party without the prior written consent of the other, except that Purchaser shall have the right **to** assign its interest in this Agreement **to a** limited partnership. When such assignee limited partnership assumes this Agreement, such an assignment shall relieve Purchaser of its obligations hereunder. Subject to the foregoing provisions, this Agreement shall inure to the benefit of and be binding upon the Parties hereto and their respective successors and assigns.

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**Category 17 GENERAL CLAUSES**

**17.1 Benefit**

This Agreement is for the benefit only of the parties hereto or (heir nominees, successors, beneficiaries, and assigns, and no other person or entity shall be entitled to rely hereon, receive any benefit herefrom, or enforce against any party hereto any provision hereof.

## 17.2 Binding Agreement

This Agreement shall be binding upon and shall inure to the benefit of the parties hereto and their respective heirs, personal representatives, successors, and assigns, and shall constitute the entire agreement among the parties.

## 17.3 Business Day

It any date herein set forth (or the performance of any obligations by Seller or Purchaser or (or the delivery of any instrument or notice as herein provided should be on a Saturday, Sunday, or legal holiday, the compliance with such obligations or delivery shall be deemed acceptable on the next business day following such Saturday, Sunday, or legal holiday. As used herein, the term "legal holiday" means any state or federal holiday for which financial institutions or post office are generally closed in the State of _____.

## 17.4 Confidentiality

(a) The parties agree that the terms of this Agreement and all information, documents, reports, and studies developed by either party in connection with the within transaction are strictly confidential and that they will make every effort to ensure that the provisions hereof and such information, documents, reports, and the like are not disclosed to any third party (including the press) without the other party's written consent.

(b) Neither the Private Placement Memorandum nor any documents relating thereto will contain statements about Seller or the Hotel unless Seller has previously reviewed such statements for accuracy. However, regardless of whether Seller does or does not review such statements, Seller will not be deemed a sponsor of the offering described in the Private Placement Memorandum, nor will Seller have responsibility (or the preparation or review of the offering documentation, and the Private Placement Memorandum will so state.

### 17.5 Controlling Law

This Agreement shall be interpreted in accordance with the laws of the Slate of New York. This Agreement shall be governed by and construed in accordance with the law of the Stale of New York.

### 17.6 Entire Agreement

This Agreement constitutes the entire understanding between the parties with respect to the transaction contemplated herein, and all prior or contemporaneous oral agreements. understandings, representations, and statements are merged into this Agreement. Neither this Agreement nor any provisions hereof may be waived, modified, amended, discharged, or terminated except by an instrument in writing signed by the party against which the enforcement of such waiver, modification, amendment, discharge, or termination is sought, and then only to the extent set forth in such instrument.

***[Alternate Clause]*** This Agreement may be executed in one or more counterparts, and all so executed shall constitute one contract, binding on all the parties hereto, notwithstanding that all of the parties are not signatory to the same counterpart.

**17.6.1 Waiver.** Either party hereto may. at its option, waive any performance by any other party required under the provisions of this Agreement by an instrument in writing.

***[Alternate Clause]*** No modification or amendment of this Agreement shall be of any force or effect unless it is in writing and executed by both Seller and Purchaser.

## 17.7 Escrow Agent

This Agreement shall serve as escrow instruction subject to the escrow agent's usual conditions or acceptance where not contrary to any of the terms hereof.

***[Alternate Clause]*** This Agreement shall serve as escrow instruction subject to the escrow agent's usual conditions or acceptance where not contrary to any of the terms hereof. Purchaser's Title Insurer shall be escrow agent (or consummation ol this transaction.

17.7.1 Escrow Fund. Each Seller and the Purchaser agree that Three Thousand Dollars ($3.000) of the closing proceeds due Seller shall be held by Escrow Agent, in escrow, for a period not to exceed ninety (90) days from the dale of Closing, which escrow monies shall be used to satisfy any liabilities and obligations of the particular Seller pursuant to this Agreement that were not known or could not have been known as of the dale o( Closing. As to any such liabilities or obligations, before Escrow Agent shall disburse any of such monies in payment of same, the Seller and Purchaser shall provide Escrow Agent with joint written instructions as to the disbursement of such funds.

## 17.8 Headings

The headings appearing in (his Agreement are inserted only as a matter o( convenience for reference purposes, and in no way define, limit, or describe the scope and intent of this Agreement or any paragraph hereof.

## 17.9 Hold Harmless

Seller agrees to indemnify and hold harmless Purchaser from and against all claims, damages, losses, and expense, including reasonable legal fees and other costs, arising from any and all liability, loss, or damage the Purchaser may suffer as a result of claims, demands, costs, or judgments against it arising from or in any way connected with any accident, action, or incident of whatever nature occurring during the period of Seller's ownership of said Premises; and Purchaser agrees to indemnify and hold harmless Seller from and against all claims, damages, losses, and expenses, including reasonable legal fees and other costs, arising from any and all liability, loss. or damage the Seller may suffer as a result of claims, demands, costs, or judgments against it arising from or in any way connected with any accident, action, or incident of whatever nature during the period o( Purchaser's ownership of said Premises.

## 17.10 Litigation

In the event of litigation between the parties with respect to the Real Property, this Agreement, the performance of their obligations hereunder, or the effect of a termination under this Agreement, the losing party shall pay all costs and expenses incurred by the prevailing party in connection with such litigation, including reasonable attorney fees. Notwith-standing any provision of this Agreement to the contrary, the obligations of the parties under this Paragraph shall survive termination of this Agreement.

***[Alternate Clause]*** In the event either party hereto is required to employ an attorney because of the default of the other party, then the defaulting party shall pay to the non-defaulting party court costs and reasonable attorney fees incurred in the enforcement of this Agreement.

### 17.11 Notices

Any notice or election that may be or is required to be given pursuant to the provisions of (his Agreement shall be sufficiently served if sent by certified or registered U.S. Mails, postage prepaid, return receipt requested and addressed as follows:

As to Purchaser:............................................................

As to Seller:................................................................

**17.11.1 Notice Deemed Served.** Any properly mailed notice shall be deemed to have been served as of five (5) days after its posting for purposes of establishing that the sending party complied with this Agreement's applicable time limitations, but it shall not be binding on (he addressee until actually received.

### 17.12 Recording

This Agreement shall not be recorded, nor shall any memorandum hereof or excerpt or summary hereof be recorded. Any violation of the preceding sentence shall automatically render this Agreement, and the rights and obligations of the parties hereunder, null and void.

### 17.13 Reference

Wherever reference is made herein to any party by name or designation, such reference shall be deemed to extend to and include the nominee, successors, and assigns of such party.

### 17.14 Severability

If any provision of this Agreement is held invalid, the validity of the remainder of the Agreement shall not be affected thereby.

### 17.15 Time of the Essence

Time is of the essence as to this Agreement.

### 17.18 Time of Termination of Offer

This offer shall be open for acceptance until ——, 199X. Acceptance shad be effected by delivery to Purchaser of a copy of this Agreement executed by Seller.

### 17.17 Currency

All amounts herein expressed in dollars shall be in the legal tender of the United States.

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# APPENDIX 3

# Management Contract Clauses

This appendix is a compilation of clauses from a number of actual management contracts. These clauses have been selected to provide a representative sample of the types of provisions included in a typical management contract. In addition to serving as a guide for an attorney drafting such an agreement, these clauses can help the parties negotiating the agreement by showing them how other contracts have been structured.

The clauses have been arranged topically into 11 different sections. In many cases, a number of different clauses are contained under one title in order to provide the reader with optional or alternative language. At the beginning of each clause is an indicator showing the orientation of the clause. Clauses can be owner-oriented, operator-oriented, or neutral. This identification of orientation should allow the reader to select the clauses that best represent his interests. Finally, many of the clauses are followed by editorial notes that provide additional insight into the content of the clause.


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## Section 1 PREOPENING MANAGEMENT SERVICES

### 1.1 Preopening Services—General

NEUTRAL In general. Operator will perform all activities necessary or reasonably required to open the Hotel for business, to see that the Hotel is properly stalled and equipped, and to see that there is in place, well prior to the Opening Date, a coordinated program for selling the room facilities and services of the hotel to the public.

**NOTE: The contract should set forth in detail the preopening duties and responsibilities of the Operator.**

*[Alternate Clause]* OWNER As part of the Preopening Services, Operator will:

A. Recruit, train, direct, and employ an initial staff (or the Hotel:
B. Initiate and conduct such promotion, publicity, and other like programs **as** Operator may deem necessary to attract guests to the Hotel on and after the Formal Opening Date;
C. Negotiate for and enter into agreement for leases, licenses, and concessions (or stores, office space, and lobby space at the Hotel, in Owner's name subject to Owner's prior written approval, as agent (or Owner;
D. Apply for. process, and take all necessary steps to procure, in Owner's name or in name of an operator or an individual on its behalf or any combination thereof as may be required by the issuing authority, all licenses and permits required for the operation of the Hotel and its related facilities, including, but not limited to. liquor and restaurant licenses;
E. Purchase or contract for the purchase of all initial inventories and operating supplies, which shall be paid for out of the Initial Working Capital furnished by Owner;
F. Assist in coordinating the efforts and activities of the architect, interior designer, and alt other consultants retained by Owner in connection with the planning and development of the Hotel;

G. Supervise the Hotel's sales staff and conduct the sales and marketing efforts through its sales and marketing staff as Operator shall deem appropriate for the Hotel;

H. Do all other things Operator deems necessary for the proper opening of the Hotel, including, but not limited to, arranging for suitable inaugural ceremonies; and

I. Coordinate all Preopening Services.

### 1.2 Payment of Preopening Fees

OPERATOR

Owner shall pay Operator a fee equivalent to two and one-half ($2^1$k) times Operator's direct personnel costs, including related fringe benefits and payroll costs for those personnel who are directly engaged in performing Preopening Services for the time such personnel are performing such services (excluding (a) personnel at other hotels managed by Operator and from Operator's corporate offices who are temporarily assigned to the Hotel to provide preopening and opening assistance in connection with the opening of the Hotel to the general public ("Preopening Personnel"), and (b) the Operator personnel assigned to the Hotel on a permanent basis in order to perform the services provided for under this clause ("Permanent Employees")). "Direct personnel costs" pursuant to this Section shall be based on Operator's mean grade salary level for personnel in each job classification, which may change from time to lime; provided however, that Operator agrees to assign personnel without regard to their actual salary level.

### 1.3 Reimbursement for Preopening Expenses

OPERATOR

Preopening expenses incurred or paid by Operator, not to exceed One Hundred Fifty Thousand Dollars ($150,000), shall be promptly reimbursed by Owner upon receipt of a statement of account for such expenses.

### 1.4 Preopening Plan and Budgets

NEUTRAL

On or before__________, 19__, Operator shall submit for Owner's approval, not to be unreasonably withheld, a preopening budget ("Preopening Budget") to Owner. Such budget shall not exceed One Hundred Fifty Thousand Dollars ($150,000).

### 1.5 Owner's Approval of Preopening Plan and Budgets

NEUTRAL

Within thirty (30) days from the date of submission of the initial Preopening Plan to Owner or submission of any additional information requested by Owner in connection with its review of the initial preopening Plan, Owner shall submit to Operator, in writing and in reasonable detail, its objections to and comments on the initial Preopening Plan. A failure to do so shall be deemed an approval thereof by Owner. If Owner and Operator are not able to reach an agreement concerning any modifications to the initial Preopening Plan resulting from Owner's objections and comments within sixty (60) days after such comments and objections are received by Operator (it being expressly understood that the inability of Owner and Operator to agree on such modifications shall not be subject to arbitration), then this Agreement and the Management Agreement shall terminate, unless Operator, by notice given to Owner prior to such date, shall elect to continue them in full force and effect for such period or periods of time, not to exceed forty-five (45) days from the date of Operator's notice as Operator shall, in its sole discretion, determine by so slating in said notice.

**1.6 Operator to Prepare Staffing and Wage Schedules**

OWNER Prior to the Opening. Operator will prepare for Owner an organization chart of Operator's corporate personnel who will perform the services to be provided by Operator under this Agreement; a proposed organization chart of job positions for the people to be employed by Operator and Owner in connection with the operation of the Hotel under this Agreement; and a preliminary staffing plan providing positions, schedules of employment, and average salaries or wages of persons to be employed by Operator and Owner in connection with the operation of the Hotel under the Management Agreement ("Staffing Plan").

*[Alternate Clause]* OWNER Prior to the Opening, Operator will prepare staffing tables, employment time tables, hiring and training guidelines for employees, and other programs relating to staffing of the Hotel.

**1.7 Operator to Assemble a Task Force of Experts**

OWNER The Operator will provide. for a task force of experts and personnel to supervise and assist with certain Preopening and Opening operations.

**1.8 Consultants**

NEUTRAL Pursuant to the services provided by Operator in this Agreement, Owner will not be required to hire separate, outside consultants for special systems (including Hotel computer systems and the Hotel telephone system) and front desk layouts.
Operator will assist Owner in determining what outside consultants are necessary for the design of the project.
Owner will submit to Operator a list of consultants proposed to be used for the design of project, which shall include the names of architect; structural, mechanical, and electrical engineers; interiors and lighting designers; food service and laundry designers; life safety, elevator, and audio-visual consultants; landscaping designer; and any other design consultants required. Operator will either approve, if acceptable, such consultants or suggest alternate consultants. All consultants to be used for the design of the project must be approved by Operator. Such approval shall not be unreasonably withheld.

**1.9 Operator to Hire Executive Staff**

OWNER At an appropriate time prior to the Opening, Operator will hire and retain, on behalf of Owner, a General Manager, director of sales, head housekeeper, and other department heads, and thereafter, with the assistance of such department heads. Operator will engage on behalf of Owner a full staff of employees for the Hotel.

**1.10 Operator to Recruit and Train Staff**

OWNER Prior to the Opening, Operator will recruit, train, direct, and employ an initial staff for the Hotel in the name of and on behalf of Operator or a wholly owned subsidiary of Operator.

**1.11 Operator to Perform Preopening Sales and Marketing**

OWNER Operator will prepare and coordinate, on behalf of the Hotel, preopening advertising, public relations, and sales budgets,. and may hire outside advertising and public relations firms, and will manage and coordinate all activities so as to develop a cohesive and coordinated preopening program for advertising, public relations, and sales, all subject to Owner's approval.
Such sales and marketing services will include the following:

A. Developing a mission statement for the Hotel;

B. Developing three-year revenue goals for major business segments of the Hotel;

C. Developing direct sales plans for the Hotel, including backlog goals, room rate guidelines, and sales strategies;

D. Developing a corporate rate program for the Hotel;

E. Developing catering market segment and sales goals;

F. Preparing and recruiting a sales organization necessary to support the goals and objectives developed in items A through D;

G. Developing a monthly reporting system to monitor sales progress;

H. Developing appropriate sales promotion strategies; and

I. Developing preopening plans for advertising, public relations, and marketing.

*[Alternate Clause]* OWNER

Operator will, on behalf of Owner, hire and retain sales personnel and establish a sales program for the purpose of "selling" the rooms of the Hotel and the use of meeting rooms and other Hotel facilities, prior to the opening of the Hotel.

**1.12 Inaugural Ceremonies**

OWNER

In cooperation with Owner, Operator will arrange for suitable opening and/or inaugural ceremonies.

**1.13 Model Room**

OPERATOR

Owner shall construct, at Owner's expense and Operator's direction, a model room or rooms in the city in which the Hotel is to be located or at some other site mutually acceptable to Owner and Operator. Said model room or rooms shall be constructed pursuant to those sections of Operator's Project Standards Manual that Operator deems appropriate, and shall be used for marketing purposes and to illustrate the Hotel guest rooms, the concept, the detail of construction, and the furniture, fixtures, and equipment (F,F,&Es) therein.

**1.14 Operator to Negotiate Loans**

OWNER

In cooperation with Owner, Operator will negotiate leases, licenses, and concession agreements for stores, office space, and lobby space at the Hotel (exclusive of retail space adjacent to the Hotel), subject to Owner's approval. All leases, licenses, or concessions shall be in Owner's name and executed by officers of Owner on its behalf.

**1.15 Operator to Secure Licenses**

OWNER

Operator *will* assist Owner in securing all licenses necessary to open and operate the Hotel, including, but not limited to, occupational licenses, liquor licenses, Health Department licenses, and the like.

**1.16 Operator to Perform Purchasing Services**

OWNER

Operator will negotiate contracts for the design, specification, and purchase of Operating Equipment, Furnishings and Equipment, and Consumable Supplies. Such contracts shall be subjected to the approval of Owner.

### 1.17 Operator to Supervise Delivery and Installation

OWNER Operator will supervise and coordinate the delivery, installation, and acceptance of Operating Equipment, Furnishings and Equipment, and Consumable Supplies.

### 1.18 Soft Opening Period

NEUTRAL If agreed upon by Operator and Owner there may be a period during which the Hotel is open to paying guests, although not on a substantially fully operational basis (the "Soft Opening Period"). Any operation of the Hotel during the Soft Opening Period, which shall not exceed three (3) months in duration, shall be treated as part of the Preopening Period, and any excess of Operating Expenses and Other Expenses over Total Revenue during such period shall not be considered in the determination of Net Operating Profit for any Fiscal Year and shall be distributed to Owner pursuant to the provisions of this Agreement.

### 1.19 Monies Invested by Operator

NEUTRAL Operator shall lend to Owner upon the terms and conditions hereinafter described the sum of Eight Hundred Thousand Dollars ($800,000), which represents a part of the estimated cost of Preopening Services (exclusive, however, of (a) all costs in connection with obtaining all licenses and permits, including attorney and consultants fees, and (b) the fee payable to Operator in accordance with the provisions of this Agreement in relation to partial operations prior to the Opening Date), according to the following schedule:

A. Ten percent (10%) thereof within thirty (30) days of the date the construction loan is committed:

B. Fifteen percent (15%) thereof upon notice to Owner from Operator on the earlier of (i) three (3) months after the construction loan is committed or (ii) fifteen (15) months prior to the Estimated Opening Date (as defined hereinabove):

C. Twenty-five percent (25%) thereof upon notice to Owner from Operator twelve (12) months prior to the Estimated Opening Date; and

D. Fifty percent (50%) thereof upon notice to Owner from Operator (6) months prior to the Estimated Opening Date.

Owner shall execute in favor of Operator a promissory note in the Original principal amount of Eight Hundred Thousand Dollars ($800,000) with interest thereon at the prime rate as set by the parties agreed upon bank from time to time, such interest to accrue on the unpaid balance until paid. The note. shall be due and payable in one balloon installment five (5) years following the Opening Date of the Hotel but shall allow Owner to prepay without penalty. Owner shall execute a deed of trust securing the construction-term loan. Operator agrees to subordinate its deed of trust to the construction-term loan upon request to Owner.

## Section 2 OPENING DATE

### 2.1 Opening Date

NEUTRAL The Opening Date is the date of the formal opening of the Hotel and shall be the earliest date after the Completion Date on which each of the following criteria has been met, as thereupon confirmed by Operator's issuance of a Certificate of Operational Readiness in the form annexed hereto as Exhibit E [omitted]:

A. Eighty-five percent (85%) of guestrooms are permanently available for sale;
B. Lobby area is equipped and functional;
C. Front desk is equipped and functional;
D. Food and beverage outlets are equipped and functional;
E. Kitchens are equipped and functional;
F. Elevators and escalators are installed and operating;
G. Public spaces, banquet rooms, and meeting rooms are equipped and functional;
H. Telephone Department is equipped and functional;
I. Parking facilities are available;
J. Heat, light, power, and air conditioning are available and operating;
K. Laundry and Valet (dry cleaning) Departments are available and functional;
L. Adequate Room status and Front Office systems equipment are installed and functional;
M. Cashiering equipment is installed and functional;
N. All necessary licenses and permits (including, without limitation, liquor licenses) required for the operation of the Hotel have been obtained;
O. Necessary operating inventories are on hand;
P. Necessary inspections by regulatory body have been completed and approvals have been received;
Q. Municipal Statement of Occupancy has been issued (temporary or permanent);
R. All required insurance coverage is in force; and
S. The Complex is capable of rendering deluxe, first-class service to guests on a substantially fully operational basis.

*[Alternate Clause]* NEUTRAL

The Opening Date is the date of the formal opening of the Hotel. It shall occur on a date to be specified by Operator with the approval of Owner after Operator deems the Hotel to be substantially completed and the Furniture and Equipment and Operating Equipment have been substantially installed therein, all in accordance with the provisions of this Agreement, after all licenses and permits required for the operation of the Hotel (including a certificate of occupancy and liquor and restaurant licenses) have been obtained, adequate working capital has been furnished by Owner in accordance with this Agreement, and the Hotel has been accepted by Operator and is ready to render first-class service to guests on a fully operational basis. Operator may, without accepting the Hotel and with Owner's consent, conduct partial operations of the Hotel prior to the Opening Date.

*[Alternate Clause]* NEUTRAL

The date for the opening of the Hotel to the public (the "Opening Date") shall be the date specified by Owner in a written notice to Operator (given at least thirty (30) days prior to the Opening Date), provided that in no event shall the Opening Date occur prior to the date on which all of the following conditions shall have been satisfied: (a) The construction of the Hotel shall have been substantially completed in accordance with the Final Plans, (b) the installation of the Furniture and Equipment and Operating Supplies in the Hotel shall have been substantially completed in accordance with the provisions of this Agreement, and (c) all certificates, approvals, licenses, and permits required for the legal use and operation of the Hotel, including liquor and restaurant licenses and certificates of occupancy, shall have been obtained from the appropriate governmental authorities. The parties hereto agree to execute an Addendum to this Agreement setting forth the Opening Date, at such time that the Opening Date is finally determined, and a counterpart of such Addendum shall be attached to and become a part of each counterpart of this Agreement.

## Section 3 GENERAL COVENANTS OF OWNER AND OPERATOR

### 3.1 Owner to Provide Supplies

OPERATOR Owner agrees to provide, at its expense, sufficient initial inventories of operating supplies for the uninterrupted and efficient operation and maintenance of the Property.

### 3.2 Owner Responsible for All Expenses

OPERATOR Owner shall be solely liable for the costs and expenses of maintaining and operating the property and shall pay all costs and expenses of maintaining, operating, and supervising the operation of the property, including, without limitation, the salaries of all of its personnel.

**NOTE:** The preceding provision makes the agreement a management contract rather than an operating lease.

### 3.3 Owner's Right of Inspection

OWNER Duly authorized representatives of Owner shall have the right to enter the Hotel upon reasonable notice at all reasonable times during the Operating Term for the purpose of inspecting the Hotel. Such inspections shall be done with as little disturbance to the business of the Hotel as possible.

All books, accounts, and records maintained for the operation of the Hotel (whether maintained at the Hotel or elsewhere by Operator) shall be open at all reasonable hours upon reasonable notice for inspection, examination, copying, and audit by Owner or any qualified accountant experienced in Hotel matters selected by Owner for that purpose, at Owner's expense.

Owner, brokers, and prospective tenants, managers, *and/or* purchasers shall have the right to enter the Hotel at all reasonable times upon reasonable notice during the Operating Term, for the purpose of inspecting the Hotel; but the same shall be done with as little disturbance to the business of the Hotel as possible.

*[Alternate Clause]* OPERATOR Owner or its agents shall have the right to free access to the Hotel and all of its facilities at all reasonable times, but only for the purpose of inspecting or having others inspect or view the premises either to determine its condition or as prospective purchasers, investors, or lenders. Any concern, comment, or question Owner may have during or after any such visit shall only be directed to Operator or its specified representatives, and not to any other Hotel Employees. In all respects, Owner shall seek to minimize any disruptions to the operation of the Hotel resulting from its access thereto.

*[Alternate Clause]* OPERATOR Owner may consult only with the General Manager, or if he is unavailable, the manager on duty, concerning any aspect of the management of the Hotel by Operator.

*[Alternate Clause]* OWNER Owner may' at any time converse with the General Manager or Operator's Vice-President in charge of the Hotel regarding any subject, and Operator shall instruct them to disclose fully to Owner upon Owner's request all information regarding the operation of the Hotel.

### 3.4 Reserve for Replacement of Furniture, Fixtures, and Equipment

NEUTRAL Owner shall establish and maintain a separate account to be known as "Reserves for Capital Improvements and Replacements of and Additions to Furniture. Fixtures, and Equipment," for use solely for capital improvements and replacement of, and additions to, furniture and equipment so as to maintain the Hotel in a first-class condition.

*[Alternate Clause]* NEUTRAL

Operator shall establish one (1) interest-bearing account (the "Replacement Fund") for use in connection with the Hotel, for the benefit of Owner, with a bank selected by Operator and approved by Owner. The monies from time to lime included in the Replacement Fund shall be the properly of Owner and shall be kept separate and apart from the Operating Accounts. Operator shall have the sole and exclusive power to designate the persons authorized, by manual or facsimile signature, to withdraw funds from the Replacement Fund shall be excluded from Gross Revenues and in computing Gross Operating Profit for any period and shall remain part of the Replacement Fund. To the extent Operator shall be required to pay any income taxes on the income as a fiduciary or otherwise, the same shall be payable out of such Replacement Fund.

**NOTE:** If operator receives an incentive fee calculated on the basis of net income less a Reserve for Replacement, then part of the Reserve has actually been funded by the operator. This point becomes important when the Operating Agreement terminates.

### 3.5 Funding the Reserve for Replacement of Furniture, Fixtures and Equipment

NEUTRAL

During each fiscal year (and proportionately for any fraction thereof), there shall be reserved and deducted in the determination of adjusted Gross Operating Profit an amount equal to the following percentages of Gross Operating Income: one and one-half percent (1.5%) in the second and third full fiscal year and two percent (2%) in any later years until the amount reserved for the replacement of furniture, fixtures, and equipment equals One Thousand Dollars ($1,000) multiplied by the number of rooms in the Hotel. After the amount reserved equals this sum, no further amount will be reserved, except that as expenditures are made they will be replaced at the two percent (2%) rate.

**NOTE:** The objective for funding a reserve for replacement of FF&E is to accumulate a sufficient amount for required replacements, but not so much as to create an excessive balance. Most formulas are based on a percentage of total revenue ranging from two to five percent (2% to 5%).

*[Alternate Clause]* NEUTRAL

Funds shall be paid from the Operating Accounts into the Replacements Fund for each Monthly Accounting Period of the Operating term in the following amounts:

A. An amount equal to one percent (1%) of the Gross Revenues of the Hotel for each full Monthly Accounting Period during (i) the Fractional Year in which the Effective Date occurs, if the Effective Date does not occur on the first day of a Fiscal Year, and (ii) the first full Fiscal Year of the Operating Term;
B. An amount equal to two percent (2%) of the Gross Revenues of the Hotel for each Monthly Accounting Period during the second full Fiscal Year of the Operating Term; and
C. An amount equal to three percent (3%) of the Gross Revenues of the Hotel for each Monthly Accounting Period of the term of this Agreement, following the end of the second full Fiscal Year of the Operating Term.

Notwithstanding the foregoing, no such payment shall be made to the extent that it would cause the balance in such fund to exceed the sum of Three Thousand Dollars ($3,000) per room for the Hotel. Operator shall be entitled to withdraw from such Replacement Fund to pay for assets in the Equipment Budget and the Capital Expenditures Budget. The items so replaced or added shall be and become, forthwith upon acquisition and installation and without further act or action, the property of Owner.

*[Alternate Clause]* NEUTRAL

For each Fiscal Year, an annualized amount initially fixed at ten percent (10%) of the original installed cost of the Furnishings and Equipment shall be set aside for the reserve for replacement of said Furnishings and Equipment. However, whenever Operator shall, from

time to time, determine that the replacement value of the Furnishings and Equipment has increased to a degree that makes it necessary to increase the said deduction in order to preserve the standards of the Hotel, Operator shall be entitled to obtain an independent appraisal of the said replacement value, the cost of which appraisal shall be an operating expense, and the amount of the deduction hereunder shall thereafter be fixed at ten percent (10%) of the replacement value as so determined. The said deduction shall be made by a monthly charge equal to one twelfth ('112) of the annualized amount determined as above.

**3.6 Reserve for Structural Repairs**

NEUTRAL

Operator shall establish, in respect of each Fiscal year during the term of this Agreement, a reserve cash amount from which shall be drawn funds for structural or extraordinary equipment repairs, replacement, or maintenance at the discretion of Owner. During each Fiscal Year of this Agreement, funds shall be transferred into the Structural Component Reserve in Accordance with the following percentages: (a) None ˉ(0%) for all Fiscal Years *through* and including the Fiscal Year in which the Renovation Program is completed; and (b) One half of one percent (0.5%) in each full Fiscal Year thereafter.

**3.7 Insufficient Reserves**

NEUTRAL

The percentages for the Replacement Fund described hereinabove are estimates. If, in good faith, Operator believes, at any time during the term of this Agreement, 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, if, in good faith, Operator decides that these percentages may not be sufficient to keep the Replacement Fund at the levels necessary to make the expenditures required for the Hotel as a high quality. first-class facility, and if the Equipment Budget and Capital Expenditures Budget prepared in good faith by Operator exceeds the available funds in the Replacement Fund, Owner shall in good faith consider reasonable proposals made by Operator, in keeping with the need to maintain the position of the Hotel in its competitive geographical market. Owner will have final say in any change to the amounts specified.

**3.8 Operator's Use of the Reserve fund**

OPERATOR

On or after the Formal Opening Date and during each Fiscal Year, Owner will make available to Operator, within thirty (30) days after receipt of Operator's request, for capital improvements and replacements of and additions to furniture and equipment, from the reserve account established therefor, the amount provided in the Annual Capital Budget therefor.

*[Alternate Clause]* OPERATOR

Any expenditure for replacement, substitution, and additions during each fiscal year may be made by Operator without Owner's consent up to the then-remaining balance in such reserve fund.

**3.9 Disposal of Furniture and Equipment**

OWNER

It is expressly understood that nothing contained in this Agreement shall be construed to give Operator any right to dispose of furniture, furnishings, fixtures, equipment, machinery, or any other personal property used in the operation of the Hotel without the prior written approval of Owner,

However, if such disposal is in accordance with the Annual Plan approved by Owner, prior written approval of Owner shall not be required.

### 3.10 Reserve Funds Upon Termination

OPERATOR

Any amounts remaining in the Reserve upon termination of this Agreement, less (a) the cost to complete any protects which have been previously committed and (b) aggregate deposits to the Reserve of proceeds from sale(s) of FF&E, shall be included in the computation of Total Revenue for the sole purpose of computing Incentive Earnings in the year of termination.

### 3.11 Operator's Right of Offset

OPERATOR

Operator shall have the right at any time, but not the obligation, to withdraw from the Agency Account any amounts owed by Owner to Operator that are not paid by Owner in accordance with the terms hereof, but no failure or forbearance by Operator to deduct any such amounts shall be or shall be deemed to be a waiver of Operator's rights to deduct such amounts subsequently or to collect such amounts from Owner in any other manner available to Operator hereunder or at law or in equity.

### 3.12 Owner to Indemnify Operator

OPERATOR

Owner shall indemnify and hold operator harmless from all liability, loss, damage, cost, or expense relating to, arising, or incurred by reason of or in connection with the operation of the Hotel, including any act or omission, negligent, tortious, or otherwise, of any agent or employee of Operator or its Affiliates unless such act of omission constitutes fraud, gross negligence, or willful misconduct. Owner shall, at Owner's sole cost and expense and at Operator's request or upon Operator's demand, assume the defense of any legal proceeding arising out of the allegation of any such act or omission.

**NOTE:** Both owners and operators usually seek some form of indemnity from the other party. The key phrases in the preceding clause are "gross negligence" and "willful misconduct," which limit the extent of the provision. The use of the phrase "negligence," (as opposed to "gross negligence") would limit this clause even further.

*[Alternate Clause]*
OWNER

Notwithstanding the foregoing, Owner shall not be required to indemnify Operator against damages suffered as a result of gross negligence or intentional or willful misconduct on the part of Operator, its agents, or its employees, or on the part of any agents or employees selected or engaged Operator on the account of Owner.

The indemnification provided by this provision shall not extend to any liabilities or claims of Owner that may arise out of the breach, intentional or otherwise, of this Agreement by Operator.

No recovery under this indemnification provision will be allowed if the liability or claim of Operator has been paid in full, or if, and to the extent that, it has been paid in part, by any insurance maintained by Owner or Operator.

### 3.13 Operator to Indemnity Owner

OWNER

Operator shall indemnify and hold harmless Owner from all liability, loss, damage, cost, or expense (including, without limitation, attorney fees and expenses) caused by Operator's breach of this Agreement, actions outside the scope of this Agreement, gross negligence, willful misconduct, fraud, or breach of trust, whether during or after the term of this Agreement. Operator's duty to indemnify Owner shall be binding upon all successors and assigns of Operator. In case of any action, suit, or proceeding brought against Owner with respect to which Owner is entitled to indemnification pursuant to this provision, Owner will, notify Operator of such action, suit, or proceeding, and of the extent to which Owner is to be indemnified. Operator may, and upon Owner's request will, at Operator's expense,

defend such action, suit, or proceeding, or cause the same to be defended by counsel designated by Operator and approved by Owner

**3.14 Operator Not Liable to Owner**

OPERATOR

Operator shall not, in the performance of this Agreement, be liable to Owner for any action or omission, negligent, tortious, or otherwise, of any agent or employee of Operator or its Affiliates, unless its act or omission constitutes fraud, gross negligence, or willful misconduct and the damages resulting therefrom are not covered by insurance that Operator is required to maintain hereunder.

*[Alternate Clause]*
OPERATOR

Notwithstanding any other provisions of this Agreement, in no event shall Owner make any claim against Operator or its Affiliates on account of any alleged errors of judgment made in good faith in connection with the operation of the Hotel hereunder by Operator or its Affiliates or the performance of services provided for herein, nor shall Owner object to any expenditure made by Operator in good faith in the course of its management of the Hotel or in settlement of any claim arising out of the operation of the Hotel (other than claims involving a settlement of excess of Ten Thousand Dollars ($10,000), which must be approved by Owner) unless such expenditure is specifically prohibited by this Agreement.

*[Alternate Clause]*
OPERATOR

Operator is not liable to Owner or others for any act or omission on the part of its employees, unless Operator has failed to use reasonable diligence in the hiring, discharge, or supervision of such employees so as to maintain a staff of qualified, competent, and trustworthy employees.

**3.15 Noncompetition Covenant**

OWNER

Except with the written consent of Owner, Operator shall not manage or have any equity interest in any other hotel or motel within the radius of five miles of the Hotel during the term of this Agreement.

*[Alternate Clause]*
OWNER

For the first five (5) years of the Operating Term, neither Owner, Operator, nor any of their subsidiaries shall either own, lease, manage, or franchise a hotel, motor inn, or similar facility within Area A outlined in red on Exhibit F attached hereto *[omitted).* Thereafter for the balance of the Operating Term, the size of the noncompetition area shall be reduced to the area designated Area B on Exhibit F attached hereto *[omitted],* it being understood that such ownership, leasing, management, or franchising outside of said area shall be totally unrestricted.

*[Alternate Clause]*
OWNER

Neither Operator, its parent, nor any subsidiary or entity related to Operator or its parent shall at any time during the Operating Term own any interest in or manage a hotel or motel that is located within seven miles of the Hotel. Except as provided hereinabove, nothing in this Agreement shall deprive or otherwise affect the right of either party to own, invest in, manage, or operate property or business activities that are competitive with the business of the hotel. Operator covenants and agrees that even though it may have either an ownership interest in or a management responsibility for other similar properties that, from time to time, may be competitive with the hotel, Operator always shall represent the hotel fairly and deal with Owner on an equitable basis.

*[Alternate Clause]*
OWNER

Operator agrees that, during the first ten (10) years of this Agreement (the "Restricted Period"), Operator shall not hold an interest in any hotel operated under a name of Operator that is located within a ten-mile radius of the Hotel (the "Restricted Area"), provided, however, that if Operator acquires, or is acquired by, a publicly held company (the "Constituent Company") through a merger, consolidation, acquisition of assets, or similar transaction and the Constituent Company holds an interest in a hotel or hotels in the Restricted

Area, the foregoing prohibition shall not apply to the hotel or hotels wherein the Constituent Company holds an interest.

### 3.16 Arbitration

NEUTRAL

In the event that the parties fail to agree on a matter as provided in this Agreement, the matter involved shall be resolved by arbitration. An arbitrator shall be selected by mutual agreement of the parties, or if they cannot agree, by appointment made by the American Arbitration Association from among the members of its panels who are qualified and who have experience in resolving matters of a nature similar to the matter to be resolved by arbitration. Each party shall submit to the arbitrator a detailed and complete statement of terms and conditions that such party considers to be a fair and reasonable resolution of the dispute and that such party considers its "last and best offer." The arbitrator shall decide the dispute by selecting the proposal made by one (1) party that such arbitrator, after consideration of the parties to this Agreement and the economic benefits the parties intend to derive from this Agreement, considers to be the most reasonable and equitable resolution of the dispute. The decision of the arbitrator shall be final and conclusive and shall be binding upon the successors and assignees of the parties.

*[Optional Additional Clause]*
NEUTRAL

The arbitrator or arbitrators shall have the right only to interpret and apply the terms of this Agreement, and may not change any such terms or deprive any party to this Agreement of any right or remedy expressly or implicitly provided in this Agreement.

### 3.17 Legal Costs

NEUTRAL

In the event that either party shall institute legal or equitable proceedings to enforce any provision of this Agreement, the prevailing party, in addition to any other remedy to which it may be entitled, shall be entitled to recover as a part of such judgment or otherwise, and the non-prevailing party shall pay, all costs and expenses incurred in such proceedings, including reasonable attorney fees and disbursements.

### 3.18 Operator Shall Not Pledge Credit of Owner

OWNER

Operator shall not, except in the purchase of Furnishings and Equipment, Operating Supplies, and services reasonably required in the ordinary course of business in the operation of the Hotel, or as may be otherwise required in the performance of its obligations under this Agreement, pledge the credit of Owner, nor shall Operator in the name of or on behalf of Owner borrow any money, execute any promissory note, or pledge, mortgage, or otherwise encumber any real or personal property used in connection with the Hotel or otherwise without the prior written consent of Owner.

### 3.19 Confidential Information

OPERATOR

Owner agrees, for itself and its agents and employees, during the term of the Management Agreement and after its termination, not to reveal to any person (except as required hereunder or as authorized by Operator) any confidential or proprietary information or any other information belonging to Operator, its parent company, or their subsidiaries or affiliates relating to the business contemplated by the Management Agreement and not generally known to the trade and to the public, including, but not limited to, trade secrets, business and financial information, and know-how. Owner further agrees not to use at any time any such confidential or proprietary information belonging to Operator or its parent company or their subsidiaries or affiliates in competition with any of them.

### 3.20 Owner's Right to Mortgage Property

OWNER

Nothing herein contained shall prevent Owner from encumbering the Hotel by mortgage, deed of trust, or trust deed in the nature of a mortgage (the first, unsubordinated mortgage, deed of trust, or trust deed and any instruments secured thereby or collateral thereto shall be herein collectively referred to as the "Mortgage," and the holders of any such Mortgage, or of the indebtedness secured thereby, are herein referred to as "Mortgagee"), provided that Mortgagee shall be subject to the approval of Operator, unless such Mortgagee is a bank, savings and loan association, savings bank, insurance company, mortgage bank, pension fund, educational institution, welfare or retirement or endowment fund, real estate investment trust, or other like institution that is regularly engaged in the business of making loans. secured by mortgages on real property, in which case no such approval shall be required

Owner agrees that, in the event of such refinancing, Owner shall provide Operator notice of such appraised value along with the name, address, telephone number, and resume of the person who performed said appraisal ("First Appraiser") which person shall be an MAI Appraiser who specializes in the appraisal of hotels Within ten (10) days of receipt thereof. Operator shall either accept the findings of said appraisal or notify Owner that it disputes said amount, in which event the following shall occur:

A. Operator shall within ten (10) days of the serving of such notice of dispute to Owner, select an MAI Appraiser ("Second Appraiser").
B. The First Appraiser, whose fees shall be paid by Owner, and Second Appraiser, whose fees shall be paid by Operator, shall, within ten (10) days of the selection of the Second Appraiser, jointly select a third MAI Appraiser ("Third Appraiser"), whose fees shall be split equally between Owner and Operator.
C. The Second Appraiser and Third Appraiser shall each independently perform an appraisal of the Hotel, which appraisals shall be delivered to Owner and Operator within ninety (90) days of the date the Third Appraiser is selected.
D. The value of the Hotel shall be determined by calculating the average of the two appraisals closest in value to each other

Upon the execution of any Mortgage. Owner shall furnish Operator with a duplicate copy thereof and shall designate the post office address where notices may be served upon Mortgagee. Operator agrees that, so long as any such Mortgage shall constitute a lien on the Hotel, when Mortgagee shall request in writing copies of any and all financial or other information, Operator, pursuant to the terms and provisions of this Agreement, is obligated to deliver same to Mortgagee as often as Mortgagee may reasonably request. Moreover, Operator shall allow, upon request of Owner, any person designated in writing by Mortgagee to examine, audit, inspect, and transcribe all books of account and all other records relating to or reflecting the operation of the Hotel.

*[Alternate Clause]*
OWNER

Owner shall have the right to incur indebtedness in favor of one or more Institutional Lenders for which the Hotel or any part thereof or any interest therein may be used as collateral, so long as the Cash Flow Available for Debt Service for the Fiscal Year immediately preceding the Fiscal Year in which such indebtedness is proposed equals one hundred fifteen percent (115%) of regular annualized debt service on all indebtedness secured and/or to be secured by the Hotel.

### 3.21 Operator, to Periodically Meet With Owner

NEUTRAL

After each fiscal quarter, Operator and Owner shall, if deemed necessary by Operator or Owner, meet at a mutually agreeable time and place to review operating results for the Fiscal Year to date and operating plans for the balance of the Fiscal Year.

### 3.22 Owner Responsible for Debts, Liabilities, and Expenses

OPERATOR All debts and liabilities to third persons incurred by Operator in the course of its operation and management of the Hotel and within the scope of its authority hereunder shall be the debts and liabilities of Owner only, and Operator shall not be liable for any such obligations by reason of its management, supervision, direction, and operation of the Hotel for Owner or for any other reason whatsoever, unless such obligations were incurred by Operator beyond the scope of its authority.

*[Alternate Clause]* OPERATOR In performing its duties hereunder during the Operating Term, Operator shall act solely for the account of Owner. All expenses incurred by Operator in performing its said duties shall be borne exclusively by Owner. To the extent the necessary funds are not generated by the operation of the Hotel, they shall be supplied by Owner to Operator upon demand.

## Section 4 OPERATOR'S DUTIES

### 4.1 Operator's Overall Duties and Responsibilities

OWNER Operator shall be responsible for and have full power, authority, discretion, and control in all matters relating to the operation, management, and maintenance of the Hotel, including, without limitation, (a) rental and occupancy of rooms and commercial space and setting of charges therefore; (b) food and beverage services (including menu development and pricing); (c) employment policies: (d) credit policies; (e) the receipt, holding, and disbursement of funds; (f) accounting; (g) budgeting; (h) maintenance of bank accounts; (i) procurement of inventories, supplies, and services; (j) promotion, sales, marketing, and publicity; (k) maintenance, repairs, and cleaning of all improvements and equipment; and (l) generally, all activities necessary for the operation, management, and maintenance of the Hotel.

### 4.2 Operator's Duties-Maximization of Profits

OWNER Operator shall use its best efforts in the management and operation of the Hotel so that the Hotel and its services will be operated and maintained in such a manner as to maximize profits and provide a first-rate environment.

**NOTE:** The preceding clause deals with a duty sometimes overlooked by management companies: the maximization of profits. Operator-oriented contracts usually omit this clause.

*[Alternate Clause]* OWNER Operator shall implement policies and practices to achieve the following goals:

A. To facilitate effective and efficient discharge of its obligations under this Agreement;
B. to create and enhance goodwill among existing and prospective guests and patrons; and
C. to establish and maintain a favorable reputation for the Hotel.

*[Alternate Clause]* OWNER Operator shall manage and operate the Hotel and its businesses, services, and sales and shall exercise its best efforts to do so at all times in a manner of a high-quality hotel, consistent with the Franchise Agreement, and within the requirements of the applicable laws. Operator will use its best efforts to maximize to Owner the profits that can be derived from the Hotel and, upon its own initiation, with reasonable frequency, shall consult with and advise Owner and otherwise bring to Owner's attention opportunities to obtain and increase such profits. Operator shall not cause or knowingly permit to occur any act or omission that would violate the Franchise.

### 4.3 Operator to Maintain a Specific Level of Quality

OWNER Operator shall operate the Hotel throughout the entire Operating Term at a "First-Class Level" and shall provide or cause to be provided all amenities in connection therewith that are customary and usual to such an operation, and shall perform all of the functions and services, including those that are customary and usual for such an operation, so long as Owner does not impair Operator's ability to maintain such First-Class Level by withholding sufficient funds in violation of Owner's obligation to provide funds.

**NOTE:** When used in an operating agreement, the preceding clause should include a definition of the desired level of quality. The last sentence releases operator from responsibility to maintain this standard if the owner withholds necessary funds.

*[Alternate Clause]* OWNER Operator agrees to diligently operate the Hotel as a deluxe hotel throughout the Operating Term and in accordance with the high standards of the hotels operated by Operator and its subsidiary companies. The term "deluxe hotel" as used herein refers to the classification listed in the official Hotel and Restaurant Guide issued July 1977, published by the Public Transportation and Travel Division, Ziff-Davis Publishing Company, annexed to this Agreement *[omitted).* Operator agrees further to provide in the Hotel all services that are customary and usual to such an operation, while at all times attempting to maximize the revenues and operating profit of the Hotel consistent with the maintenance of the standards set forth hereinabove.

**NOTE:** The reference cited in the preceding clause can be replaced with other sources, such as provided by the Mobil Travel Guide and AAA.

*[Alternate Clause]* OWNER The term "luxury hotel" shall mean a luxury hotel as currently exists in the United States of America comparable in size to the Hotel, with the Hyatt Union Square hotel in San Francisco being used as an example of a luxury hotel at the date of this Agreement.

**NOTE:** The quality level in the above clause is defined by reference to a specific property. However, this practice can sometimes be difficult for long-term management contracts because the level of quality of the comparable hotel can be altered.

### 4.4 Operator to Advise Owner of Major Policy Matters

OWNER Operator shall submit outlines, in reasonable detail, to Owner setting forth its plans for and/or any major changes in its management and operation of the Hotel that are likely to have a material effect upon the profitability of the Hotel prior to Operator's institution of such changes.

*[Alternate Clause]* OWNER Operator shall consult with and advise Owner concerning all policies and procedures affecting all phases of the conduct of business at the Hotel and will give consideration to suggestions made by Owner. To the extent possible and where required under this Agreement, such consultation and advice shall take place prior to the institution of any major policies and procedures.

*[Alternate Clause]* OWNER Operator agrees that it will not make any major policy changes not reflected in the applicable Annual Business Plan that would have a potentially substantial material effect on the operations of the Hotel without first obtaining Owner's approval of such policy change. Notwithstanding any provision herein set forth to the contrary, in the event that it shall ever be determined that Operator has made a major policy change not reflected in the applicable Annual Business Plan without obtaining Owner's approval, and that such change actually has had a substantial material adverse effect upon Hotel operations, Owner may require that Operator reinstate the policy from which Operator departed without Owner's approval, and may seek such other remedies as may be available hereunder.

**NOTE:** The first part of the preceding clause ties into the Annual Business Plan, which should incorporate specific Owner approvals. The last part of this clause gives the owner the ability to correct mistakes of the operator. This is a strongly owner-oriented clause.

### 4.5 Operator to Have Absolute Operational Control

OWNER

Operator shall have absolute control and discretion in the operation, direction, management, staffing, supplying, and supervision of the Hotel, including, without limitation, performance of the following activities:

A. Determination of labor policies (including the hiring and firing of all employees);
B. Granting and limiting credit and establishing credit in connection with the operation of the Hotel (including entering into policies and agreement with credit card organizations);
C. Determining the terms of admittance for guests and users of the Hotel, including charges for rooms;
D. Deciding entertainment, amusement, food, and beverage policies;
E. Instituting such legal proceedings in the name of Owner or Operator as Operator shall deem appropriate in connection with the operations of the Hotel;
G. Arranging, in cooperation with the Owner, for all advertising, promotion, and publicity relating to the Hotel;
H. Entering into such contracts, concession agreements, and other undertakings as Operator shall from time to time consider appropriate;
I. Purchasing operating supplies and other services for the Hotel; and
J. Undertaking such other and further matters as Operator shall deem consistent with the good order and management of the Hotel.

### 4.6 Operator to Comply With Franchise Requirements

OWNER

Operator agrees to operate and manage the Hotel in compliance with any franchise agreement Owner may have with, and with the rules, regulations, and requirements of, any major hotel franchisor.

*[Alternate Clause]*
OWNER

Operator shall administer compliance with the Franchise, and shall, in connection therewith, communicate with Franchisor, purchase such supplies and services as may be required by the franchise, conduct the business of the Hotel in compliance with the Franchise, and prepare any and all writings and make all payments required by the Franchise. Operator shall forward to Owner copies of all notices, correspondence, and other writings received from or sent to the franchisor immediately following such receipt or dispatch. Upon Owner's request, Operator shall cause an appropriate employee of Operator to attend any and all meetings administered by Franchisor or held by or for the Franchisees and to prepare reports of such meetings for Owner.

### 4.7 Operator to Comply With Terms of Mortgage

OWNER

Operator shall cause the operation of the Hotel to comply with all terms, conditions, and obligations contained in the Mortgage Instruments of which Operator is made aware (provided that Operator shall be under no obligation to ensure that sufficient funds for payment thereof are generated from Hotel operations) and with any leases or other agreements of which Operator is made aware that are executed by Owner and that relate to the Hotel. Operator shall execute and deliver promptly any agreements and documents that Owner or lender may reasonably request to provide for or verify operation of the Hotel in such manner.

**4.8 Operator to Establish Prices**

OWNER As part of the Annual Business Plan, Operator will submit to Owner for its approval the rates to be published and charged to members of the general public for normal transient occupancy of the various categories of rooms and suites in the Hotel (hereinafter referred to as the "Rack Rates") during such fiscal year. The Rack Rates, as approved by Owner, may not be changed without Owner's further approval. However, it is understood that the said rates will not apply to group business or other categories of business to which Operator may extend a lower rate and that in its discretion Operator may from time to time permit individuals to occupy rooms or suites at the Hotel at rates lower than the said published rates. Operator will also provide Owner with price schedules for all other products and services of the hotel, such as food, beverage, meeting rooms, and commercial space.

**4.9 Operator to Establish Credit Policies**

NEUTRAL Operator shall establish and implement policies and procedures for verifying, accepting, limiting, and rejecting the credit of guests and patrons of the Hotel. In connection with the foregoing, Operator shall make appropriate arrangements to honor American Express, Visa, MasterCard, such credit cards as may be required or provided by Franchisor, and such other credit cards as Operator or Owner may deem desirable. Operator shall utilize its best efforts to make such arrangements on the most favorable terms available.

**4.10 Operator's Collection Practices**

OWNER Operator shall employ its best efforts to collect any and all credit card charges, checks, traveler's checks, drafts, and other accounts receivable. Operator shall employ collection agencies and legal counsel, where appropriate, to pursue such claims. If, during any three-month period, more than three percent (3%) of the Gross Revenue is not collected when due, Operator shall promptly explain to Owner, in writing, the reasons therefor and shall revise the credit policies and practices pursuant to Owner's reasonable suggestions.

**4.11 Operator to Submit Annual Plan**

OWNER Operator shall submit to Owner for Owner's approval an annual plan for the Hotel in form reasonably satisfactory to Owner. Such plan shall be submitted to Owner no later than sixty (60) days prior to the scheduled Effective Date and at least forty-five (45) days prior to the beginning of each Fiscal Year thereafter.

**NOTE:** The deadline for submission of the annual plan can range from thirty (30) to one hundred twenty (120) days prior to the beginning of the fiscal year. The owner should have sufficient time to review the plan and negotiate modifications.

**4.12 Operating Budget**

NEUTRAL The operating budget should contain a Profit and Loss Statement on a monthly and yearly basis, that is generally in accordance with the *Uniform* System of Accounts *for Hotels* promulgated by the Hotel Association of New York City, Inc., as adopted by the American Hotel Association of the United States and Canada (the "Uniform System of Accounts"). This statement should include detailed departmental and supporting schedules for each line item. Such budget estimates shall be presented on the form of pro forma operating statement attached hereto *[omitted).*

The operating budget shall also include the following items:

A. Projected occupancy and average room rate by month;
B. Projected gross revenue, detailed by source;
C. Leasing plan with respect to commercial or retail spaces that will be vacant;
D. Projected expenses, detailed by type;
E. Detailed proposed scheduling of staff, salaries, and wages;
F. Hotel room rates and charges for other services;
G. Insurance premiums and property taxes;
H. Property operations and maintenance (non-capital);
I. Advertising, promotional, and marketing expenses;
J. Calculation of base and incentive fees; and
K. Narrative overview of all budgeted revenue and expense levels and an analysis of budgeted levels to the previous year's actual results. Any differences should be explained.

**4.13 Capital and Equipment Budgets**

NEUTRAL As part of the Annual Plan, Operator will prepare a Capital Expenditures Budget setting forth in reasonable detail Operator's best estimate of capital expenditures to be made for major building improvements, renovation, repairs, and expansion for such period. Operator will also prepare an Equipment Budget setting forth Operator's estimate of the capital expenditures for additions and replacement of FF&E.

**4.14 Submission of Annual Plan to Owner**

OWNER Operator shall submit the Annual Plan to Owner for its approval, and Owner shall have the right to make any changes thereto or to refuse to expend any money suggested by the Annual Plan. Owner shall inform Operator in writing of any such change or refusal before the commencement of the period covered by the Annual Plan. Except as so changed by Owner, the Annual Plan shall be final for all purposes hereunder.

**NOTES:** The owner should have at least thirty (30) days from receipt of the Annual Plan to make changes. The above clause is strongly owner-oriented.

**4.15 Settlement of Disputes Regarding the Annual Plan**

NEUTRAL In the event that Owner and Operator shall not agree on any item of any Annual Plan, the terms or items included in such Annual Plan that have been agreed to by both Owner and Operator shall become operative immediately. In regard to the terms or items over which the parties are in dispute, pending the settlement thereof, operator may continue to operate the Hotel at the levels of expenditures agreed to in the most recently approved Annual Plan increased by a percentage equal to the increase in the Consumer Price Index for the calendar year preceding the calendar year for which the dispute has arisen. In the event that Owner and Operator cannot reach agreement on any term or item of the Annual Plan within sixty (60) days of its submission to Owner, such dispute shall be resolved by arbitration.

*[Alternate Clause*] NEUTRAL Pending resolution of any dispute over any item or term of an Annual Plan, the specific disputed items shall be suspended and replaced for the fiscal year in question by an amount equal to the lesser of (a) the amount proposed by Operator for such fiscal year or (b) such budget item for the fiscal year prior thereto, subject to escalation per item by the percentage increase in the Consumer Price Index over the twelve (12) -month period immediately preceding the start of the fiscal year in question.

*[Alternate Clause]* OWNER If any of the items in the Annual Plan are disapproved by Owner, Operator and Owner shall enter into negotiations in an attempt to determine mutually satisfactory budgets and programs. Owner shall make final determination with respect to the budgets and programs.

**NOTE:** The preceding clause gives the owner total veto power over all Annual Plans. Operator-oriented contracts omit any clause calling for owner approval of Annual Plans.

**4.16 Operator Must Comply With Annual Plan**

OWNER Operator shall comply with the Annual Plan, once it is approved by Owner, and shall not deviate substantially therefrom as to any item, incur additional expense or capital expenditure or obligation, or change the manner of operation of the Hotel without the written consent of Owner, except where such deviation is due to and is in direct proportion to an increase in business at the Hotel in excess of the pro forma operating statement, or in case of an emergency, or where failure to lake a particular action would expose Owner to the imminent danger of criminal liability other than the payment of fines

*[Alternate Clause]* OWNER Operator may deviate from the Annual Plan under the following conditions and for the following reasons:

A. The actual expenditures for the Department within which any given expense is allocable will not exceed one hundred ten percent (110%) of the total budgeted expenditures for such Department approved in the Operating Budget (for the purpose of this Agreement, the term "Department" shall mean each of the following twelve (12) general expense categories along with all of the individual expenses included therein as set forth in the Chart of Accounts: (1) Food. (2) Beverage, (3) Rooms, (4) Food and Beverage, (5) Telephone, (6) Golf, Pool, and Health, (7) Laundry, (8) Other Costs, (9) Heat, Light, and Power, (10) Repair and Maintenance, (11) Advertising and Promotion, and (12) Administrative and General);

B. Such expenditure is expressly authorized in this Agreement;
C. Operator obtains Owner's prior approval of such expenditure;

D. Such expenditure is warranted by increased levels of business;

E. Such expenditure is required to meet emergency conditions and Owner is promptly advised thereof;

F. Additional costs are incurred because of the occurrence of an event(s) not reasonably foreseeable by Operator; or

G. Such expenditure is caused by the occurrence of an event(s) outside Operator's reasonable control.

*[Alternate Clause]* OWNER Operator's sole right to deviate from the planned expenditures on a line-item basis within the accounts for Administration and General, Advertising and Business Promotion, and Property Operations and Maintenance shall be to exceed such planned expenditures on a line-item basis within the foregoing accounts by an amount not to exceed the greater of Fifty Thousand Dollars ($50,000) (adjusted in accordance with changes in the Consumer Price Index) or ten percent (10%) of the line-item amount. Any substantial deviations from the overall direction of the Marketing Plan portion of the Annual Plan contemplated by Operator shall be submitted to Owner, for its prior approval. Operator shall make no material changes in material business policies affecting the Hotel without Owner's prior approval.

**4.17 Operator Does Not Guarantee Financial Projections**

OPERATOR Owner hereby represents that in entering into this Agreement Owner has not relied on any projection of earnings ("Projections"); statements as to the possibility of future success, or other similar matters that may have been prepared by Operator. Any Projections made by Operator in contemplation of or in the course of implementing this Agreement will not take into account, nor make provisions for, any rise or decline in local or general economic conditions, and Owner understands that (a) no guaranty is made or implied by Operator as to the cost or the future financial success of the Hotel, and (b) Operator does not warrant or guarantee the Projections in any way whatsoever. Any use of this information is based on this understanding.

**NOTE:** The preceding clause refers to projections performed by the operator made prior to commencing the management contract. A similar clause should be used to state that the Operator makes no guarantee, warranty, or representation with respect to the budget.

**4.18 Minimum and Maximum Budget Expenditures**

NEUTRAL At a minimum, the Annual Plan will provide for an expenditure of an amount equal to four percent (4%) of gross revenues of the Hotel (determined in accordance with the Uniform System of Accounts for Hotels) for repairs and maintenance.

**NOTE:** Some contracts also provide for minimum and maximum amounts for advertising, repairs, and maintenance based on a percentage of total revenue, a specific dollar amount per room, or a specific total dollar amount. Any deviation must be approved by the Owner.

**4.19 Revised Operating Budgets**

OWNER In addition to the Operating Budget, Operator shall prepare a Revised Operating Budget within thirty (30) days after the end of the third (3rd), sixth (6th), and ninth (9th) Accounting Periods if the Hotel's income before fixed charges for any fiscal quarter is less than ninety percent (90%), of the Gross Operating Profit set forth in the Operating Budget for such fiscal quarter.

**4.20 Duty of Operator to Supervise Hotel Operations**

OWNER Operator shall reasonably employ the resources of its home office and regional facilities and personnel to supervise and assist the operation of the Hotel. Operator shall cause appropriate officers and employees of Operator to visit and inspect the Hotel and the operation thereof with reasonable frequency, and in any event Operator's regional executive in charge of hotel management shall visit the Hotel no less frequently than once each sixty (60) days.

**4.21 Cost of Supervisory Services**

OWNER The overall supervisory and management services to be rendered by the home office personnel and staff of Operator in connection with the operation of the Hotel shall be provided by Operator at its own expense and not charged to Owner.

**NOTE:** When the preceding clause is used, the contract should specify who pays travel expenses and what mode of travel should be utilized.

*[Alternate Clause]* OWNER Upon commencement of operations after the Opening Date, the supervisory services of Operator's corporate officers and employees other than those regularly or tempora-

rily employed on a full-time basis at the Hotel, and specifically including its home office administrative heads of maintenance, housekeeping. decoration and design, public relations, advertising, food and beverage operations, entertainment, sales promotion, forecasting and operations analysis, staff planning, accounting, and reservations, shall be provided by Operator at its own expense and not charged to Owner, except as otherwise specifically provided for in this Agreement, including, without limitation, the out-of-pocket expenses as may be chargeable to the operations of the Hotel. Without limiting the generality of all of the foregoing, Owner shall not be charged with the salaries or wages of any officers, directors, or employees of Operator or any of its affiliated or subsidiary companies except as otherwise specifically provided *in* this Agreement, or except with such personnel who shall be regularly or temporarily employed on a full-time basis at the Hotel.

*[Alternate Clause]* NEUTRAL

Operator may charge to the Hotel (a) the tourist-class travel expenses and meals, for its home office personnel, to the extent reasonably allocable to the Hotel and not to other businesses, and (b) the salaries of such personnel only if and for such time as the subject employees are located at the Hotel and are performing full-time services as substitutes for regular Hotel Employees.

*[Alternate Clause]* NEUTRAL

Operator may find it desirable to assign one or more of its employees to the Property on a temporary basis to perform hotel-related business, Owner agrees to reimburse Operator for all actual expenses to and from the Property and for all room and board while at the Property for such employees.

**4.22 Cost of Special Services**

OPERATOR

Extraordinary types of expenses incurred for projects, such as labor negotiations, renovation or rehabilitation programs, and special market studies, that involve a substantial time commitment of Operator's personnel or the .engagement of outside professionals will be reimbursed as a hotel expense, provided, however, that Operator shall not, without Owner's prior approval, incur expenses for such projects in excess of Twelve Thousand Dollars ($12,000) per project, as such amount may be increased by changes in the Consumer Price Index.

**4.23 Duty of Operator to Consult With Owner**

OWNER

Upon request by Owner, from time to time, Operator shall provide the services of qualified personnel to consult with Owner regarding such subjects relating to the Hotel as Owner may designate, provided that Operator shall have no obligation to provide consulting services of any persons other than employees of Operator or other persons whose services are provided to other hotel owners by Operator.

**4.24 Operator to Enter Into Leases**

NEUTRAL

Operator will use its best efforts and due diligence in entering into leases and concession agreements for stores, commercial space, and services at the Hotel. Any lease or concession for a period in excess of six (6) months (including any renewal options) shall be subject to the prior written approval of and be executed by Owner. Leases or concessions of a term of six (6) months or less may be executed by the Operator in the name of Owner without its consent. Operator shall, subject to the limitations of such leases and concession agreements and general hotel practice, also supervise and control the activities of tenants, concessionaires, and other persons in possession, and their employees and agents.

**4.25 Operator to Enter Into Service Contracts**

NEUTRAL

Operator is authorized to make and enter into all such contracts, equipment leases, and agreements as are required in the ordinary course of business and as are budgeted in the approved Operating Budget for the operation, maintenance, and service of the Hotel, and to make payment for the same when payment is due. However, Operator shall be required to obtain the consent of Owner before entering into any contract for the account of Owner, of whatever nature, if the total amount payable under such contract exceeds One Thousand Dollars ($1,000), as such amount may be adjusted to reflect changes in the Consumer Price Index, unless such contract is made under circumstances that the Operator reasonably considers to constitute an emergency or such contract is budgeted and approved by Owner. Notwithstanding the foregoing, Operator shall use its best efforts to contact and secure the approval of Owner should any such emergency expenditure be likely to exceed One Thousand Dollars ($1,000), as such sum may be adjusted pursuant to changes in the Consumer Price Index. Operator shall use its reasonable best efforts to secure for Owner all possible rebates, discounts, and other benefits to be derived from every contract. Any rebate, discount, or other benefit derived under any such contract, lease, or agreement shall accrue to the benefit of the Hotel. Operator shall not be responsible to Owner for the performance of any contract that is not recommended or approved by Operator; however, Operator shall make every effort to ensure the success of Owner's decision with respect thereto.

**NOTE:** The $1,000 limit on service contracts in the preceding clause is on the low end of the range. Large properties should have higher limits.

*[Alternate Clause]*
NEUTRAL

Operator will negotiate and enter into, on behalf of the Owner, service contracts required in the ordinary course of business in operating the Hotel, including, without limitation, contracts for electricity, gas, telephone, detective agency protection, vermin extermination, water, steam, cleaning, elevator and boiler maintenance, air-conditioning maintenance, master television service, laundry and dry-cleaning, and other services that Operator deems advisable. However, no contract with a duration in excess of one (1) year or involving an expenditure of more than Five Thousand Dollars ($5,000) per annum in the aggregate shall be entered into without Owner's approval.

**NOTE:** For purposes of the preceding clause, dollar limit on service contracts can range from $1,000 to $25,000 over terms of one to five years.

**4.26 Operator to Enter Into Entertainment Agreements**

NEUTRAL

Operator will negotiate and enter into, on behalf of Owner, agreements for entertainment within the Hotel facilities for one hundred twenty (120) days or less.

**4.27 Purchasing by Operator**

OWNER

Operator shall purchase such Consumable Supplies and other expendable items as are necessary to operate the Hotel, and shall pay for such supplies out of the General Account. When taking bids or issuing purchase orders, Operator shall be under a duty to use its reasonable best efforts to secure for and credit to Owner any discounts, commissions, or rebates obtainable as a result of such purchase.

*[Alternate Clause]*
OWNER

Operator shall promptly remit to Owner all discounts, rebates, profits, commissions, or other emoluments received by Operator or by any "Affiliate" of Operator, which term shall mean any corporation or other entity related to Operator or any officer, director, employee, or shareholder of Operator or of such related corporation or other entity, in connection with any purchase of materials or supplies delivered to or for the Hotel or in connection

with any contracts or agreements entered into on behalf of Owner or in connection with the Hotel. This clause is intended to ensure that neither Operator nor any Affiliate of Operator shall receive, directly or indirectly, any compensation other than that to be paid by Owner to Operator hereunder.

### 4.28 Purchasing From Operator

OWNER Whenever Operator shall contract with any company controlled by or under common control with Operator, the terms thereof shall be no less favorable to Owner than what Operator could have obtained in the public marketplace for materials or services of the same quality and quantity from independent third parties and on terms no less favorable to Owner than those pursuant to which the Affiliate provides similar services to any other Hotel owned or operated by Operator shall advise Owner of the substance of
any such agreement.

### 4.29 Repairs, Replacements, and Improvements

OWNER Operator shall make or install, at Owner's expense, all necessary or desirable repairs, decorations, renewals, revisions, alterations, replacements, additions, and improvements in and to the site, building, furnishings, and equipment of the Hotel; provided, however, that such are included in the budget or do not exceed One Thousand Dollars ($1,000) per item.

**NOTE:** For purposes of the preceding clause, dollar limitations can range from $500 to $100,000. It is important to specify what is a repair and what is a capital replacement.

*[Optional Additional Clause]* OWNER Owner shall at all times have the right to do or arrange for any of such work itself. All such work done or arranged for by Operator involving a payment in excess of Ten Thousand Dollars ($10,000) shall be contracted for on a competitive bid basis. Operator shall not receive from Owner or from any contractor any markup or payment from any such contract.

*[Alternate Clause]* OWNER In accordance with the requirements of the Franchise and the standards applicable to a high-quality hotel, Operator shall (a) maintain the Hotel in good condition and repair generally and (b) maintain, repair, and replace when necessary the Operating Equipment and the FF&E, all out of funds made available for such purposes by Owner. Operator will keep the Hotel and surrounding property in a safe, neat, clean, and sanitary condition at all times and will promptly remove all garbage and trash and ice and snow from the sidewalks, adjoining driveways, and parking areas.

### 4.30 Cost of Maintenance and Repairs

NEUTRAL It is accepted in principle that over the term of this Agreement, expenditures on maintenance and repairs will average not less than live percent (5%) of gross revenue.

**NOTE:** The preceding clause provides a minimum amount of maintenance and repairs. However, this approach can cause problems, because operations and maintenance do not always vary as a percentage of total revenue. Many other factors, such as the property's age, ratio of food and beverage to rooms, location, and occupancy should be considered.

### 4.31 Operator to Provide Licenses and Permits

OWNER Operator will seek, on behalf and in the name of Owner (unless the law requires that a particular license be in the name of Operator), the necessary licenses and permits as may be required for the conduct and operation at the Hotel of the business herein contem

plated. including licenses and permits relating to signage and to the sale of alcoholic beverages. Owner agrees to cooperate fully with Operator in applications for such licenses and permits.

**NOTE:** Some contracts allow the owner or operator to terminate in the event certain licenses or permits cannot be obtained. It is very important for all licenses to revert to the owner at end of the operating term.

*[Alternate Clause]* OPERATOR

Owner agrees to execute and deliver any and all applications and other documents and to otherwise cooperate to the fullest extent possible with Operator in applying for, obtaining, and maintaining such licenses and permits.

*[Alternate Clause]* OWNER

Operator will maintain at all times throughout the term of this Agreement all licenses and permits required of Owner or Operator in connection with the operation and management of the Hotel.

**4.32 Compliance With Government Rules and Regulations**

OWNER

Operator shall exercise its best efforts to conduct the business of the Hotel in, compliance with all applicable laws and to ensure that no activity or condition occurs on or about the Hotel in violation of any laws In the event that Operator shall have reason to believe that any laws may be violated on or about the Hotel, Operator shall promptly so notify Owner.

**4.33 Contesting Government Regulations**

NEUTRAL

Owner shall have the right to contest or to cause Operator to contest any alleged violation of any law and to postpone compliance with the law pending the determination of such contest as permitted by law. In such event, Owner shall indemnity Operator and its employees from any resulting loss, cost, damage, or expense (including fees of attorneys approved or selected by Owner).

**4.34 Operator's Bank Accounts**

NEUTRAL

Operator, on behalf of Owner, shall establish two bank accounts (the "Operating Accounts") for the Hotel in Operator's name, in banks approved by Owner (which approval shall not be unreasonably withheld), with Operator being the only party authorized to draw from the Operating Accounts unless otherwise agreed upon by the parties. One of the Operating accounts for the Hotel shall be known as the Depository Account and shall be used to deposit all cash and rental receipts generated by the Hotel. Operator shall deposit all funds collected from the operation of the Hotel in the Depository Account. The other account shall be known as the General Account and from it all disbursements for the Hotel shall be made. At the end of each Monthly Accounting Period, the amount in the Depository Account shall be drawn down to a minimal balance, and the excess funds shall be transferred to the General Account. Additionally, Operator regularly may draw funds from the Depository Account and deposit them in the General Account. In the event a nearby bank can be used to deposit funds directly into the General Account, the Operator may elect to not use a Depository Account. Funds from the General Account shall be disbursed by the Operator to pay its Base Management Fee, as well as to pay the normal and reasonable expenses of the Hotel incurred in the operation and maintenance of the Hotel pursuant thereto, including all expenses of the type deducted from Gross Revenues in determining Gross Operating Profit hereof and all expenditures of the type deducted from Gross Operating Profit in determining Cash Flow. It is understood and agreed that to facilitate the payment in expenses for the Hotel, Operator may elect to make such payments from an account maintained by Operator for making such payments with regard to

the Hotel and other properties operated by it and shall be entitled to withdraw from the General Account and to deposit to such other account, from time to time, an amount equal to the checks drawn upon such other account for the payment of expenses of such Hotel. All bank accounts shall be owned by Owner and shall be controlled and operated by Operator as the agent of Owner. The agency status of Operator shall be designated on the checks and drafts drawn on such bank accounts.

#### 4.35 Transfer of Funds to Owner

OWNER

Subject to maintaining adequate reserves for replacements and working-capital requirements, Operator, at Owner's request, shall transfer such funds as Owner shall specify to a bank account opened and maintained solely by Owner.

*[Alternate Clause]*
NEUTRAL

Within twenty-five (25) days after the end of each calendar month, and simultaneously with the delivery of the financial statements, Operator shall remit to Owner the balance in such bank accounts, less disbursements and advances made on behalf of and for the account of Owner, and less also such reasonable sums as Operator may reasonably deem necessary or appropriate to meet obligations that will or that Operator reasonably believes may become due thereafter, taking into account estimated future income. Operator is also authorized to draw as an advance on its Basic Fee for the preceding month directly from the bank account(s), provided all statements required by this Agreement have been delivered by Operator to Owner.

#### 4.36 Owner to Furnish Working Capital

NEUTRAL

On the formal Opening Date and thereafter from time to time throughout the Operating Term, Owner shall furnish to Operator (by deposit into the Agency Account) funds in the amounts requested by Operator to cause the Working Capital to be and remain at a level reasonably sufficient for the uninterrupted and effective operation of the Hotel. All such Working Capital shall be funds of Owner and shall be kept in the Agency Account to be utilized by Operator in Operator's sole discretion *in a* manner consistent with the practices of the hotel industry.

*[Alternate Clause]*
NEUTRAL

Owner shall provide to Operator the sum of Fifty Thousand Dollars ($50,000) as Initial Working Capital for use by Operator for initial inventories and operating supplies during the Preopening Period.

*[Alternate Clause]*
NEUTRAL

On or before the Effective Date, Owner agrees to deposit in the General Account the sum of Fifty Thousand Dollars ($50,000) (the "Initial Minimum Working Capital Balance"). Thereafter, at any time when the balance in the General Account shall be less than the Initial Minimum Working Capital Balance and the balance in the Depository Account is not sufficient to fund such deficit, Owner agrees to deposit to such General Account. as needed, an amount equal to such deficiency (the "Operator Advance"). The total of such deposits is not to exceed Eighty Thousand Dollars ($80,000) at any given time. Notwithstanding anything herein to the contrary, if, at any time, Owner deposits an Operator Advance to fund any such deficit, such Operator Advance shall be repaid to Owner by Operator without interest out of the General Account at such times when the amounts in the General Account exceeds the Initial Minimum Working Capital Balance.

#### 4.37 Repayment of Funds Advanced by Operator

OPERATOR

Operator shall in no event be required to advance any of its own funds for the operation of the Hotel, nor to incur any liability in connection therewith, unless Owner shall have furnished Operator funds necessary for the discharge thereof. If Operator shall at any time advance funds in payment of any expenditure of the Hotel, which Operator shall have the

right but not the obligation to do, Owner shall repay Operator immediately upon demand all or any part thereof with interest, at the prevailing prime rate of the bank or trust company serving as the depository for the Agency Account, which amount Owner hereby promises to pay.

*[Optional Additional Clause]* OPERATOR

If Owner does not provide the Initial Working Capital funds within said thirty (30) days, Operator may elect to provide such funds, and shall be reimbursed therefor by Owner out of Owner's separate funds (not those of the Hotel) with interest at a rate equal to four (4) percentage points over the prime rate.

**NOTE:** In the preceding clause, the operator may want to add a sentence stating that it can withdraw reimbursable funds from operating cash flow.

### 4.38 Operator to Provide Cash Management

OWNER

Operator shall provide cash management for the cash portion of the Working Capital. For the purpose of this Agreement, the term "cash management" shall mean expediting cash inflows, controlling cash outflows, and, if reasonably possible, investing the difference between cash inflows and outflows at a market rate.

### 4.39 Insurance Coverage

NEUTRAL

Concurrently with the submission of the Annual Plan, Operator shall furnish Owner with a schedule setting forth the kinds and amount of insurance Operator intends to procure in connection with the operation of the Hotel. This schedule shall specify the kinds and amounts of insurance required to be maintained pursuant to any mortgage, lease, or other agreement, as well as such other kinds and amounts of insurance as Operator shall deem necessary or advisable for the protection of Operator and Owner. Promptly following the receipt of such schedule, Owner shall notify Operator of any changes that Owner shall elect to make in such schedule, and Operator shall thereupon forthwith apply for and obtain, if obtainable, all such insurance from such companies and through such brokers as Owner shall direct.

### 4.40 Types and Amounts of Insurance

NEUTRAL

Owner shall also provide and maintain the following insurance throughout the Operating Term:

**A.** Public liability insurance having a minimum per occurrence limit of One Hundred Million Dollars ($100,000,000) against all claims that may be brought anywhere in the world for personal injury (including bodily injury), death, or damage to property of third persons. This insurance shall include coverage against liability arising out of the ownership or operation of motor vehicles, as well as coverage in the said amount against all claims brought anywhere in the world arising out of alleged (i) sale and/or sale of intoxicating beverages ("Dram Shop" coverage); (ii) assault or battery; (iii) false arrest, detention, or imprisonment or malicious prosecution; (iv) libel, slander, defamation, or violation of the right of privacy; (v) wrongful entry or eviction; and (vi) contractual liability.

**B.** Workers' compensation insurance or insurance required by similar employee benefit acts as mandated by law, as well as insurance against all claims that may be brought for personal injury or death of Hotel Employees, such insurance to have a minimum limit of not less than One Hundred Thousand Dollars ($100,000) per occurrence.

**C.** Business Interruption Insurance covering loss of income to both Owner and Oper ator for a minimum period of one (1) year resulting from interruption of business caused by

the occurrence of any of the risks insured against under the property damage insurance referred to in item A.

**D**. Crime insurance, including bonds covering Hotel Employees for a minimum of One Million Dollars ($1,000,000) per loss.

**E.** Boiler and machinery insurance, including use and occupancy (loss of income) for all direct loss or damage to property caused by failure of boilers or breakdown of machinery, in minimum limits of One Million Dollars ($1,000.000).

Operator may reasonably require Owner to increase the limits of insurance coverage set forth hereinabove and may reasonably require Owner to carry other or additional insurance, it being reasonable for Operator to require insurance of the types and in the amounts generally carried on hotels owned or operated by Operator or its affiliates. Owner shall pay all premiums on the insurance required by items A, B, C, D, and E, but the cost of insurance required under items A, B, C, and D shall be an Operating Expense.

**4.41 Insurance Policies**

NEUTRAL

Operator shall deliver to Owner, at the commencement of the Operating Term or promptly thereafter, original insurance policies or certificates covering all insurance required c' authorized to be maintained under this Agreement, and not less than live (5) days prior to the expiration of the then existing policies shall deliver to Owner such policies, renewals of policies, or certificates.

**4.42 Disputes Over Insurable Value**

NEUTRAL

Any dispute between Owner and Operator as to full insurable value shall be determined as an expense of the Hotel by an appraiser jointly selected by the parties. The value determined by the appraiser so selected shall be binding upon both parties until changed by a subsequent appraisal, but neither party shall have the right to require another appraisal within two (2) years after an appraisal has been made in accordance with this provision. If the parties are unable to agree upon an appraiser within thirty (30) days after the request by one of them for such agreement, the matter may be submitted for arbitration.

**4.43 Insurance Claims**

NEUTRAL

Owner shall give to Operator, and Operator shall give to Owner, prompt notice of any claims in excess of Ten Thousand Dollars ($10,000) made against Owner or Operator, and each party shall cooperate fully with each other and with any insurance carrier to the end that all such claims will be properly investigated and defended. Operator shall promptly engage legal counsel to defend any such claim against Owner, which counsel shall be approved by Owner.

**4.44 Owner to Assume Liability for Inadequate Insurance**

OPERATOR

Owner assumes all risks in connection with the adequacy of any insurance or self-insurance program, and waives any claim against Operator and its Affiliates for any liability, cost, or expense arising out of any uninsured claim, in part or in full, of any nature whatsoever except for the gross negligence or willful misconduct of Operator, its servants, and employees.

### 4.45 Owner and Operator Waive Claims Against Each Other

NEUTRAL Provides' that Operator shall procure and keep in force all of the insurance required to be obtained by Operator pursuant to this Agreement, neither Owner nor Operator shall assert against the other any claims for any losses, damages, liabilities, or expenses (including attorney fees) incurred or sustained by either of them, to the extent that the same are covered by such insurance, on account of damage or injury to person or property arising out of the ownership, operation, or maintenance of the Hotel. The parties agree that all policies of insurance to be procured by Operator shall permit the foregoing waiver.

### 4.46 Operator to Keep Books of Accounts

NEUTRAL Operator shall keep full and adequate books of account and such other records as are necessary to reflect the results of the operation of the Hotel. Such books and records shall be kept in all material aspects in accordance with the Uniform System of Accounts for Hotels (The Uniform System of Accounts for Hotels, 8th rev. ed. 1986).

**NOTE:** The Uniform System of Accounts is updated periodically. The contract should specify the current edition. It is very difficult to sell and refinance hotels that do not follow this system.

*[Alternate Clause]* OWNER Operator shall establish and operate accounting and internal audit control systems reasonably acceptable to Owner, and in connection with the foregoing, Operator shall establish and maintain for the benefit of Owner complete, proper, .current, and accurate records and books of account reflecting all transactions of the Hotel and of Operator with respect to the Hotel. Such books and records shall be prepared on an accrual basis and otherwise in accordance with generally accepted accounting principles and the Uniform System of Accounts, consistently applied within each accounting period and from year to year. Operator shall store safely such books and records for a minimum of three (3) years following the Fiscal Year to which they are applicable, and' Operator shall not destroy or dispose of the same except by delivery to Owner for further storage or destruction as Owner may determine.

### 4.47 Storage and Inspection of Books and Records

NEUTRAL Except for the books and records that may be kept in Operator's home office or other suitable location pursuant to the adoption of a centralized billing system or other centralized service, the books of account and all other records relating to or reflecting the operation of the Hotel shall be kept at the Hotel. All books and records relating to the Hotel shall be available to Owner and its representatives at all reasonable times after each notice from Owner to Operator of Owner's desire to examine, audit, inspect, and transcribe same.

### 4.48 Books and Records Upon Termination

NEUTRAL Upon any termination of this Agreement in accordance with its terms, all books and records shall be forthwith turned over to Owner so as to ensure the orderly continuance of the operation of the Hotel, but such books and records shall thereafter be available to Operator at all reasonable times for inspection, audit, examination, and transcription for a period of not less than seven (7) years from the date of said termination.

### 4.49 Operator's Monthly Financial Reports

NEUTRAL Operator shall deliver to Owner at or prior to the end of each month an accounting for the operations of the Hotel, including a detailed profit and loss statement and balance sheet and cash forecast showing the results of the operation of the Hotel for the preceding month and for the fiscal year to date and the cash needs, it any, for the subsequent six (6) months. Such statement shall (a) be in the customary form with the schedules annexed and in the same detail as generally prepared by Operator for other hotels it owns or operates, (b) be taken from the books and records maintained by Operator in the manner hereinabove specified, and (c) follow the general form set forth in the Uniform System of Accounts for Hotels (8th rev. ed 1986), unless Owner reasonably specifies a different form, and shall be calculated on the accrual method.

**NOTE:** The timing for submission of the financial reports discussed ranges from 15 to 30 days after the cease of the accounting period.

### 4.50 Operator's Annual Financial Reports

NEUTRAL Within ninety (90) days after the end of each fiscal year, Operator shall deliver to Owner financial statements including a detailed balance sheet, a statement of sources and uses of funds, an income and expense statement, and a computation of the Incentive Management Fee, certified by the Independent Certified Public Accountant, showing the results of operations of the Hotel during such fiscal year. Such financial statements shall be calculated on the accrual method. Any disputes as to the contents of any such statements or any accounting matter hereunder shall be determined by the Independent Certified Public Accountant.

### 4.51 Operator to Prepare Additional Reports

NEUTRAL Operator shall render to Owner, and any persons so designated by Owner, at Owner's expense, any additional financial statements reasonably required by Owner.

*[Alternate Clause]* OWNER Upon request by Owner, from time to time, Operator promptly shall prepare or cause to be prepared additional reports showing aging of receivables, schedules of payables, schedules of supplies and inventory, detailed cash flow information, occupancy reports, reports on insurance claims, reports on the physical condition of the Hotel, information regarding marketing outlook, and information regarding other matters of interest to Owner. Owner shall pay Operator's reasonable expenses incurred in preparation of such reports. Upon Owner's request, from time to time, the General Manager and Owner (or its agents) shall meet and discuss the operations of the Hotel.

### 4.52 Annual Audit

OWNER Following the close of each Fiscal Year, Owner shall have the right to cause an audit of the books, records, and operations of the Hotel to be made by an independent certified accounting firm. Operator shall cooperate fully with such auditors and shall make available to them any and all information concerning the Hotel. Owner shall deliver to Operator copies of all financial reports regarding the Hotel promptly after they are received from such auditors. Any adjustments to the Management Fee required because of the results of such audit shall be made by the parties within ten (10) business days. The cost of any such independent audit shall be an administrative and general expense of the Hotel for the succeeding Fiscal Year, provided that such cost shall be an expense of the subject year in the event that such year is the last year of the term hereof.

**4.53 Operator to Pay All Bills**

NEUTRAL Operator will pay all proper bills and expenses incurred in the operation of the Hotel and will file and pay all sales and use, property, franchise, income, and other tax records and returns relating to the Hotel. Operator shall pay as a part of the operating expenses of the Hotel, when due, all charges for water, gas, electricity, and all other public services furnished to the Hotel. Operator likewise shall pay as part of the operating expenses of the Hotel the replacement cost of the Consumable Supply, Other Supply, and other type of supplies; all wages; and all other costs incurred for the property operation of the Hotel in accordance with the provisions hereof. Operator will furnish centralized computing services for the efficient processing of payroll services, financial statements, accounts receivable, and accounts payable.

*[Alternate Clause]* NEUTRAL Operator shall cause its accounting department to prepare and timely file all necessary reports with respect to withholding taxes, social security taxes, unemployment insurance, disability insurance, the Fair Labor Standards Act, and all other statements and reports pertaining to labor employment on Owner's payroll in or about the Hotel.

*[Alternate Clause]* NEUTRAL Operator shall maintain all required records and prepare and file all forms related to the collection and payment of all sales and use taxes. Operator shall make required payments to the appropriate taxing authority from funds collected therefore by the Hotel. Operator's responsibilities hereunder specifically exclude the preparation or filing of local, state, or federal income tax returns.

*[Optional Additional Clause]* OWNER Provided that Owner has timely furnished sufficient funds for the payment thereof, Operator shall indemnify Owner from any penalties incurred as a result of Operator's failure to file sales tax, payroll tax, or local lax returns on behalf of the Hotel, other than income tax returns, for any tax period commencing on or after the date hereof. Any penalties incurred by reason of such failure or Operator's part shall not be considered an expense of the Hotel.

**4.54 Operator to Provide Centralized Accounting**

NEUTRAL Operator shall make available, in connection with the operation of the Hotel, its complete system of central financial services utilizing Operator's home office financial staff and computer equipment for so long as Operator shall provide such services for at least ten (10) other hotels in this chain.

Such services shall include, without limitation, cash management; verification of daily work; preparation of payroll and benefits administration; preparation of payroll tax returns; handling of accounts receivable (including normal in-house collection activities) and accounts payable; billing under national credit cards; cash management; preparation of monthly internal operating statements; verification of financial controls; advice and monitoring of accounting and reporting systems and internal controls (relating to cash, inventories, and accounts receivable); and training and supervision of cashiers, front desk, and inventory personnel. Such services shall not include the cost of a certified audit or the preparation and filing of state and federal tax returns, other than payroll and sales tax returns.

*[Optional Additional Clause]* OPERATOR In addition to all other fees due hereunder, Owner agrees to pay to Operator an Accounting Fee of Two Thousand Dollars ($2,000) per month to reimburse Operator for the expense of off-premise central office bookkeeping and accounting services, including, without limitation, the cost of issuance of checks and preparation of payroll statements; provided, however, that such Accounting Fee shall, in accordance with Operator's current standard fee schedule therefore be subject to increase annually by the lesser of ten percent (10%) or the percentage of increase in the Consumer Price Index as specified hereinabove.

*[Alternate Additional Clause]*
OPERATOR

For so long as Operator provides the Centralized Accounting Servers described hereinabove, Operator shall receive a Centralized Financial Service Charge, in an amount equal to one and one-half (1 ½%) percent of Total Revenues, payable monthly in the same manner as the Basic Fee.

*(Alternate Additional Clause)*
OPERATOR

Operator *will* be paid a fee of $750, to be adjusted to reflect the Consumer Price Index, on January 1, 1989 and annually thereafter, as an administrative and general expense of the Hotel, for each Monthly Accounting Period as a non-allocatable reimbursement for centralized computer, payroll processing, checks, accounting, and bookkeeping services. It is expressly understood that no outside accounting services *will* be hired as an expense of the Hotel for any reason whatsoever, except for the annual audit.

**4.55 Inventory**

NEUTRAL

Operator shall, on or before the Opening Date, and for every third Year of Operation thereafter, conduct an inventory of all Furnishings and Equipment and maintain complete records of such at the Hotel.

**4.56 Internal Audits**

OWNER

At Operator's sole option, Operator may perform internal audits of the operation of the Hotel. The cost of each audit shall be borne exclusively by Operator and shall not be an Expense of Operation of the Hotel; provided, however, that the out-of-pocket travel costs of Operator's employees engaged in the performance of such audit(s) shall be considered a Reimbursable Expense.

**4.57 Legal Actions for Guest or Tenant Default**

NEUTRAL

Operator may institute, in its own name or in the name of Owner, as required by the law, at the expense of Owner, any necessary legal actions or proceedings to collect charges, rent, or other income for the Hotel or to oust or dispossess guests, tenants, or other persons in possession, and concessionaires, or to cancel or terminate any lease or concession for the breach thereof or default thereunder by the tenant or concessionaire; provided that Operator shall not institute any legal actions with respect to any lease of one (1) year or more or involving more than Ten Thousand Dollars ($10,000) without the prior written consent of Owner. Any legal counsel engaged under this provision shall be designated by Owner.

**4.58 Legal Actions Against the Property**

NEUTRAL

Operator may, but shall not be obligated to, take at Owner's expense appropriate steps to protest or litigate final court decisions for any violation, order, rule, or regulation affecting the property.

*[Alternate Clause]*
NEUTRAL

Operator and Owner shall use their best efforts to prevent any liens from being filed against the Hotel that arise from any maintenance, changes, repairs, alterations, improvements, renewals, or replacements in or to the Hotel. They shall cooperate fully in obtaining the release of any such liens. 11 such a lien arises that was not occasioned by the fault of either party, it shall be treated as an expense of the Hotel. If the lien arises as a result of the fault of either party, then the party at fault shall bear the cost of obtaining the lien release.

### 4.59 Operator to Provide Advertising, Promotion, and Sales

OWNER Operator will plan, prepare, and contract for advertising and promotions for the Hotel designed to publicize the Hotel and attract guests in accordance with the standards set by other high-quality first-class hotel operations. To this end, Operator shall arrange and make contracts for such advertising and promotion as it may deem advisable from time to time for the successful operation of the Hotel.

*[Alternate Clause]* OWNER Operator shall provide the Hotel with such advertising, public relations, and promotional services as are judged by it to be reasonably necessary and appropriate in order to promote the name and facilities of the Hotel and to maintain its identity as one of the Operator's Hotels. Such services shall include but not be limited to assistance in the following areas:

**A.** Developing and implementing the Hotel's communications plan following the Operator's guidelines. This task includes planning, publicity and internal communications, and organizing and budgeting the Hotel's advertising and public relations programs;

**B.** Selecting and providing guidance as required for the public relations personnel;

**C.** Preparing and disseminating news releases for trade and consumer publications, both national and international; and

**D.** Selecting an advertising agency.

Operator shall coordinate the Hotel's communications program with Operator's corporate communications program and shall include the Hotel in Operator's corporate identity programs and in its national advertising programs as appropriate.

### 4.60 Operator to Prepare a Marketing Plan

OWNER Operator will prepare on an annual basis a marketing plan that shall include, but not be limited to, projected occupied room-nights and average daily rate by market segment, a detailed program for advertising and promotion, a detailed program for sales strategies, and a competitive hotel analysis.

### 4.61 Operator to Utilize Franchisor's Marketing and Reservation Services

OWNER Operator shall cooperate with Franchisor to cause the Hotel to be included in the national advertising programs and central reservation system for all hotels franchised by Franchisor. Operator shall use its best efforts to secure bookings for the Hotel through the sales and reservations systems of Franchisor and Operator and shall encourage the use of the Hotel by and for travelers, organizations, groups, meetings, conventions, travel agencies, and other recognized sources of hotel business.

### 4.62 Operator's Centralized Marketing and Reservations

OWNER Operator shall provide, or shall cause an Affiliate to provide, in the operation of the Hotel and for the benefit of its guests, inter-hotel reservations, convention and business meeting marketing and promotions, sales promotions, publicity, public relations, and all other group marketing benefits, services, and facilities, including joint advertising programs to the extent appropriate (all herein collectively called "Centralized Services"), similar to those furnished to other hotels owned and operated by Operator. Owner shall pay Operator monthly, as an expense of the Hotel deducted in calculating Hotel Net Income, a Cen

tralized Services Fee of one and one-half percent (1 1/2%) of Hotel Gross Revenue for the proceeding month.

*(Alternate Clause]* NEUTRAL — Owner shall be charged for all costs of reservation equipment, communication facilities, and credit card company charges, and for its pro rata share of all central reservation services payable to third parties, on the same basis as other hotels owned or operated by members of Operator.

*(Alternate Clause)* NEUTRAL — Operator shall process reservations for the Hotel through Operator's reservations system. Any charges payable to third parties in connection with the securing of reservations for the Hotel shall be an operating expense of the Hotel

*(Alternate Clause)* OWNER — Owner's obligation to participate *in* the reservation system and related programs shall be conditioned upon the charges therefor being in an amount satisfactory to Owner. In the event the charges therefor are not satisfactory to Owner, Owner may elect not to participate in said system.

**4.63 Joint Advertising and Sales Promotion**

OPERATOR — It is understood and agreed that where advertising or sales promotion for the Hotel is supplied in conjunction with advertising for other of Operator's owned, operated, or affiliated hotels or motels, the cost of such advertising or sales promotion shall be prorated to the Hotel and the other hotels and motels benefited thereby on a per-room basis: provided, however, that within the total advertising and promotion budget for such fiscal year the cost of such joint advertising and sales promotion allocated to the Hotel shall not exceed one third (1/3) thereof. It is agreed that the Hotel is not benefited unless its name and location appear in the advertising.

**4.64 Operator's Regional Sales Offices**

OPERATOR — As a result of the growth of the number of hotels owned and/or operated by Operator. Operator is planning to establish regional sales offices in major metropolitan areas throughout the United States. Owner agrees to pay its pro rata share of the expenses of such regional sales offices to be allocated on a per-room basis in the same method as the joint advertising and sates promotion expenses are allocated. The expenses to be allocated to Owner shall not exceed one half of one percent of the Gross Operating Income of the Hotel in any one fiscal year and the per-room charge shall not include any profit for Operator.

**4.65 Operator's Credit Card System**

NEUTRAL — Operator may, from time to time, at its sole discretion implement a charge card system for the convenience of guests and for the promotion of Operator's Hotels. At any time when such a charge card system is in effect. Operator shall make such system available to the Hotel, and Owner hereby authorizes Operator to accept such charge card and all other charge or credit cards designated by Operator for all Hotel charges authorized in accordance with Operator's credit card billing policies, as they may be amended from time to time. Operator shall retain the right at any time during the term of this Agreement to discontinue utilization of its charge card system.

**4.66 Operator's Logotype and Symbols**

OPERATOR — Owner acknowledges that the Hotel's communications plan must be in accordance with Operator's sales, advertising, and public relations philosophies and must adhere to Oper

ator's corporate identity requirements. In furtherance thereof, Owner acknowledges that Operator's logotype shall be the only logotype or symbol used to identify the" Hotel.

**4.67 Public Statements by Owner and Operator**

NEUTRAL Owner and Operator shall coordinate with one another on all public statements, whether written or oral and no matter how disseminated, regarding their contractual relationship as set forth in this Agreement and/or the performance by either of them of their respective obligations hereunder.

**NOTE**: Many management contracts are confidential and the terms cannot be released by either party.

**4.68 Operator to Provide Centralized Group Services**

NEUTRAL Operator may, at the request of Owner and with Owner's approval in each instance, cause its affiliates or subsidiary companies to provide for the Hotel and its guests the full benefit of any reservation system hereafter established by Operator and its affiliates and, with Owner's approval, may cause any such companies to so provide such aspects of any accounting services or other group benefits and services as are made available generally to properties managed by Operator, all of which are collectively referred to herein as "Centralized Services." Owner hereby agrees that the Hotel may participate in all such Centralized Services on the terms and conditions hereinafter specified.

**4.69 Cost of Group Services**

NEUTRAL Operator shall not charge any profit for group services but shall be entitled to reimbursement for the cost of those specific services elected by Owner to be performed centrally and for the property's pro rata share of all costs and expenses incurred in connection with the rendition of group advertising, business promotion, and reservations services, allocated on the same basis as allocated to other properties owned or operated by Operator.

*[Alternate Clause]* NEUTRAL Operator's affiliated or subsidiary companies that provide Centralized Services shall be entitled to be reimbursed for the Hotel's share of the total costs incurred in providing such services on a system-wide basis to hotels and motor inns owned or managed by Operator or its affiliates or subsidiaries. Such costs may include, without limitation, salaries (including payroll taxes and employee benefits) of employees and officers of Operator and its affiliated and subsidiary companies, costs of all equipment employed in the rendition of such services, and a reasonable charge for overhead that does not include any profit. The Hotel's share of said costs shall be determined in an equitable manner by Operator as certified by Operator's chief financial officer taking into account, to the extent possible, differing cost factors relating to the individual properties covered. The Hotel's costs shall be an operating expense of the Hotel.

*[Optional Additional Clause]* OWNER Each time that Operator shall charge the operation of the Hotel for its pro rata share of Allocable Chain Expense for any period, it shall furnish to Owner a statement in sufficient detail to provide Owner with data supporting such charge. Owner may, in connection with any such statement for any period, cause an audit to be made of the books and records of Operator and its affiliates relating to the data furnished in such statement, including, without limitation, the Chain Expense and Allocable Chain Expense incurred during such period in the average number of key guestrooms during such period in hotels opened to the public and situated in the United States and operated by Operator or its affiliates.

*[Optional Additional Clause]* OWNER

If Operator shall at any time institute major changes in the character or cost of its Group Services, the increased costs shall not be charged to Owner unless those changes have been implemented and the costs thereof allocated among at least two thirds (26) of the other hotels Managed by Operator in which Owner has no equity interest.

**4.70 Emergencies**

NEUTRAL

In the event that any circumstance shall occur that Operator reasonably and in good faith judges to be an emergency threatening the safety of persons or property (an "Emergency"), then Operator shall take such action and shall cause such things to be done as Operator reasonably and in good faith believes necessary. Operator shall inform Owner of any and all Emergencies as soon as practicable. It practicable, Operator shall obtain Owner's prior approval of any action in response to an Emergency.

**4.71 Taxes and Assessments**

OWNER

Operator shall obtain bills for real estate and personal property taxes, improvement assessments, and other like charges that are or may become liens against the Hotel and recommend to Owner payment thereof or appeal therefrom. Operator annually shall review and submit all real estate and personal property taxes and all assessments affecting the property to Owner and shall file all personal property tax returns.

## Section 5 MANAGEMENT FEES

**5.1 Management Fees-General**

NEUTRAL

As consideration for the services to be rendered by Manager as set forth in this Agreement, Owner agrees to pay to Manager a basic management fee (the "Basic Fee"), an incentive fee (the "Incentive Fee"), and an accounting fee (the "Accounting Fee"), each to be determined and paid in accordance with the terms set out herein during each Operating Year of the Operating Term (and, unless otherwise provided, proportionately for a fraction of an Operating Year).

**5.2 Amount of Management Fees-Basic Fee**

NEUTRAL

Commencing on the Effective Date, Owner shall pay Operator a Basic Management Fee equal to five percent (5%) of the Gross Revenues of the Hotel. The Basic Management Fee shall be calculated for each Monthly Accounting Period during the Operating Term and three percent (3%) shall be payable by Operator to itself out of the Operating Accounts (as defined herein) prior to any distributions to Owner and prior to payment of any mortgage Indebtedness or obligations under any Equipment Leases, the remaining two percent (2%) being subordinated to the payment of principal and interest on the initial permanent or take-out loan on the Hotel, accrued without interest, and repaid.

**5.3 Amount of Management Fees-incentive Fee**

NEUTRAL

Commencing on the Effective Date, Owner shall pay Operator an Incentive Management Fee equal to fifteen percent (15%) of:

A. The annual Gross Operating Profit, less (i) annual ad valorem taxes, (ii) property insurance, (iii) the amounts paid into the Replacement Fund, and (iv) Nine Hundred Thousand Dollars ($900,000) (hereinafter call "Net Cash Flow"). In the event the hotel is refinanced, Net Cash Flow shall be adjusted by the difference

between Nine Hundred Thousand Dollars ($900,000) and the then actual annual principal and interest payments.

B. Sale or refinancing proceeds in excess of Eight Million Five Hundred Thousand Dollars ($8,500,000), including the distribution of funds related to the Replacement Fund and initial Reserve Fund.

**NOTE:** If the incentive fee is based on profits, then the method used to calculate profits should be clearly defined.

*[Alternate Clause]* OWNER

The payment of Incentive Management Fees shall be made only to the extent of Cash Flow during such fiscal year. In any *year* in which Cash Flow is not sufficient to pay Operator the Incentive Management Fee, such unpaid Incentive Management Fee shall accrue and be paid from Cash Flow available in later years until such time as all accrued and unpaid Incentive Fees have been paid.

**5.4 Payment of Management Fees**

NEUTRAL

On or before the twenty-fifth (25th) day following the expiration of each three (3) -month period of the Operating Term, Operator shall receive out of the Operating Account its Incentive Fee for the said three (3) -month period just ended. The Incentive Fee for each three (3) -month period subsequent to the prior three (3) -month period or periods of each Operating Year hereof shall be equal to the excess of the Incentive Fee, calculated on a cumulative basis from the commencement of the then current Operating Year to the end of such three (3) -month period in respect of which the Incentive Fee is being paid, over the aggregate of the Incentive Fee theretofore paid in respect of such Operating Year. To the extent that there may be insufficient funds in the Operating Account for such payment, Owner shall pay to Operator forthwith, on demand, such Incentive Fee. To the extent the cumulative Incentive Fee paid to Operator in any then current Operating Year exceeds, at any time, the actual cumulative amount of Incentive Fee to which Operator is entitled, Operator shall promptly refund the excess to Owner.

**NOTE:** The incentive fee can also be paid on a monthly basis.

**5.5 Disputes Over Management Fees**

OWNER

If Owner questions any of the amounts or computations for any period (a) as shown by the Annual Statement of Operator's Fee, or (b) in determining Net Distributable Cash, or (c) as shown in statements submitted, and if Owner and Operator are unable to agree thereon, the matter in dispute shall be submitted for a binding decision by a Certified Public Accountant selected by the parties from the following list *(omitted]* in the order listed, subject only to their availability and to their independence, at the time, with reference to Owner, Operator or any affiliate or either:

*[list parties*]

Any expenses incurred in connection with such a resolution shall be treated as an expense of the Hotel. Owner shall be conclusively deemed to have accepted the accuracy and correctness of each Annual Statement of Operator's Fees unless Owner notifies Operator that Owner questions specific items therein within ninety (90) days after the later of its receipt by Owner or discovery of facts not reasonably in Owner's knowledge at the time it was received, but in any event not later than one (1) year from the date of the report.

### 5.6 Management Fee Definitions

NEUTRAL The term "Gross Income" shall mean all revenues, sales, or income of any kind, including service fees, resulting from the operation of the Hotel and over which Operator has any direct or indirect responsibility, including, but not limited to the following

**A.** Rental of rooms (excluding sales tax, hotel tax, and any other tax relating to room rental):

**B.** Rentals and other payments from licenses, sublessees, concessionaires, and others occupying space or rendering services at the Hotel (but not including the gross receipts of such licensees, sublessees, concessionaires, or others):

**C**. Food and beverage sales (excluding sales taxes and gratuities) from meeting rooms, restaurants, bars, and/or room service, it such services are conducted by Operator;

**D.** Subsidy payments;

**E.** Proceeds of use and occupancy insurance received or business interruption insurance payments (after deducting therefrom necessary expenses in connection with the adjustment or collection thereof): and

**F.** Any other form of income, from any source whatsoever, that is directly attributable to the Hotel, but not including the proceeds of any financing or refinancing, casualty or liability insurance proceeds, or condemnation proceeds

The following amounts shall not be included in determining Gross Income:

**A.** Gratuities or payments in the nature of gratuities that the Owner is obligated to pay over to employees;

**B.** Sums and credits received in settlement for loss, theft, or damage to property unless in excess of the cost of settlement of such loss, theft, or damage to property;

**C.** Excise, sales, or use taxes or similar charges that are required by law to be collected directly from patrons or guests or as part of the sale price of any goods or services or displays, and that must be remitted to governmental authorities; and

**D.** Credits or refunds to guests not previously deducted.

**NOTE: The contract should contain specific definitions for all accounting terms used that are not clearly defined in *The Uniform System of Accounts for Hotels* or for which the parties require a modified definition.**

*[Alternate Clause]* NEUTRAL Gross Operating Profit for the Hotel for any period shall mean and refer to Gross Revenues of the Hotel for such period, less the following expenses for such period incurred or authorized by Operator in operating the Hotel:

**A.** All wages and salaries of all employees (exclusive of salaries paid to corporate executive personnel of Operator, but including such wages, salaries, and other compensation chargeable to such employees used by Operator in connection with the operation and management of the Hotel) and all other payroll costs, fringe benefits, employer taxes, and similar charges related to employment: provided, however, that if any employee is also employed elsewhere by Operator, such compensation shall be equitably prorated among the Hotel and such other properties where such employee also is employed.

**B.** All departmental, administrative, and general expenses relating to the Hotel, including, without limitation, payments to the Marketing Fund and other advertising, promotional, and entertainment expenses; commissions; and the cost of heat, light, power, and other utilities.

**C.** All costs and expenses of routine maintenance, repairs, and minor alterations to keep the Hotel in good operating condition, which under generally accepted accounting principles are expensed currently rather than capitalized.

**D.** All license fees and permits relating to the Hotel or the operation thereof.

**E.** All amounts due under service contracts relating to the Hotel or the operation thereof.

**F.** The cost of all Consumable Supplies consumed in the operation of the Hotel.

**G.** A reserve for uncollectible accounts receivable in a reasonable amount determined y Operator and adjusted from time to time to reflect actual experience.

**H.** All costs and fees of accountants, attorneys, and other third parties who perform services required or permitted hereunder, which under generally accepted accounting principles are expensed currently -rather than capitalized.

**I.** All costs and fees of technical consultants and operational experts for technical or specialized services in connection with non-routine hotel work or matters that under generally accepted accounting principles are expensed currently rather than capitalized.

**J.** The Base Management Fee (as hereinafter defined).

**K.** All franchise royalties and other fees or expenses paid or payable by Operator under and pursuant to the Franchise Agreement pursuant to which the Hotel is operated or under or in connection with any renewal or extension thereof.

## Section 6 EMPLOYMENT PRACTICES

### 6.1 Operator's Personnel Duties

NEUTRAL Operator shall select, employ, promote, terminate where appropriate, supervise, direct, train, and assign the duties of all personnel that Operator reasonably determines to be necessary or appropriate for the operation of the Hotel (collectively, the "Hotel Employees"). Operator shall employ its best efforts and exercise reasonable care to select qualified, competent, and trustworthy employees. To the extent possible, Operator shall use local labor in the operation of the Hotel.

### 6.2 Employee Training

OWNER Operator shall provide appropriate training for all Hotel Employees. Operator also shall cause the appropriate employees to attend any program required by Franchisor pursuant to the Franchise Agreement. The costs of attending any such meetings or seminars, including the cost of tourist-class travel, accommodations, and food, shall be an expense of the Hotel, but shall not unreasonably exceed the amount provided for such purpose in the Operating Budget.

### 6.3 Employee Conduct

OWNER Operator shall require each Hotel Employee to be at all times (to the greatest extent possible within the scope of his duties) clean, neat, well-groomed, well-postured, unobtrusive, and dignified and to conduct himself at all times and in all contacts with guests, patrons, other Hotel Employees, and members of the public in a friendly, cooperative, helpful, and responsive manner and otherwise in such a way as to contribute to the comfort and goodwill of the guests and patrons of the Hotel and other Hotel Employees and to enhance the reputation of the Hotel generally. Operator shall employ its best efforts to create and maintain among the Hotel Employees a business-like but congenial atmosphere, a spirit of cooperation and goodwill, and a sense of pride associated with providing quality products and services and performing their jobs well.

NOTE: The preceding clause asserts the Owner's interest in maintaining top quality employees. The attitude and conduct of employees is an important factor in the success of a hotel venture.

### 6.4 Employees Are Employed by Owner

OPERATOR Each Hotel Employee shall be the employee of Owner and not of Operator, and every person performing services in connection with this Agreement, including any agent or employee of Operator or its Affiliates or any agent or employee of Owner hired by Operator, shall be acting as the agent of Owner

*[Alternate Clause]* NEUTRAL The General Manager (or other such Hotel Employees as designated by Operator) shall be an employee of Operator, and Owner shall reimburse Operator monthly for the General Manager's salary and fringe benefits.

*[Alternate Clause]* OPERATOR All Hotel Employees and agents shall be on Owner's payroll. Manager shall not be liable to such employees for their wages or compensation.

### 6.5 Operator to Negotiate Labor Contracts

NEUTRAL Operator will negotiate on Owner's behalf, after consulting with Owner or, if Owner is not available, with Owner's attorney, with any labor union lawfully entitled to represent the Hotel Employees. However, Owner, in its discretion, may participate in such negotiations. No collective bargaining agreement or labor contract resulting from such negotiations shall be valid unless executed by Owner.

*[Optional Additional Clause]* NEUTRAL Owner's approval will not be withheld in any case if such contract is consistent with similar agreements commonly in effect in the area.

**NOTE:** When using the preceding clause, Owner should verify Operator's ability to conduct labor negotiations prior to signing the management contract.

### 6.6 Limits on Employee Compensation

OWNER Subject to the restrictions imposed by the Operating Budget, Operator shall set the salaries and fringe benefits of all Hotel Employees. Operator shall not. permit such compensation to exceed by a substantial amount the compensation paid to employees with similar skills and responsibilities at comparable hotels in and about the area.

**NOTE:** The annual plan should contain a wage survey of area lodging facilities.

*[Alternate Clause]* OWNER No Hotel Employee shall receive compensation in excess of Sixty Thousand Dollars ($60,000) per year without Owner's prior approval of the pay rate.

**NOTE:** The preceding clause provides ownership control over employee compensation. The $60,000 base should be adjusted to reflect local conditions.

*[Alternate Clause]* OPERATOR

In determining employee salaries, Operator may pay such incentive salaries and bonuses to department heads and sales staff as Operator may deem appropriate, provided that such payments are pursuant to an incentive compensation plan that has been previously approved by Owner.

**6.7 Limits on Employment Contracts**

OWNER

Operator shall not enter into, institute, or grant employee benefits or employment agreements with respect to Hotel Employees that (a) require more than thirty (30) days' notice of cancellation, (b) require more than a thirty (30) -day grace period for termination of funding or participation, or (c) require a penalty or extraordinary payment on cancellation or any such termination, except those benefits or agreements required pursuant to union contracts, as the same may be changed from time to time to comply with applicable laws.

**6.8 Selection of General Manager**

OWNER

The selection of the General Manager, as well as his salary, shall be subject to Owner's prior written approval, which shall not be unreasonably withheld.

*(Alternate Clause]* OWNER

The General Manager shall be selected by Operator, but his employment, termination, or transfer to another Hotel shall be subject to the prior approval of Owner. In the event that the General Manager shall resign or be terminated or shall be absent from the Hotel for any period in excess or ordinary vacations and leave time, Operator shall replace the General Manager with a qualified person as soon as reasonably practicable.

**6.9 Replacement of General Manager**

OWNER

If the General Manager shall not prove satisfactory to Owner, Owner may, in writing, request Operator to discharge the General Manager, setting forth therein the reasons for such action. It the grounds for removal set forth by Owner shall be sufficient to constitute a violation of the terms of this Agreement, Operator must discharge the General Manager.

*[Alternate Clause]* OPERATOR

Operator may change or replace the General Manager of the Hotel at any time. The decision in regard to any change or replacement shall be at the sole discretion of Operator.

**6.10 Owner May Not Rehire General Manager**

OPERATOR

Owner agrees that if the General Manager of the Hotel leaves the employ of Operator for any reason, Owner shall not hire the General Manager in any capacity for at least one (1) year following such termination.

**NOTE:** The preceding clause prevents the Owner from terminating the management company and retaining the General Manager, a practice that can sometimes be tempting from the Owner's point of view. Time periods for such clauses range from one to three years.

**6.11 Salary for General Manager**

OWNER

Owner shall be given prior written notification, subject to its approval, of the appointment and total compensation package of the General Manager. Owner's approval of such compensation package shall not be unreasonably withheld or delayed.

### 6.12 Fringe Benefits for General Manager

OPERATOR

The General Manager is entitled to annual holidays as well as reasonable time off from regular duties for the purpose of attending professional development seminars, managers' meetings, and industry conferences and conventions, and for the purpose of attending to such other business as may be reasonable in the hotel industry. Owner shall pay all reasonable expenses of the employee in attending such meetings, seminars, conferences, and conventions.

### 6.13 Owner May Not Give Orders to Hotel Employees

OPERATOR

Owner may at any time consult or communicate with Operator regarding any of the Hotel Employees, but Owner shall not give orders to or otherwise interfere in the day-to-day activities of the Hotel Employees.

## Section 7 TRADE NAMES

### 7.1 Use of Trade Name

OPERATOR

In its operation of the Hotel, Operator may utilize trade names or trademarks that, in whole or in part, may be the same as or similar to the trade names or trademarks now or hereafter used by it or other members of Operator's Group, in connection with the operation of other hotels. The exclusive rights to the use of the trade names and trade marks will belong to Operator, and are not in any way to be considered appurtenant to the Hotel, irrespective of whether any of the trade names and trademarks are used by Operator for the first time at the Hotel or elsewhere. Upon the termination of this Agreement for any reason, all further rights to use the trade names and trademarks shall remain with Operator, and neither Owner nor any other occupant of the Hotel shall have any rights thereto.

*[Alternate Clause]*
OPERATOR

After termination of this Agreement, neither Owner nor any other owner or operator of the Hotel shall have the right to use the trade name or any trademarks, emblems, insignia, slogans, or distinguishing characteristics in connection with the operation of the Hotel or in any other manner.

*[Alternate Clause]*
OPERATOR

Operator has registered the name, trade name, trademark, and service mark of certain names for restaurants that are used in hotels owned and/or operated by Operator. Owner agrees that any such name, trade name, trademark, or service mark registered by Operator shall remain the exclusive property of Operator: provided, however, that Owner shall have the right to approve the name of any restaurants in the Hotel.

## Section 8 SUCCESSORS AND ASSIGNS

### 8.1 Assignment by Operator

OWNER

This Agreement, or any rights and duties expressed herein, shall not be assigned or transferred by Operator without the prior written consent of Owner. Transfer or issuance of the stock of Operator resulting in any change of control thereof shall be deemed a transfer of this Agreement by Operator.

*[Alternate Clause]*
OPERATOR

Operator, without consent of Owner, shall have the right to assign this Agreement to any successor or assignee of Operator that may result from any merger, consolidation, or

reorganization, or to any corporation or firm, fifty percent (50%) or more of whose voting stock or control is owned directly or indirectly by Operator, or to another corporation that shall acquire all or substantially all of the business and assets of Operator.

*[Alternate Clause]* OPERATOR

Operator shall have the right to assign its rights and obligations under this Agreement, or any portion thereof or interest therein, to any person or entity that acquires all or substantially all of the assets of Operator, or the partnership interest of any partner of Operator, without the consent of Owner; provided, however, that any such assignee shall expressly assume in writing the obligations of Operator (or the obligations, it any, of such former partner or Operator) hereunder, in which event the liability of Operator (or of such former partner of Operator, as the case may be) hereunder $hall terminate. Operator shall not have the right otherwise to assign its rights and obligations under this Agreement, except with the prior consent of Owner, which consent may not be unreasonably withheld. It is understood and agreed that any approval given by Owner to any assignment shall not be deemed a waiver of the covenant herein contained against assignment in any subsequent case. Any assignee who succeeds to the interest of Operator hereunder (or to the interest of an assignee of Operator hereunder) shall be deemed to be Operator hereunder for all purposes.

*[Optional Additional Clause]* OWNER

Any consent granted by Owner to any such assignment shall not be deemed a waiver against assignment in any subsequent case.

**8.2 Assignment by Owner**

OWNER

Owner shall have the absolute right to assign this Agreement to any person or entity acquiring all of Owner's right, title, and interest in and to the Hotel without the consent of Operator, provided, however, that any such assignee shall expressly assume in writing the obligations of Owner hereunder in which event the liability of Owner shall terminate hereunder and the assignee who succeeds to the interest of Owner hereunder (or to the interest of an assignee of Owner hereunder) shall be deemed to be Owner hereunder for all purposes.

*[Alternate Clause]* OWNER

Owner can sell or lease the property provided that the purchaser expressly assumes in writing all of the Owner's obligations under this Agreement.

**8.3 Acceptable Purchaser**

OPERATOR

Operator shall not terminate this Agreement if the proposed purchaser of the property from Owner is an "Acceptable Purchaser," which shall mean one that has (a) total assets of at least Twenty Million Dollars ($20,000,000) in 1989 dollars, (b) a financial net worth at least equal to twenty-five percent (25%) of the then fair market value of the Hotel (or such proportion if less than all of the Hotel is to be sold), (c) a reputation in the business world generally at least equal to that of Owner and its constituent transferors, (d) no significant part of its business in competition with Operator as a national or regional hotel chain (whether or not in direction competition with the Hotel), and (e) an agreement with Owner to execute at the closing of such proposed sale a document in writing assuming all of the Owner's obligations pursuant to this Management Agreement

*[Alternate Clause]* OWNER

If Owner's interest in the Hotel is contracted to be sold or leased, this Agreement shall remain in lull force and effect and binding upon Operator, except that Operator shall have the right to terminate this Agreement effective upon transfer of ownership of the Hotel if the purchaser or lessee is: (a) in the reasonably and good faith opinion of Operator, not of sufficient net worth to comply with the obligations reasonably anticipated at such time to be incurred by Owner hereunder, (b) a party who is generally reputed to be controlled by

persons known to be engaged in criminal activities or an associate or agent of criminals, or (c) not an operator of hotels or motels Operator shall notify Owner of its election to terminate this Agreement within fifteen (15) days of receipt by Operator of notice of any proposed sale of the Hotel. Operator shall not be entitled to exercise the right of termination it Owner shall have notified Operator in writing of the identity of the proposed purchaser or lessee with reasonable supporting background information pertaining thereto. and within fifteen (15) days of such notification, either (a) Operator does not signify in writing to Owner the manner in which any of such purchaser(s) or lessee(s) fall within any of the categories listed hereinabove, or (b) it, having signified as aforesaid, such objections are thereafter resolved to Operator's reasonable satisfaction, or if not so resolved, determined not to be valid pursuant to an arbitration proceeding.

*[Alternate Clause]* OPERATOR

Owner and Operator recognize that certain Operator Affiliates are now engaged, and will in the future be engaged, in various gaming or casino business activities that are strictly regulated by governmental authorities, and that, by virtue of applicable licensing requirements and other regulations, such activities may be adversely affected by the character and reputation *of* persons with whom Operator does business Accordingly, Owner agrees to notify Operator in writing of the identity of any of the following persons or entities together, in each case, with such additional information concerning any such person or entity, and [tie officers and owners of such entity, as Operator may reasonably request:

**A.** Any proposed assignee of this Agreement in connection with any contemplated sale or lease of the Hotel;

**B.** Any proposed assignee/transferee of a controlling interest in Owner; or

**C**. Any proposed purchaser of a limited partnership interest in Owner in connection with the original offering of such interests or any proposed transferee of any such interest.

Operator shall have a period of ninety (90) days after receipt of such information to investigate the backgrounds and reputations of such persons or entities and shall have the right to disapprove any of the proposed transactions on the basis that it may jeopardize its gaming or casino business activities. Owner and Operator acknowledge the discretionary nature of the governmental regulations and licensing requirements imposed upon Operator Affiliates and agree that Operator shall have the widest possible discretion in withholding its approval if it determines in good faith that any proposed assignment of this Agreement is likely to have an adverse impact or would other wise jeopardize or delay any present or future gaming or casino business venture (including, without limitation, any approvals, temporary or permanent licensing requirements, or other regulatory procedures in connection therewith) engaged in by any Operator Affiliates.

*[Optional Additional Clause]* OPERATOR

Any consent granted by Operator to any such sale, lease, or assignment shall not be deemed a waiver against sale, lease, or assignment in any subsequent case.

### 8.4 Right of First Refusal

OPERATOR

Owner shall extend to Operator a first right to purchase the Hotel in the event that Owner decides to sell the Hotel, or any part thereof, Owner shall extend to Operator in writing the opportunity to buy the Hotel upon certain terms and conditions (the "Offer"). Operator shall have thirty (30) days from its receipt of the Offer to accept same. Operator's failure to accept the Offer within such thirty (30) -day period shall be deemed Operator's refusal to purchase the Hotel on the terms and conditions offered, and Owner shall have the right to sell the Hotel upon the same terms and conditions con

tamed in the Offer, or upon terms more favorable to Owner, provided that a contract reflecting such transaction is executed by Owner and the new Purchaser within nine (9) months of the date Operator declines the Offer. In the event no contract has been executed within such nine (9) -month period, or if a contract has been executed during such period but such contract later fails, Owner must resubmit to Operator a written offer to sell the hotel, or any part thereof and, Operator shall again have thirty (30) days to accept or decline such offer.

**8.5 Future Owners and Operators**

NEUTRAL All references to "Owner" and "Operator" throughout this Agreement shall include and apply to their respective authorized successors and assigns; provided, however, that no assignment of this Agreement shall relieve the assignor of its obligations and liabilities under this Agreement.

**8.6 Assignment as Collateral Security**

OWNER Nothing herein contained shall prevent Owner from assigning this Agreement to any bank, insurance company, or other financial institution as collateral security to any first mortgage on the property.

**8.7 Subordination to Mortgages**

OWNER It is mutually agreed that this Agreement is subject and subordinate to the lien of all and any mortgages (the term "Mortgages" shall include both construction and permanent financing as well as secondary or junior financings and personal property financing and shall include deeds of trust and similar security instruments) that may now or hereafter encumber or otherwise affect the Hotel and to all and any renewals, extensions, modifications, recastings, or refinancings thereof. This clause shall be self-operative and no further instrument of subordination shall be required by any mortgage, trustee, beneficiary, or secured party. However, as confirmation of such subordination, Operator shall, at Owner's request, promptly execute any requisite or appropriate certificate or other documents.

Operator agrees to negotiate in good faith with Owner with respect to any modifications to this Agreement or any ancillary agreement that may reasonably be required or requested by any such construction or permanent institutional first mortgagee. Operator agrees that the operation is expressly conditioned upon the approval hereof by such mortgagee and the satisfaction by Owner and Operator of such additional conditions and requirements as may be imposed by such construction or permanent institutional first mortgagee.

It is agreed that in the event any party shall succeed to the interest of Owner through foreclosure or through a deed in lieu thereof, no liability or outstanding obligation of Owner to Operator that arose prior to such foreclosure or deed shall bind, obligate, or become a liability of such party, but Owner shall remain liable therefore.

It requested to do so by any mortgagee, Operator shall furnish to such mortgagee a copy of any financial report, statement, schedule, or plan required under this Agreement, to be submitted by Operator to Owner.

A copy of all notices of default under this Agreement shall be provided to any mortgagee of the Hotel, and such mortgagees shall be given a reasonable opportunity to cure such default. In addition, upon the request of any mortgagee or of either party hereto, Owner and/or Operator shall provide for such requesting party or such mortgagee estoppel certificates that shall state that this Agreement is in full force and shall specify any known defaults, if any, thereunder. Operator shall certify to such mortgagee, and/or to

Owner, that all preconditions and the full effectiveness of the Agreement have been satisfied and that the Operating Term has commenced.

## Section 9 CONDEMNATION, DAMAGE, OR DESTRUCTION

### 9.1 Partial Condemnation

NEUTRAL If only a part of the Hotel shall be taken or condemned and the taking or condemnation of such part does not make it unreasonable or imprudent, in Operator's reasonable opinion, to operate the remainder as a hotel of the same type and class as immediately preceding such taking or condemnation, this Agreement shall not terminate, but out of the award to Owner so much thereof as shall be reasonably necessary to repair any damage to the Hotel, or any part thereof, so as to render the Hotel a complete and satisfactory architectural unit as a hotel of the same type and class as immediately preceding the taking or condemnation, shall immediately be made available for this purpose, subject to the interests of any mortgagee; and the balance of the award, after deduction of the sum necessary for restoration, shall be distributed to the Owner.

In the event of a taking or condemnation of all or part of the Hotel for temporary use, this Agreement shall remain in lull force and effect. Restoration, repairs, and alterations shall be commenced promptly after the termination of the taking or condemnation for temporary use and same shall be completed with diligence. Operator's fees shall be computed on the basis of actual Gross Income and Adjusted Gross Operating Profit.

To the extent that any of the provisions of this Article conflict with the terms of any mortgage or other secured financing covering the Hotel, the terms of such mortgage or other secured financing shall supersede the provisions herein.

### 9.2 Use of Award for Partial Condemnation

OPERATOR Any compensation or award received by Owner with respect to any taking of the property in partial condemnation shall be used first for any restoration, repair, replacement, or rebuilding required by Operator and, thereafter, any excess shall be divided between Owner and Operator in such proportion that Operator will receive twenty percent (20%) of that fraction of the excess determined by dividing the then-remaining number of years in the term of this Agreement (including partial *years* and assuming exercise of all options to renew) by the remaining number of years in the useful life of the Hotel (for Hotel purposes) prior to the taking.

### 9.3 Total Condemnation

OPERATOR If the whole of the Buildings and the Land shall be taken or condemned by reason of any eminent domain, condemnation, compulsory acquisition, or like proceeding by any competent authority for any public or quasi-public use or purpose, or if such a portion thereof shall be taken or condemned as to make it imprudent or unreasonable, in the reasonable opinion of Owner, to use the remaining portion as 'a hotel of the same type and class as immediately preceding such taking or condemnation, then, in either of such events, this Agreement shall terminate with respect to the Hotel as of thirty (30) days after written notice from Owner to Operator of Owner's decision to terminate this Agreement under this provision, Owner and Operator each shall have the right and authority, as to their respective interests in such hotel, to defend at their own expense against any such taking or condemnation or to sue for or appeal from any such award and, in the exercise of such right, to compromise and settle any such action or award solely as to their own interest in the Hotel, on such terms as they may deem advisable. Operator shall continue to manage

the Hotel and to perform all of the duties required hereunder until such time as this Agreement terminates as herein provided.

### 9.4 Award for Total Condemnation

OWNER

If, in Operator's reasonable opinion, it is not possible to use the remaining portion of the Hotel as a hotel of the type and class immediately preceding such taking or condemnation, then Operator may terminate this Agreement as of the date of such event. Operator shall not be entitled to participate in any award of such taking or condemnation.

*[Alternate Clause]*
OWNER

All proceeds of any condemnation shall belong to Owner, except to the extent that separate award is made to Operator. Operator shall have the right to seek an award in an eminent domain, condemnation, compulsory acquisition, or like proceeding only if such action by Operator is not likely to, and does not, in Owner's opinion, prejudice any of Owner's rights or diminish or adversely affect any award or proceeds sought by or awarded to Owner.

*[Alternate Clause]*
OWNER

Owner shall receive the whole of any award for any complete expropriation; provided, however, that Operator may separately claim, prove, and receive an award for any separately compensable rights of Operator taken in such expropriation only if Operator shows, to Owner's satisfaction, that such claim may be made separately from Owner's claim, and that any award would not adversely affect the timing or amount of the award to which Owner is entitled.

*(Alternate Clause]*
OPERATOR

Operator shall have the right, during the first ten (10) full Fiscal Years of the Operating Term, in the case of either total or partial taking or condemnation, either to institute or to intervene in any available administrative proceeding or judicial action intended to determine just compensation for such taking, for the purpose of representing Operator's compensable interest in any award thereof arising from this Agreement and more specifically from Operator's right of quiet enjoyment pursuant to this Agreement. Such award, after first paying any amounts due any mortgagee and all borrowings of the joint venture owning the property and returning Owner's initial capital contribution to Owner, shall be apportioned between the parties hereto in consideration, without limitation, of the following factors: (a) recoupment by Owner of its investment, (b) return on investment to date, (c) actual loss of income, in the event of partial taking or condemnation, (d) loss of reasonably anticipated future income, in the event of total taking, (e) length of unexpired term and any renewals thereof, and/or (f) proportion that Operator's fees under this Agreement bear to return to Owner after Operator fees. Any award that does not recognize such separate and compensable interest in Operator shall be the subject of arbitration between the parties hereto pursuant to the provisions of this Agreement. Thereafter, Operator may institute a proceeding and shall be entitled only to any separate award made to Operator that does not reduce the award otherwise payable to Owner.

*[Alternate Clause]*
OPERATOR

In the event that this Agreement terminates owing to a full condemnation, the aggregate of the awards or other proceeds of the taking (including any interest included in or paid with respect to such award or proceeds) shall be paid to Owner; provided, however, that if such awards or other proceeds of the taking shall represent loss of income to Operator, Operator shall be entitled to a fair and equitable share of such awards or other proceeds to the extent of such loss of income.

### 9.5 Taking for Temporary Use

NEUTRAL

In the event of a taking of all or part of the Hotel for temporary use, this Agreement shall remain in full force and effect, and the following shall be applicable:

**A.** It the taking is for a period not extending beyond the Operating Term, the awards or other proceeds on account of the taking (including any interest included or paid with respect to such awards or proceeds) other than any portion of such awards or proceeds specifically identified as compensation for alterations or damages to the Hotel shall be included in Gross Revenue and Operating Profit for the Operating Year or Years in which received. When and if, during the Operating Term, the period of temporary use shall terminate, Owner shall make all such restorations, repairs, and alterations as shall be necessary to restore the Hotel to its condition prior to such taking for temporary use and shall complete the same with diligence.

**B.** If the taking is for a period extending beyond the Operating Term, the awards or other proceeds on account of the taking (including any interest included or paid with respect to such awards or proceeds) other than any portion of such awards or proceeds specifically identified as compensation for alterations or damages to the Hotel for the period of the taking up to the staled expiration of the Operating Term shall be included in determining Gross Revenue and Operating Profit for the Operating Year or Years in which received, and the remainder of such awards or other proceeds (including interest as aforesaid) shall be paid to Owner.

**9.6 Owner's Options After Fire or Casualty**

OWNER

If the Buildings, Operating Equipment, or Furniture, Furnishings, and Equipment for the Hotel shall be damaged or destroyed to the extent of twenty-five percent (25%) or more of its replacement cost during the Operating Term by fire or other casualty, Owner shall have the right and option, upon notice served upon Operator within sixty (60) days after such fire or other casualty (or within ten (10) days after ascertaining the amount of such proceeds of insurance, if later), to either (a) replace and restore the Hotel to the condition that existed prior to such destruction and to have the full proceeds from the insurance thereon, in which case this Agreement shall continue in full force and effect, or (b) to terminate this Agreement as to the Hotel, provided that such notice of termination shall be voidable at the option of Operator and by written notice to Owner it, within one (1) year after such notice is given to Operator, Owner (or any affiliate of Owner) shall commence to repair, restore, rebuild, or replace the destroyed Buildings, Operating Equipment, or Furniture. Furnishings, and Equipment with the intent of operating the Hotel as a hotel, motel, or other transient lodging facility. In case of such termination by Owner, the amount of any Incentive Fee due to Operator under this Agreement shall be agreed upon mutually.

**9.7 Termination for Total Destruction**

NEUTRAL

Owner shall be entitled to elect, by written notice given to Operator within ninety (90) days after a fire or other, casualty, to terminate this Agreement, it one of the following conditions is met:

**A.** The Hotel is damaged or destroyed to such an extent that the cost of repairs or restoration exceeds, in Owner's determination, eighty-five percent (85%) of the full replacement cost (excluding excavations, footings, and foundations) of the Hotel; or

**B.** The major food and beverage facilities in the Hotel are rendered substantially unusable for their intended use during the last eighteen (18) months of the Operating Term; or

**C**. The percentage of the guestrooms in the Hotel referred to in column x shall be rendered unsuitable for use by guests as a result of any damage or destruction to the whole or any part of the Hotel when the Operating Term shall have no more than the number of years to run set forth in column y, as follows:

| Percentage *of* Rooms Rendered Unusable *x* | *Years* *y* |
|---|---|
| 55 | Five |
| 40 | Four |
| 30 | Three |
| 20 | Two |
| 10 | One |

*[Alternate* Clause] NEUTRAL If the percentage of the guestrooms in the Hotel referred to in column a shall be rendered unsuitable for use by guests as a result of any damage or destruction to the whole or any part of the Hotel when the term of this Agreement shall have no more than the number of years to run that is set forth in column *b* below, as follows:

| *a* | *b* |
|---|---|
| 50 | Five |
| 40 | Four |
| 30 | Three |
| 20 | Two |
| 10 | One |

then Owner or Operator may terminate this Agreement within thirty (30) days after the occurrence of such damage or destruction by giving notice to the other party hereto irrespective of the insurance coverage applicable to said damage or destruction.

### 9.8 Uninsured Casualty

OWNER If the whole or any part of the Hotel shall be damaged or destroyed by any cause for which insurance coverage was not required to be maintained by Owner, and the cost of the Casualty Restoration with respect thereto shall exceed thirty percent (30%) of the replacement value of the Hotel, as determined by an independent licensed architect selected by Operator and Owner, then Owner may terminate this Agreement by providing written notice to Operator within thirty (30) days after the occurrence of such damage.

### 9.9 Payment to Operator for Casualty Termination

OPERATOR If all or any part of the Hotel is damaged or destroyed to such an extent that the estimated cost of the Casualty Restoration exceeds fifty percent (50%) of the total replacement cost (without deduction for depreciation) of the Hotel, then, if Owner reasonably concludes on the basis of the factors existing at the time of such casualty that it would be uneconomic to repair and restore the Hotel, Owner shall have the right to terminate this Agreement with respect to the Hotel upon payment to Operator of a termination fee equal to five (5) times the total Base Fee and Incentive Fee (without any accrual or limitation based on Cash Available for Incentive Fee) earned by Operator with respect to the Hotel for the most recent full Operating Year. Notwithstanding such termination, the Hotel shall remain subject to Operator's right of first refusal pursuant to this Agreement.

**NOTE:** The termination fee included in the above clause is higher than most such fees. Usually the fee is two or three times the management fee.

### 9.10 Payment to Operator During Restoration

OPERATOR At all times until operations of the Hotel are fully recommenced, Owner shall pay to Operator each month an amount equal to the average total monthly payments paid to Operator for the twelve (12) months preceding the appropriation (or such lesser actual period, if the

Hotel has been managed by Operator for less than twelve (12) months) but in no event an amount that exceeds the sum of Total Revenue and the proceeds of business interruption insurance after payment or provision for payment of all other operating expenses of the Hotel, including debt service on indebtedness permitted to be incurred pursuant to this Agreement and taxes for such month.

### 9.11 Operator's Response to Casualties, Accidents, and Claims

OWNER Operator shall promptly investigate all accidents and claims for damage relating to the ownership, operation, and maintenance of the Hotel and related facilities and any damage or destruction to the Hotel and related facilities. Operator shall report to Owner any such incident that is material, together, if applicable, with the estimated cost of repair thereof.

*[Alternate Clause]* OWNER In the event of any damage or loss to the Hotel by fire or other casualty, Operator shall give immediate written notice thereof to Owner if the damage or loss involves more than Twenty-Five Thousand Dollars ($25,000).

*[Alternate Clause]* OWNER As agent for Owner, Operator shall promptly apply for the insurance covering such damage or loss, and in the Owner's name shall prosecute and negotiate for payment of such proceeds, employing counsel (to be selected by the Owner) if necessary for such purpose.

*[Alternate Clause]* OWNER Operator shall prepare any and all reports required by any insurance company as a result of any such incident and shall submit to Owner the paperwork concerning any material incident for approval prior to submission to any such insurance company.

### 9.12 Restoration of Hotel

NEUTRAL If the Hotel, or any portion thereof, shall be damaged or destroyed at any time or times during the Operating Term by fire or any other casualty, the Owner, at no expense or risk to Operator, shall, using diligence and dispatch, repair, rebuild, or replace the same (such repairing, rebuilding, or replacing being herein referred to as "Restoration") so that after such Restoration the Hotel shall be substantially the same as prior to such damage or destruction, and all proceeds of insurance, other than business interruption insurance, shall be made available to the Owner for this purpose. Owner shall use its best efforts to obtain the consent of any Mortgagee of the Hotel to make insurance proceeds available for application to such Restoration, and it such Mortgagee consents, Operator shall have the right to ensure that such proceeds of insurance shall be applied to such Restoration. If the Owner fails to undertake such Restoration within one hundred twenty (120) days after a fire or other casualty that affects a material portion of the Hotel, or fails to complete the same diligently, Operator may, at its option, terminate this Agreement by written notice to Owner, effective as of the date received by Owner. Operator shall supervise all aspects of the restoration at no cost to Owner, provided, however, that if the proceeds of insurance provide for a supervisory fee, such fee shall be paid to Operator.

## Section 10 TERMINATION RIGHTS

### 10.1 Operator's Breach of Contract

OWNER Owner may terminate this agreement if Operator shall have committed a material breach of this Agreement, or otherwise failed to observe or perform any material covenant or provision of this Agreement, and Owner shall have served written notice upon Operator

setting forth the details of such alleged breach, and Operator shall not, within thirty (30) days after the mailing of such notice, have cured such breach to the reasonable satisfaction of Owner, or if such breach is of a nature that it cannot be cured within such thirty (30) -day period, Operator shall not within such thirty (30) -day period have commenced and at all times thereafter have diligently proceeded with all acts required to cure such breach and does not cure such breach to the reasonable satisfaction of Owner within sixty (60) days. Any such termination under this subdivision shall be without prejudice, however, to any and all other rights and remedies that the Owner may have for breach of this Agreement by the Manager.

*[Alternate Clause]* OWNER

In the event that Operator violates any of its covenants and agreements herein, or fails to perform any of its obligations, undertakings, or conditions as set forth in this Agreement, and shall not cure such failure within thirty (30) days after written notice from Owner, Owner may terminate this Agreement upon ten (10) days' prior written notice to Operator.

### 10.2 Operator's Willful Misconduct or Fraud

OWNER

Owner may terminate this Agreement if Operator shall engage in any act of willful misconduct or fraud with respect to, or the misappropriation or diversion of funds or property of, Owner for Operator's own benefit.

### 10.3 Operator's Bankruptcy

OWNER

If Operator shall file in any court, pursuant to any statute of either the United States or any state, a petition in bankruptcy or insolvency, or for a reorganization, or for the appointment of a receiver or trustee of all or a substantial portion of Operator's property, or if Operator makes an assignment for or petitions for or enters into an arrangement for the benefit of creditors, or if a petition seeking relief under the bankruptcy laws is filed against Operator that is not discharged within ninety (90) days thereafter, then. Owner may terminate this Agreement upon written notice to Operator.

*[Alternate Clause]* OWNER

If Operator shall file a voluntary petition for reorganization or for any arrangement under any provisions of any bankruptcy code now or hereafter enacted, Owner may terminate this Agreement upon written notice to the party filing such petition.

*[Alternate Clause]* OWNER

If a petition shall be filed by any third party for the reorganization of Operator under any provisions of any bankruptcy code now or hereafter enacted and such proceeding is not dismissed within ninety (90) days after such filing, then Owner may terminate this Agreement upon written notice to the party against whom such petition was filed.

### 10.4 Appointment of a Receiver for Operator

OWNER

If a receiver, trustee in involuntary bankruptcy, or other similar officer shall be appointed to take care of all or a substantial portion of the property of Operator, then Owner may terminate this Agreement upon written notice to the party for whom such official has been accepted.

### 10.5 Operator's Assignment for Creditors

OWNER

If Operator makes a general assignment for the benefit of its creditors. Owner may terminate this Agreement upon written notice to the party making such assignment.

### 10.6 Operator Causes Licenses to Be Revoked

OWNER If the property's licenses or permits, including, but riot limited to, occupancy, food, and alcoholic beverage service, are revoked because of the wrongful acts of Operator, Owner may terminate this Agreement upon written notice to Operator.

### 10.7 Operator Causes Franchise to Be Terminated

OWNER If the Franchise is terminated as a result of the operation of the Hotel being in non-compliance with the Franchise requirements, Owner may terminate this Agreement upon written notice to Operator, unless such termination is due to Owner's failure to fund sums to maintain the Franchise in good standing.

### 10.8 Operator Not Active in Hotel Business

OWNER Operator shall be deemed to have ceased to be actively engaged in the business of operating and managing hotels and inns if less than sixty-six and two thirds percent (66$^{2}$3%) of the total gross income of Operator and its wholly-owned Affiliates or wholly owned Related Entities shall be derived from the hotel, inn, catering, restaurant, beverage, and related businesses.

*[Alternate Clause]* OWNER If Operator and other members of its chain collectively shall cease to own, lease, or manage at least ten (10) hotels in the continental United States, Operator shall be deemed to have ceased to be actively engaged in the business of operating and managing hotels and inns.

### 10.9 Operator Fails to Provide Chain Services

OWNER Owner may terminate this Agreement if Operator shall fail to maintain, at Operator's expense, at all times during the Operating Term, a toll-free operator-tended inter-hotel reservation system pursuant to which persons located anywhere in the United States can, without long distance charge to such persons, make reservations by telephone at the Hotel.

### 10.10 Acquisition of Operator by Criminal

OWNER Owner may terminate this Agreement if Operator shall be acquired or controlled by a party who is generally reported to be controlled by persons known to be engaged in criminal activities or an associate of criminals.

### 10.11 Termination of Operator for Poor Operating Performance

OWNER In the event that the Payment to Owner as provided herein shall, for any three (3) consecutive full Fiscal Years, be insufficient to meet Owner's debt service requirements for the Hotel under the original mutually agreed financing plan for the Hotel after provision for real estate taxes, or if during the extended period of operation the Gross Operating Profit of the Hotel as defined herein shall, for any two (2) consecutive Fiscal Years, average less than one hundred fifty (150) times the average room rate for each such year times the number of available guestrooms in the Hotel, Owner shall have the right to issue a Notice of Termination of this Agreement, on three (3) months' notice to Operator. Il such notice is accompanied by a declaration by Owner that it has determined to cease the use of the Improvements as a Hotel, this Agreement shall automatically terminate at the end of the three (3) months' notice period, provided, however, that if at any time within five (5) years thereafter the Improvements are again to be used as a Hotel, Operator shall have the right, but not the obligation, to reinstate this Agreement and to operate the Hotel in accor

dance with the terms and conditions thereof, except that the Operating Term shall be extended for the period in which the building has not been used as a hotel. If the Notice is not accompanied by such a declaration, Operator shall have the right to serve a notice of arbitration upon Owner pursuant to the terms of this Agreement, and the date of termination specified in the notice shall be extended until thirty (30) days alter a final award has been entered that Operator has not sustained the affirmative burden of proving, by a preponderance of evidence, that the failure to meet the performance standard was due to causes or conditions beyond Operator's control. In the event that the arbitrator shall determine that Operator has sustained the aforesaid burden of proof, the aforesaid notice of termination shall be nullified and shall have no force and effect.

**NOTE:** The preceding clause provides for termination due to the operator's failure to achieve specific profit levels.

*[Alternate Clause]* OWNER

In addition to the foregoing rights of termination for default, if the Adjusted Gross Operating Profit for any two (2) consecutive fiscal years occurring after the first three (3) full Fiscal Years (i.e., Fiscal Years of not less than three hundred sixty-five (365) days) of the Operating Term of this Agreement shall be less than zero (0) for each such Fiscal Year, Owner may terminate this Agreement.

Operator shall have the right; but not the obligation, on one occasion and one occasion only, to pay Owner the difference between the actual Adjusted Gross Operating Profit for either of the two consecutive Fiscal Years that give rise to Owner's right to terminate on which Owner's said notice was based and zero (0) (or such amount to which it may have been reduced in accordance with the preceding paragraph), in which event Owner's notice of termination shall be deemed withdrawn, provided, however, that in the event the next fiscal year following such cure by Operator results in an adjusted gross operating profit of less than zero (0), Owner shall have the option to terminate.

**NOTE:** The preceding clause gives the operator the right to cure.

*[Alternate Clause]* OWNER

Owner shall have the right, within sixty (60) days after the sixth (6th) anniversary of the Formal Opening Dale, to terminate this Agreement by giving Operator written notice during such sixty (60) -day period of Owner's intent to terminate this Agreement on a date set forth in such notice, which date shall not be less than ninety (90) days nor more than one hundred eighty (180) days after Operator's receipt of such notice, if Operator fails to achieve a Total Income Before Fixed Charges of at least $................ during the twelve (12) months immediately preceding the sixth (6th) anniversary of the Formal Opening Date.

If Owner so advises Operator of Owner's intent to terminate this Agreement in such a manner, Operator shall have fifteen (15) days from the date of receipt of such notice of termination during which Operator may cure such failure by loaning to Owner an amount equal to the difference between $ ..and the Total Income Before Fixed Charges actually achieved by the Hotel in the twelve (12) months immediately preceding the sixth (6th) anniversary of the Formal Opening Date.

In the event that Operator cures such failure described above by making a loan to Owner, such loan shall be evidenced by a promissory note from Owner to Operator, in form and substance satisfactory to Operator and consistent with the terms hereof, and shall bear interest at the rate of six percent (6%) per annum. Repayment of the full amount of the loan is to be made from Cash Flow beginning in the *year* following the seventh (7th) anniversary of the Formal Opening Date, after payment of the Incentive Management Fees due and payable as provided for herein, and payments on such loan shall be made monthly or otherwise as such Cash Flow is available until such loan has been paid in full

**NOTE:** The preceding clause allows the operator to cure its default by making a loan.

*[Alternate Clause]* OWNER

If, after the first two (2) lull calendar years of operation, the Hotel has no Gross Operating Profit in any Operating Year, Owner may, at its option, terminate this Agreement, unless Operator advances the necessary funds required to fully cover (a) any negative Gross Operating Profit; (b) plus an amount equal to a fifteen percent (15%) annual return on equity funds *(as* hereinafter defined) invested in the Hotel. Should Operator advance any funds necessary for such purpose. Operator shall be reimbursed for any such advances out of future Adjusted Gross Operating Profit, if any, derived from the operation of the Hotel; provided, however, that such reimbursement shall not result in a negative Adjusted Gross Operating Profit and provided that such reimbursement shall reduce Adjusted Gross Operating Profit upon which any Incentive Fee is computed Such reimbursement shall be in an amount equal to the amount so advanced plus interest on the balance of funds advanced outstanding from time to time at a rate of fifteen percent (15%) per annum, provided, however, that such reimbursement shall be payable only from funds remaining after Owner shall have received a fifteen percent (15%) return on Equity Funds invested in the Hotel

*[Optional Additional Clause]* OWNER

In addition to the other provisions regarding termination herein provided, Owner shall have the right to terminate this Agreement if after five (5) full years of operation of the Hotel, eighty percent (80%) of the Adjusted Gross Operating Profit for any subsequent Operating Year does not equal at least a fifteen percent (15%) annual return for equity funds invested in the Hotel.

As used herein, the term "Equity Funds" shall mean all funds invested in or loaned to Owner by its principals and applied to the construction and operation of the Hotel over and above all borrowed funds, plus lair market value of all other assets, such as land contributed by the principals in Owner to Owner in return for a capital account credit, but only to the extent such assets are used in connection with the Hotel.

*[Alternate Clause]* OWNER

Owner shall have the right, at its option, to terminate this Agreement on thirty (30) days' written notice to Operator if, for any two (2) consecutive Fiscal Years during the Operating Term, the amount of Gross Operating Profit is less than the amount corresponding to each of the following Fiscal Years:

| *Year* | Gross *Operating Profit* | *Percentage of Market Study Projections* | *Percentage Cash on Equity* |
|---|---|---|---|
| 1988 | $1,197,000 | 95 | 5.3 |
| 1989 | 1,447,000 | 95 | 13.4 |
| 1990 | 1,619, 000 | 95 | 19.0 |
| 1991 | 1,692,000 | 90 | 21.4 |

For each *year* thereafter, the Gross Operating Profit number will be adjusted by the Consumer Price Index. In the event the Hotel were to be wholly or partially closed for business during any such year, for reasons beyond the control of Operator, then the foregoing performance standards shall be equitably adjusted.

Notwithstanding the above, Operator shall have a one-time right to cure the termination by paying to Owner, within five (5) business days, the amount that the actual Gross Operating Profit was deficient for each of the two Fiscal Years. If Operator makes this payment, the termination will be waived; however, if the actual Gross Operating Profit is less than the amount corresponding for the immediately succeeding Fiscal Year, Owner will again have the right to cancel this Agreement, and, as Operator will have already used its one-time right to cure, Operator will not be able to cure. If this Agreement is terminated as a result of this provision, the Incentive Fee to Operator will remain in effect.

*[Alternate Clause]* OWNER

A "Negative Earnings Event" shall occur if, at the completion of any Fiscal Year, the cumulative Performance Test Cash Flow for all Fiscal Years through such Fiscal Year is less

than One Dollar ($1). "Performance Test Cash Flow" shall mean Cash Flow Available for Debt Service less Notional Free and Clear Cash Flow.

"Notional Free and Clear Cash Flow" shall be (a) none ($0) through and including that Fiscal Year (the "Base Year") in which the Renovation Program is completed, (b) One Million Five Hundred Thousand Dollars ($1,500,000) for the first full Fiscal Year following the Base Year, (c) Two Million Five Hundred Thousand Dollars ($2,500,000) for the second full Fiscal Year following the Base Year, (d) Three Million One Hundred Thousand Dollars ($3,100,000) for the third full Fiscal Year following the Base Year, and (e) Three Million Four Hundred Thousand Dollars ($3,400,000) for the fourth full Fiscal Year following the Base Year and each Fiscal Year thereafter.

If a Negative Earnings Event shall occur, Owner may elect to terminate this Agreement upon written notice to Operator, within ninety (90) days after receipt of the annual financial statements as provided herein disclosing the occurrence of such a Negative Earnings Event. In this event, this Agreement shall terminate on the last day of the second (2d) calendar month following the month in which such notice was given.

A Negative Earnings Event shall not be a default hereunder, nor shall a default hereunder be a Negative Earnings Event.

*[Alternate Clause]*
OWNER

Beginning in the fourth (4th) lull or partial Fiscal Year of operation of the Hotel. Operator shall achieve a level of performance (the Performance Standard) that is at least equal to eighty-five percent (85%) of the approved budgeted Gross Operating Profit or any revised approved budgeted Gross Operating Profit. If Operator fails to achieve the Performance Standard for three Fiscal Years of any five (5) -fiscal-year period, Owner shall have the option to terminate (his Agreement. Notwithstanding the foregoing, if the Performance Standard is not met for any Fiscal Year, the Performance Standard shall be deemed to be met for such Fiscal Year to the extent that the deficiency for that Fiscal Year ("Performance Deficiency") is cured by operations in the succeeding Fiscal Year. To the extent that operations in the next succeeding Fiscal Year do not cure the Performance Deficiency, Operator may at its option contribute an amount equal to the Performance Deficiency for such Fiscal Year by deposit in the Bank Account (as hereinafter defined) by April 30 of the second (2d) succeeding Fiscal Year, and upon such contribution, the Performance Standard shall be deemed to have been met for the Fiscal Year.

**10.12 Termination by Owner Upon Payment of Termination Fee**

OWNER

From the Formal Opening Date until the second anniversary of the Formal Opening Date, Owner shall have no right to terminate this Agreement except for those events of default set forth herein. Commencing with the second (2d) anniversary of the Formal Opening Date, this Agreement may be terminated by Owner for any reason by notice to Operator of Owner's intent to terminate this Agreement upon the expiration of a period of not less than ninety (90) nor more than one hundred eighty (180) days from the date of notice and payment of the following amounts:

**A.** If notice is given by Owner to Operator during the period commencing on the second (2d) anniversary of the Formal Opening Date, but prior to the fifth (5th) anniversary of the Formal Opening Date, Owner shall *pay* Operator a fee equal to one and one half (1 1/2) times the amount of Base Management, Centralized Service, and Incentive Fees earned by Operator for the twelve (12) months immediately preceding the date of termination.

**B.** If notice is given by Owner to Operator alter the fifth (5th) anniversary of the Formal Opening Date, and prior to the tenth (10th) anniversary of the Formal Opening Date, Owner shall pay Operator a fee equal to one (1) times the amount of Base Management, Centralized Services, and Incentive Fees earned by Operator during the twelve (12) months immediately preceding the date of termination.

**C.** If notice of termination is *given* by Owner to Operator after the tenth (10th) anniversary of the Formal Opening Date, Owner shall pay Operator a fee equal to seventy-five percent (75%) of the Base Management, Centralized Services, and Incentive Fees earned by Operator during the twelve (12) months immediately preceding the notice of termination. In no event, however, shall the amount paid Operator by Owner under this provision be greater than the amount determined by multiplying (i) the amount earned by Operator during the year commencing on the ninth (91h) anniversary of the Format Opening Date for Base Management Fees, Centralized Services, and Incentive Fees by (ii) a fraction, the numerator of which is the latest published Consumer Price Index figure available as of the date of termination and the denominator of which is the latest published Consumer Price Index figure available as of the tenth (10th) anniversary of the Formal Opening Date.

**NOTE:** Termination fees generally range up to three times the total management fee paid over the previous 12-month period.

*[Alternate Clause]* OPERATOR If this Agreement terminates pursuant to Owner's election, Owner shall pay to Operator liquidated damages, representing the agreed. reasonable stipulated sum of all loses suffered by Operator because of such termination (including, without limitation, home office and key Hotel personnel commitments and loss of profits), in an amount equal to three (3) times annual fees and charges payable to Operator in the Fiscal Year ended immediately prior to the date on which Owner gives a termination notice to Operator.

*[Alternate Clause]* OWNER Owner may terminate this Agreement without cause and upon thirty (30) days' prior written notice only in the event of a sale of the Hotel to a third party and then only as follows:

**A.** There shall be no right to terminate hereunder for the first three (3) years after the Effective Date;

**B.** If the Agreement is terminated in the fourth (4th) year, Owner will pay to Operator three (3) times the prior year's Base Management Fee as liquidated damages;

**C.** If the Agreement is terminated after the fourth (4th) year, Owner will pay to Operator the lesser of two and one half *(2½), or* the number of years remaining under the Initial Term, times the prior year's Base Management Fee as liquidated damages.

**D.** In addition, Operator shall be entitled to receive its Incentive Management Fee upon such sale, as per provisions of this Agreement.

**10.13 Owner Indemnifies Operator After Termination**

OPERATOR As a further condition of termination for any reason, Owner and, if this Agreement terminates in connection with a sale, any successor Owner shall indemnify and keep Operator harmless against any and all losses, costs, damages, liabilities, claims, and expenses, including reasonable attorney fees, arising or resulting from the failure of Owner or any prospective purchaser, lessee, or operator to provide any of the services contracted for in connection with the business booked for the Hotel to and including the date of termination, including any and all business so booked as to which facilities or services are to be furnished subsequent to the date of termination.

**10.14 Termination by Operator**

OPERATOR This Agreement and the employment of Operator may be terminated at the option of Operator ninety (90) days alter written notice, and, except as to liabilities or claims that shall have accrued or arisen prior to such termination, all obligations hereunder shall cease upon the happening of any of the events specified herein below.

**10.15 Owner's Breach of Contract**

OPERATOR

Operator may terminate this Agreement if Owner shall have committed a material breach of this Agreement, and Operator shall have served written notice upon Owner setting forth the details of such alleged breach, and Owner shall not, within ten (10) days after the mailing of such notice in the case of a monetary default, have cured such breach, or if Owner shall not, within thirty (30) days after the mailing of such notice in the case of any other default, have cured such breach, or if such breach is of a nature that it cannot be cured within such thirty (30) -day period, and Owner shall not within such thirty (30) -day period have commenced and at all times thereafter have diligently proceeded with all acts required to cure such breach or does not cure such breach within sixty (60) days. Any such termination under this subdivision shall be without prejudice, however, to any and all other remedies that the Manager may have for breach of this Agreement by the Owner.

*[Alternate Clause]*
OPERATOR

In the event that Owner violates any of its covenants and agreements herein, or fails to perform any of its obligations, undertakings, or conditions as set forth in this Agreement, and shall not cure such failure within thirty (30) days after written notice from Operator, Operator may terminate this Agreement upon ten (10) days' prior written notice to Owner.

**10.16 Owner's Bankruptcy**

OPERATOR

If Owner shall file, in any court and pursuant to any statute, of either the United States or any State, a petition in bankruptcy or insolvency or for a reorganization or for the appointment of a receiver or trustee of all or a substantial part of Owner's property, or if Owner makes an assignment for or petitions for or enters into an arrangement, for the benefit of creditors, or if a petition seeking relief under the bankruptcy laws is filed against Owner that is not discharged within ninety (90) days thereafter, Operator may terminate this. Agreement upon written notice to Operator.

*[Alternate Clause]*
OPERATOR

If Owner shall file a voluntary petition for reorganization or for any arrangement under any provisions of any bankruptcy code now or hereafter enacted, Operator may terminate this Agreement upon written notice to the party filing such petition.

*[Alternate Clause]*
OPERATOR

If a petition shall be filed by any third party for the reorganization of Owner under any provisions of any bankruptcy code now or hereafter enacted and such proceeding is not dismissed within ninety (90) days after each filing, then the Operator may terminate this Agreement upon written notice to the party against whom such petition was filed.

**10.17 Appointment of a Receiver for Owner**

OPERATOR

If a receiver, trustee in involuntary bankruptcy, or other similar officer shall be appointed to take care of all or a substantial portion of the property of Owner, then Operator may terminate this Agreement upon written notice to the party for whom such official has been accepted.

**10.18 Owner's Assignment for Creditors**

OPERATOR

If Owner makes a general assignment for the benefit of its creditors, the Operator may terminate this Agreement upon written notice to the party making such assignment.

**10.19 Owner Causes Licenses to Be Revoked**

OPERATOR

Operator shall have the right to cancel and terminate this Agreement with respect to the Hotel if Owner causes any material license, permit, or other governmental authorization

necessary for the operation of the Hotel in accordance with the provisions of this Agreement to be revoked, rescinded, or terminated or its renewal to be refused by the governing authority having jurisdiction thereof where such revocation, rescission, termination, or refusal to renew is due to circumstances beyond Operator's control.

**10.20 Owner Falls to Provide Adequate Funds**

OPERATOR Operator may terminate this Agreement upon Owner's failure to maintain agreed-upon minimum balance in the Property's operating bank account.

**10.21 Owner Fails to Compensate Operator**

OPERATOR Operator may terminate this Agreement it compensation due Operator from Owner is not received by Operator thirty (30) days after Operator has submitted a written request for such compensation.

**10.22 Owner's Default Under Ground Lease or Mortgage**

OPERATOR Operator may terminate this Agreement as a result of a default by Owner under the ground lease (if any) or the mortgage, or if the landlord or mortgagee shall declare a default or take any other action in pursuance of the remedies arising as result of such default.

**10.23 Owner Not in Compliance With Municipal Laws**

OPERATOR If Owner shall fail to comply with any rule, order, termination, ordinance, or law of any federal, state, county, or municipal authority and Owner is not in good faith contesting same, Operator may terminate this Agreement upon ten (10) days' written notice to Owner.

**10.24 Condemnation of Property**

OPERATOR Operator may terminate this Agreement if the property is condemned in whole or in part and if Operator determines that the remaining facilities are insufficient for the efficient and profitable operation of the property.

**10.25 Owner Fails to Restore After Casualty**

OPERATOR Operator may terminate this Agreement if the property or any portion thereof shall be damaged or destroyed by fire or other casualty and if Owner fails to undertake to repair, restore, rebuild, or replace any such damage or destruction within ninety (90) days after such fire or other casualty, or shall fail to complete such work diligently.

**10.26 Owner Falls to Secure Financing**

OPERATOR Operator may terminate this Agreement if Owner has not secured firm investment commitments and firm financing commitments in amounts and upon terms approved by Operator in order to finance the construction, furnishing, equipping, and operation of the property.

**10.27 Owner Interferes in Operation**

OPERATOR Operator may terminate this Agreement if Owner repeatedly fails or refuses to observe Operator's right of non-interference.

### 10.28 Termination by Operator for Any Reason

OPERATOR

Operator may terminate this Agreement with or without cause if it gives thirty (30) days' notice in writing to Owner, without payment of any damages to Owner, after the first (1st) complete year of operation.

### 10.29 Operator May Not Terminate Because of Foreclosure

OWNER

If any mortgagee or other person or legal entity shall become Owner of the property, or any part thereof, as a result of any foreclosure or a conveyance in lieu of foreclosure, Operator shall have no right or power to terminate this Agreement solely because of such change in ownership of the property, or any part thereof, and shall recognize the mortgagee or such other person or legal entity as Owner hereunder to the same extent as though it or they had been Owner hereunder as of the execution of this Agreement, provided that such mortgagee or such other person or legal entity shall agree in writing with Operator to be bound by the terms and conditions of this Agreement to the same extent as if such mortgagee or such other person or legal entity had been an original party hereto.

### 10.30 Termination by Mutual Consent

NEUTRAL

This Agreement and the employment of Operator may be terminated at any time by mutual agreement of Owner and Operator.

### 10.31 Termination Because Hotel Does Not Open

NEUTRAL

If the opening of the Hotel shall not have occurred by July 1, 1990, then this Agreement shall terminate, unless Operator, by notice given to Owner prior to such date, shall elect to continue them in full force and effect for such period or periods of time as it shall, in its sole discretion, determine by so stating in said notice.

### 10.32 No Default During Arbitration

NEUTRAL

Notwithstanding the foregoing, neither Owner nor Operator shall be deemed to be in default under this Agreement if a bona tide dispute with respect to any of the foregoing events of default has arisen between Owner and Operator and such dispute has been submitted to arbitration.

### 10.33 Payment of Accounts After Termination

NEUTRAL

All accounts due and owing as between the parties shall become immediately due and payable upon termination, including a pro rata share of the Basic Fee and Incentive Fee then due Operator, if any.

*[Alternate Clause]*

OPERATOR

Upon termination of this Agreement after the Commencement Date for any reason, Operator shall be entitled to receive from Owner the following amounts, subject to Owner's right of set-off in cases of termination of this Agreement by Owner because of a breach of this Agreement by Operator:

A. Reimbursement of all expenses incurred with respect to the Hotel and to which it is otherwise entitled pursuant to this Agreement.

B. Payment of all of its Basic Fees, Deferred Fees (and accrued interest thereon), Incentive Fees, and Centralized Financial Services Charges to date of termination;

C. Payment of any other sums due Operator hereunder; and

D. Reimbursement of the actual cost, together with administrative costs incurred, of all non-cancelable or non-terminable employee benefits to which employees (whether employed by Owner or Operator, other than those who continue to be employed by Operator after such termination) and their covered dependents may be entitled alter the date of termination of this Agreement, including, without limitation, any amounts required to be paid pursuant to the Employee Retirement Income Security Act of 1974, as amended, in accordance with the terms of such documents or instruments as may be in force on the date of termination of this Agreement provided, that (i) the parties shall cooperate, to the extent reasonably practicable, in order to create plans and provide benefits such that there will be no liability pursuant to this section as a result of the termination of the coverage of any such employees pursuant to such plans; and (ii) the parties shall cause the trustee under any defined benefit plan that applies to employees of Owner pursuant to a collective bargaining agreement to determine, or cause an actuary selected by it to determine, as of the termination date of this Agreement, the excess of the accrued vested benefits over the balance of funds in such plan or, in the case of a multi-employer plan, the amount of the termination liability attributable to Owner's participation in the plan pursuant to the collective bargaining agreement relating to employees of the Hotel, and, at such times as such excess or termination liability is required to be funded, Operator shall fund twenty percent (20%) of such amount as of the termination date but will not, however, be obligated to fund amounts pursuant to this provision or the immediately following sentence that, in the aggregate, exceed the aggregate of Incentive Fees paid to Operator pursuant to this Agreement. Twenty percent (20%) of the cost of such determination and any costs associated therewith shall be paid by Operator. The balance of any amounts not required to be paid by Operator pursuant to this subsection D shall be Owner's obligation. Upon termination of this Agreement, Operator shall render a final accounting within forty-five (45) days after the end of the month of termination, regardless of the reason for such termination.

### 10.34 Operator to Remove Property After Termination

OWNER At the termination of this Agreement, Operator shall remove all its property from hotel's premises.

### 10.35 Operator to Deliver Property to Owner After Termination

OWNER Upon termination of this Agreement, Operator agrees to deliver to Owner any and all Furnishings and Equipment (along with then existing warranties, operating instructions, and service contracts). Operating Supplies, keys, locks and safe combinations, reservation lists, ledgers, bank statements for the Hotel Operating Account, budgets, accounting books and records, insurance policies, bonds and other documents, memoranda, schedules, lists, contracts, agreements, leases, licenses, correspondence, and other items required for' the operation of the Hotel, including the Working Capital and the Reserve Fund. Any of the foregoing which are held in Operator's name shall be assigned by Operator to Owner.

*[Optional Additional]* OWNER Upon termination of this Agreement, all of such books and records forthwith shall be turned over to Owner so as to ensure the orderly continuance of the operation of the Hotel, but such books and records shall be available to Operator at all reasonable times for inspection, audit, examination, and transcription for a period of three (3) years thereafter.

*[Alternate Clause]* OWNER Operator shall transfer to Owner (a) all of Owner's books and records regarding the Hotel that are in the custody and control of Operator, and (b) all Operator's right, title, and interest in and to all liquor, restaurant, and other licenses and permits, if any, used by

Operator in running of the Hotel; provided, however, that if Operator has expended any of its own funds in the acquisition of such licenses and permits, Owner shall reimburse Operator therefor if Owner requests such assignment and transfer of such licenses and permits.

**10.36 Inventory at Termination**

OPERATOR Upon termination of this Agreement, at the expense of Owner, Operator shall arrange for an independent agency to conduct an inventory of Furnishings and' Equipment (the cost of which shall be an Expense of Operation), copies of which shall be made available to both Owner and Operator.

**10.37 Operator to Assign Licenses at Termination**

OWNER Operator shall, in connection with the termination of this Agreement, surrender and assign to Owner any and all licenses, permits, and/or other authorizations or property required for the operation of the Hotel in accordance with the directions of Owner and with applicable governmental laws, regulations, orders, or other provisions.

**10.38 Cooperation During Termination**

NEUTRAL During the period of termination of this Agreement, Owner and Operator shall fully cooperate with each other in connection with all matters relating to the Hotel that took place prior to termination.

**10.39 Use of Operating Supplies on Termination**

OPERATOR Upon the expiration or earlier termination of this Agreement, Owner shall have the right to use in connection with the operation of the Hotel any and all items of Operating Supplies bearing the name of Operator, but shall not reorder any such items. However, it within fifteen (15) days after termination of this Agreement, Operator offers to buy any and all of said Operating Supplies bearing the name of Operator, trademarks, emblems, insignias, slogans, or distinguishing characteristics, at fair market value, Owner shall cease to use same and shall sell same to Operator. In the event of any dispute as to such fair market value, the Independent Auditor shall determine said value. Removal of Operator's name from the Hotel shall be at Operator's cost.

*[Alternate Clause]* OWNER Operator will purchase from Owner, for a purchase price equal to fair market value but not exceeding cost, all unbroken cases of operating supplies and expendable products then on hand at the Hotel or ordered or purchased and that bear only the identification of Operator.

## Section 11 GENERAL PROVISIONS

**11.1 Ownership of Hotel**

NEUTRAL Owner covenants and agrees that its right, title, and interest in and to the Hotel will upon the Commencement Date be as detailed in the description of the hotel project, the survey, and the legal description of the land attached hereto as Exhibit I [omitted).

**NOTE:** The preceding clause assures the Operator that the contract is with the actual owner of the hotel.

### 11.2 Qualifications of Operator

NEUTRAL Operator is qualified in the supervision, operation, and management of hotels.

### 11.3 Engagement of Operator

NEUTRAL Owner desires to engage Operator to manage and operate the Hotel for the account of Owner, and Operator desires to accept such engagement, all upon the terms and conditions hereinafter set forth

*[Alternate Clause]* OPERATOR Owner turns over to Operator all control and discretion in the operation, direction, management, and supervision of the property

### 11.4 Furniture, Fixtures, and Equipment

NEUTRAL The phrase "Furniture, Fixtures, and Equipment" shall mean the furniture, furnishings, fixtures, and equipment installed and used in the Hotel, including, without limitation: (a) all necessary furniture and furnishings for guestrooms, public areas, and non-public areas (e.g., kitchen, laundry, and cleaning facilities, rooms for the use of employees, storage areas, front desk, and administrative offices), floor and window coverings; decorative light fixtures; and equipment. However, this phrase shall not encompass the Hotel's major mechanical and electrical equipment and systems (e.g., the elevators).

**NOTE:** The preceding clause provides a definition of furniture, fixtures, and equipment for the Hotel. Such a definition is important because such items are generally replaced from a Reserve for Replacement account.

### 11.5 Licenses

NEUTRAL Owner hereby certifies that it has all necessary food and liquor licenses authorizing sale and consumption upon the premises.

### 11.6 Franchise

OPERATOR Owner will keep in full force and effect the Franchise, if any, and will comply with all terms and conditions of such Franchise required to be performed by Owner.

### 11.7 Operator's Right to Quiet Enjoyment

OPERATOR Owner covenants to Operator that, so long as no grounds exist for termination of this Agreement by Owner, Operator shall and may peaceably and quietly possess, hold, occupy, enjoy, and manage the Hotel throughout the Operating Term, free from molestation, eviction, ejection, or disturbance by Owner, any person through whom Owner may derive title to the Hotel, or any other person claiming by, through, or under Owner. Owner agrees to pay and discharge any payments and charges and, at its expense, to prosecute or defend all appropriate actions, judicial or otherwise, necessary to ensure such peaceful and quiet possession of the Hotel by Operator.

*[Alternate Clause]* OPERATOR The parties acknowledge and agree that the continued operation by Operator of the Hotel pursuant to the terms hereof represents a valuable asset of Operator, and, moreover, is critical to the maintenance by Operator of its reputation in the hotel industry. Therefore, and notwithstanding any provision of law or of this Agreement otherwise pertaining, it is agreed that any attempt by Owner to disturb Operator's right to quiet enjoyment of the Hotel or to terminate this Agreement, other than in strict accordance with its terms, would

cause Operator to suffer great, incalculable, and irreparable harm, and may be enjoined by Operator in any court of law having jurisdiction, to the end that this Agreement may be specifically enforced in the aforesaid manner by Operator.

**NOTE**: Although the preceding clause is attractive from the operator's viewpoint, it sets the owner up for a massive damage suit if the contract is terminated. In addition, this provision might impact the principal-agent relationship that allows for termination of the agency. An owner would be unlikely to agree to this clause.

**11.8 Initial Operating Term**

NEUTRAL The phrase "Operating Term" shall mean and refer to that period commencing on the *Effective .Dale and ending at 11:59 PM on the last day of the fifteen (15th) full Fiscal Year* thereafter, or on any earlier date upon which this Agreement terminates pursuant to the provisions hereof.

*[Alternate Clause]* NEUTRAL The obligations of Owner and the services of Operator under this Agreement shall commence upon the completion of the construction of the Hotel and the issuance of all permits required for the operation of the Hotel (the "Commencement Date") and shall expire on December 31 of the fifteenth (15th) year following the Commencement Date, unless terminated sooner by the terms of this Agreement.

**11.9 Renewal Terms**

OWNER After the expiration of the initial Operating Term, the term of this Agreement shall continue on a calendar year-to-year basis unless canceled by Owner upon the giving of four (4) months' advance written notice.

*[Alternate Clause]* OPERATOR Operator shall have the right to extend the Operating Term for three (3) successive periods of ten (10) years each, provided that the following conditions are met:

A. Owner at such time is not entitled to terminate this Agreement by reason of Operator's default;

B. The Operating Term shall have been extended for all prior periods; and

C. Operator shall have given notice to Owner of its, election to extend the Operating Term on or before the first (1st) day of January on the last full calendar year of the Initial Operating Term, or any extension thereof then in force.

**11.10 Delegation of Authority**

OPERATOR The operations of the Hotel shall be under the supervision, direction, and control of Operator, and, except as otherwise specifically provided in this Agreement, Owner delegates to Operator sole and full responsibility for the proper and efficient operation, management, and maintenance of the Hotel.

**NOTE:** In the preceding clause, the phrase "without interference from Owner" can be added to strengthen the operator's position.

**11.11 Establishment of an Agency Relationship**

NEUTRAL In the performance of its duties as Operator, Operator shall act solely as agent of Owner. No provision of this Agreement shall constitute or be construed to be or create a partnership or joint venture between Owner and Operator.

### 11.12 Operator as Independent Contractor

OPERATOR Owner hereby appoints and engages Operator, and Operator hereby accepts such appointment on the terms and conditions hereinafter provided by this Agreement, to maintain, operate, manage, supervise, rent, and lease the Hotel on Owner's behalf. The performance of all activities by Operator hereunder shall be as an independent contractor and not as an agent of Owner, except as otherwise specifically provided herein. Operator's appointment and engagement hereunder encumbers the Hotel and runs with the Land upon which the Hotel is situated.

**NOTE:** The preceding clause attempts to make the owner-operator relationship an encumbrance that runs with the land in the manner of a lease, thereby giving the operator greater possessory rights. It is doubtful, however, whether a management contract can be construed as anything more than an agency agreement.

### 11.13 Use of Property

OWNER Operator shall use the property solely for the operation of a hotel under standards comparable to those prevailing in the hotel industry and for all activities in connection therewith that are customary and usual to such an operation. Operator, in any event, shall comply with and abide by all applicable laws and regulations

### 11.14 Nature of Agreement

NEUTRAL The relationship of Owner and Operator created hereby is that of a principal and agent, it being understood that Operator's agency is defined by virtue of this Agreement. Nothing herein contained shall constitute or be construed to be or create a co-partnership or joint venture between Owner and Operator with respect to the management of the Hotel as provided for in this Agreement.

### 11.15 Operator Does Not Guarantee Profits

OPERATOR Operator makes no guarantee, warranty, or representation that there will be profits or that there will not be losses from the operation of the Properly.

### 11.16 Reliance on Operator's Projections.

OPERATOR Owner hereby certifies that it has not relied on any projection of earnings, statements as to the possibility of future success, or other similar matter that may have been prepared by Operator, and understands that no guaranty is made or implied by Operator as to the future financial success of the Hotel.

### 11.17 Timely Consent by Parties

NEUTRAL Except as herein otherwise provided, whenever in this Agreement the consent or approval of Owner or Operator is required, such consent or approval shall not be unreasonably withheld or delayed and shall be in writing, signed by an officer or agent, thereunto duly authorized, of the party granting such consent or giving such approval. In cases where consent or approval is required, the failure to respond within twenty (20) Business Days of the receipt of the request for such consent or approval shall be conclusively deemed to constitute the requested consent or approval unless another period is expressly provided for in this Agreement in which case the other period shall apply.

#### 11.18 Severability

NEUTRAL In the event any term or provision of this Agreement or any application thereto to any person or circumstance shall be declared prohibited, invalid, or unenforceable to any extent in any jurisdiction, as determined by a court of competent jurisdiction, such term or provision shall, in that jurisdiction, be ineffective only to the extent of such prohibition, invalidity, or unenforceability, or as applied to such persons or circumstances, without invalidating or rendering unenforceable the remaining terms or provisions hereof or affecting the validity or enforceability of such term or provision in any other jurisdiction or as to other persons or circumstances in such jurisdiction, unless such would effect a substantial deviation from the general intent and purpose of the parties or make a significant change in the economic effect of the Agreement on the party benefited by such term or provision.

#### 11.19 Partial Invalidity

NEUTRAL In the event that any portion of this Agreement shall be declared invalid by order, decree, or judgment of a court, this Agreement shall be construed as if such portion had not been inserted herein except when such construction would operate as an undue hardship to Operator or Owner or constitute a substantial deviation from the general intent and purpose of said parties as reflected in this Agreement.

#### 11.20 Binding Effect

NEUTRAL This Agreement shall be binding upon Owner and Operator and, as provided in this Agreement, their respective successors and assigns, provided that, except as specified in this Agreement, neither of the parties hereto shall assign their rights hereunder without the consent and approval of the other party. This Agreement contains the final and entire agreement between the parties hereto. No change or modification of this Agreement shall be valid or binding upon the parties hereto unless such change or modification shall be in writing and signed by the parties hereto. Neither the parties nor their agents shall be bound *by any* terms, conditions, statements, warranties, or representations, oral or written, not herein contained.

#### 11.21 Notices

NEUTRAL Any notice, statement, or demand required to be given under this Agreement shall be in writing, sent by certified mail, return receipt requested, postage prepaid. Notices shall be sent to Owner at the address specified hereinabove or at such or to such other address or addresses as Owner shall designate in the manner herein provided. Notices shall be sent to Operator, at the address specified hereinabove, marked "Attention: President," with a copy to the attention of the Senior Vice President of Finance, or at such or to such other address or addresses as Operator shall designate in the manner herein provided. A notice shall be deemed to have been given on the day ten (10) business. days after it shall have been deposited as aforesaid in any post office or post box maintained by the United States Government.

#### 11.22 Waiver

NEUTRAL The failure of either party to insist upon a strict performance of any of the terms or provisions of this Agreement or to exercise any option, right, or remedy herein contained, shall not be construed as a waiver or as a relinquishment for the future of such term, provision, option, right, or remedy, but the same shall continue and remain in full force and effect. No

waiver by either party of any term or provision hereof shall be deemed to have been made unless expressed in writing and signed by such party.

### 11.23 Construction of Additional Facilities

OPERATOR

In the event a casino. restaurant, or cocktail lounge should be operated at the Hotel, Operator shall have the exclusive right to operate same and to include gross revenues in the total revenues of the Hotel and gross revenues less operating expenses in the Gross Operating Profit of the Hotel.

*[Alternate Clause]*
OPERATOR

In the event a casino should be operated at the Hotel, Operator shall have the exclusive right to operate same, and the excess of the gross amount wagered therein over the total amount of money won by wagerers will be included in the Total Revenue of the Hotel. The said excess, reduced by the Operating Expenses specified herein that relate to the casino, will be included in the Gross Operating Profit of the Hotel.

### 11.24 Operator Not Responsible for Owner's Obligations

OPERATOR

Owner shall not represent in any proposed financing arrangement or to any proposed lender or participant in a private or public investment that Operator shall be in any way responsible for Owner's obligation in financing arrangement other than to state that the property will bear the name of Operator, will be managed by Operator, and will be a part of the Operator's hotel system.

### 11.25 Operator to Review Financing Instruments

OPERATOR

In order to ensure Owner's full and faithful compliance with the terms of this Agreement and to prevent any misunderstanding on the part of a proposed lender or participant in any such investment offering, Owner shall, prior to the closing of any such proposed financing arrangement, inform and furnish Operator with the identity of the proposed lender and copies of the proposed closing documents, and Owner shall, prior to the printing of any prospectus concerning said private or public investment offering, furnish Operator with a copy of said prospectus, and said prospectus shall not be published or distributed without the prior written consent of Operator.

### 11.26 Modification of Agreement for Refinancing

OWNER

If, in connection with any refinancing of the Hotel, any Mortgagee shall request modifications of this Agreement as a condition of such refinancing, Operator covenants not to unreasonably withhold or delay its agreement to such modifications, provided that such modifications are reasonable and do not increase the obligations or adversely affect the rights of Operator hereunder.

### 11.27 Exculpation

OWNER

Operator agrees that it will look only to Owner's estate and property in the Hotel (or the proceeds thereof) for the satisfaction of Operator's remedies for the collection of a judgment requiring the payment of money by Owner in the event of any default by Owner hereunder, and no other real or personal property or assets of Owner or of Owner's individual principals shall be subject to levy, execution, or other enforcement procedures for the satisfaction of Owner's remedies under or with respect to this Agreement.

### 11.28 Real Estate Broker Indemnification

NEUTRAL Each party agrees to indemnity and hold the other party harmless from and against all loss, cost, damage, or expense (including reasonable attorney fees) suffered or incurred in connection with claims made by a real estate broker or other persons claiming, *by or* through the indemnifying party, entitlement to any brokerage fees or similar payment in connection with the negotiation and execution of this Agreement.

### 11.29 Consumer Price Index Adjustments

NEUTRAL Expenditure limitations and required minimums and maximums specified herein are based on the purchasing power of money as of the date of this Agreement. Notwithstanding Operator's authorization to revise the Operating Budget and Capital Budget as heretofore specified, said limitations, minimums, and maximums shall be subject to annual adjustment to retain the purchasing power intended at the onset of :his Agreement. The annual adjustment shall be based upon annual percentage increases or decreases in the Consumer Price Index for all Urban Consumers (1967 = 100) specified for "All Items" as published by the United States Department of Labor, Bureau of Labor Statistics.

### 11.30 Freedom of Action

OPERATOR Operator may engage in and/or possess an interest in other business ventures of every nature and description, independently or with others, including, but not limited to, the ownership financing, leasing, operation, management, brokerage, and development of real property, which may be adjacent to and/or competitive with, the Hotel. Owner shall not have any right by virtue hereof in and to such other business ventures or to the income or profits derived therefrom.

### 11.31 Owner's and Operator's Use of the Hotel

NEUTRAL Officers and employees of Operator or its parent company, or a reasonable number of persons designated by Owner may occupy guest rooms at a fifty percent (50%) discount from the rates charged to the public, provided, however, that lodging facilities may be utilized in such a manner only if space is available and not reserved or occupied by members of the public and is utilized in accordance with Operator's standard employee privilege program, as amended from time to time. The percentage discount may also vary from time to time as percentage changes are made and promulgated in Operator's employee benefit handbook or employee benefit card. In the event a room occupied by a person paying less than the full room rate, as provided hereunder, is needed to satisfy the demands of full-paying guests, such person shall be given the choice of vacating the room or paying full price for the room, so long as the demand for such room persists.

*[Alternate Clause]* OWNER Operator agrees that during the Operating Term and subject to availability, Operator will make rooms in the Hotel available (a) without charge to the officers of the general partner (and its constituent partners) of Owner, (b) at fifty percent (50%) of the normal rate for such rooms to the limited partners of Owner, and (c) at fifty percent (50%) of the normal rate for such rooms to certain brokers involved in marketing the interests in Owner's partnership (a list of such brokers shall be provided to Operator by Owner) for a period of one (1) year after the Closing. The provisions of this clause shall be limited to seven (7) nights for each calendar year period.

*[Alternate Clause]* OWNER Operator shall provide complimentary suites at the Hotel to Owner, its officers, directors, employees, agents, and guests upon request at such times as vacancy permits and at other times in reasonable amounts and upon reasonable notice. Operator shall provide

such complimentary accommodations to Franchisor as are required under the Franchise and shall provide complimentary accommodations to travel agents and others to the extent necessary to market and promote the Hotel as provided in the Operating Budget.

**11.32 Employee Use of the Hotel**

OPERATOR

Operator, in its discretion and as is customary and usual in hotels, may provide reasonable food and lodging for full time employees of the Hotel, and allow them the reasonable use of Hotel facilities.

APPENDIX 5

# Hotel Ground Leases

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Midrate commercial hotel—Northeast | 300 | 1966 | 30 years with two 15-year extensions | 3% of room revenue and 1% of food and beverage revenue | .5182 |
| First-class commercial suite hotel—South Central | 260 | 1984 | 25 years and three 10-year options | During construction: $100,000<br>Years 1–2: $150,000<br>Year 3: $200,000<br>Year 4: $250,000<br>Thereafter: $300,000 | 1.61 |
| Midrate commercial hotel—South Central | 200 | 1968 | 33 years | 3% of room revenue, 1% of F&B revenue | 4.99 |
| Midrate commercial hotel—North Central | 230 | 1967 | 33 years with two renewals of 33 years each | $5,000 per year through original term | 1.15 |
| Proposed convention hotel—Northeast | 300 | 1984 | 30 years from opening; right to renew for three additional 15-year periods each; maximum term is 75 full fiscal years beginning 1984 | $180,000 from 1984 to 1987; in 1987, an amount equal to the greater of $225,000 for first 2 years and $250,000 thereafter or 2.75% of annual gross sales if landlord is not contractor (25% if landlord is contractor) | 16.05 |
| Midrate commercial hotel—Southeast | 600 | 1973 | 99 years | 4% of gross room rentals (up to 75% occupancy on any given night), 2% of gross F&B | 5.96 |
| Proposed midrate commercial hotel—North Central | 180 | 1985 | 40 years with four successive 10-year options | $10 per year plus maintenance of a small city park; 12% of fair market value after 40-year-term | 1.71 |
| Midrate commercial hotel—South Central | 300 | 1966 | 20 years with five 10-year renewals | $5,400 annually (CPI adjusted every 5 years) | 1.625 |
| Midrate commercial hotel—South Central | 300 | 1967 | 33 years with one 33-year extension | 3% of room revenue, 1% of F&B revenue, 10% of shop and store income | 4.64 |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Midrate commercial hotel—South Central | 300 | 1984 | 30 years and two 10-year extensions | 2.5% of room revenue, 1% of F&B revenue, 2% of other income | .71 |
| Convention hotel—Northwest | 480 | 1980 | 20 years and two options of 20 years each | $30,000 per month in sixth year, additional rent of 5% of net cash flow | 5.55 |
| Motor hotel—Northwest | 230 | 1973 | 75 years | $13,804.80 fiscal rental per year (adjusted by CPI equates to roughly $31,000 in 1987–1989); adjusted every 10 years | 12.3 |
| Luxury commercial hotel—Northeast | 170 | 1986 | 10 years with two 10-year options | Year 1: $400,000<br>Year 2: $800,000<br>Years 3–10: $1,200,000<br>Bonus after 5.5% management fee (cumulative), landlord receives 100% of NCF to $300,000, 80% up to maximum of $750,000, 75% thereafter | 1.02 |
| Resort hotel—Southwest | 125 | 1978 | 55 years with two 10-year renewal options | Base $90,000 quarterly; percentage is the greater of 8% of room revenue or 4% of gross sales | 9.8 |
| Midrate commercial hotel—Midwest | 117 | — | 20 years with two 10-year options | Greater of 5.3% net receipts or $53,781 (in 1986) or $139,532 (in 2024) | 2.5 |
| Midrate commercial hotel—Midwest | 120 | — | 20 years with four 5-year extensions | 5.5% net room revenue or fixed $75,000 (in 1986) or $169,396 (in 2024) | 2.75 |
| Midrate commercial hotel—Northwest | 123 | — | 20 years with four 10-year extensions | Year 1: $82,250<br>Year 2: $82,250<br>Thereafter: 5% of net revenue, buy-out option between 27th and 48th months at $780,000 | 1.6 |
| Airport hotel—Southwest | 272 | 1984 | 50 years | 5% of room revenue, 4% of beverage revenue, 2% of food revenue | 10.3 |
| Proposed midrate commercial hotel—Northeast | 230 | 1986 | 60 years | Greater of 3% of room revenue plus 1% of F&B revenue or $150,000 (years 1–10) or $200,000 (years 11–60); $50,000 added to percentage rent in year 11 and thereafter; $150,000 per year is fixed rent for first 4 years | 2.55 |
| Luxury hotel—Southeast | 500 | 1982 | 99 years | $150,000 per year until constructed or 42 months, whichever is first; upon completion, $425,000 for 10 years during the succeeding 10-year period, rent fixed for 10 years at lesser of 10% FMV of land as vacant or greater of 2.5% of room revenue or 1.75 of gross revenue never to be less than $425,000 | 1.0 |

HOTEL GROUND LEASES

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Commercial hotel—Southeast | 285 | 1984 | 50 years with two 20-year renewals | Greater of percent rent or base rent is paid<br>Year 1: $300,000 (1%)<br>Year 2: $300,000 (2%)<br>Year 3: $300,000 (3.5%)<br>Year 4: $315,000 (3.5%)<br>Year 5: $331,000 (3.5%)<br>Year 6: $447,000 (3.5%)<br>Year 7: $365,000 (3.5%)<br>Year 8: $383,000 (3.5%)<br>Year 9: $402,000 (3.5%)<br>Year 10: $422,000 (3.5%) | 6.89 |
| Motel—Southeast | 130 | 1983 | 40 years with two 15-year options | Minimum: $120,000<br>Years 1–2: $125,000<br>Year 3: $130,000<br>Years 4–10: $135,000<br>Years 11–40: $145,000<br>Years 41–55: $155,000<br>Year 56 through end of term: 3% of gross in excess of $2,100,000 | 3.5 |
| Hotel—Northeast | 300 | 1985 | — | 4% of total revenue each year (loss in any one year may not be applied to other years' fees) | 11.0 |
| First-class hotel—Southeast | 312 | — | — | 3% rooms, 1% F&Bs, $96,000 minimum | — |
| Motel—Southeast | 130 | 1983 | 45 years plus option on two 15-year terms | Annual rent of $22,500 before opening, $45,000 annually first 5 years of operation, 15% increase every 5 years | 3.4 |
| Conference center—South Central | 300 | 1986 | 99 years | Ground rent $300,000 per year plus 1% of gross revenues in excess of $150,000 up to $30,000,000 | 8.7 |
| First-class hotel—Southwest | 414 | — | — | 3.5% of room revenue, $155,000 minimum | — |
| First-class commercial hotel—South Central | 300 | 1980 | 30 years with 20- and 10-year renewals | Greater of $5,000 per month or 5% of room revenue, 4% of beverage revenue, 2% of food revenue and 6% of miscellaneous income | 8.65 |
| Extended-stay hotel—South Central | — | 1982 | 30 years with 20- and 10-year renewals | 5% of room revenue, 4% of beverage revenue, 2% of food revenue, 6% of miscellaneous income; $79,540 minimum, adjusted in 10 years with increase to provide return on appraised value of land, maximum increase 20% | — |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| First-class commercial hotel—Southeast | — | 1981 | 60 years with two 10-year renewal options | Greater of base rent or 4% of room revenue and 2% of alcohol sales.<br>Years 1–10: $120,000<br>Years 20–30: $180,000<br>Years 21–30: $240,000<br>Years 31–40: $300,000<br>Years 41–50: $360,000<br>Years 51–60: $420,000<br>Capital improvements escrow escalating from 1% to 5% | 10 |
| First-class commercial hotel—Southwest | — | 1981 | 75 years | $200,000 per year for 18 months, $400,000 per year thereafter, .3% of gross sales, applied against $400,000 per year base 7% of gross sales if lease is subordinated | 5 |
| Resort hotel—West Coast | — | 1983 | 99 years | Years 1–2: $260,000 per year<br>Years 3–11: $520,000 per year<br>Thereafter: 10% of fair market value plus 15% of net cash flow | 7.33 |
| Midrate commercial hotel—West | — | 1971 | 50 years | Year 1: $25,000<br>Year 2: $30,000<br>Years 3–8: $45,000 per year<br>Thereafter: 7% of fair market value<br>Percentage: 5% of room revenue, 3% of alcohol sales, 1.5% of food revenue | 6.69 |
| First-class commercial hotel—Southeast | — | 1981 | 99 years | Years 1–2: $550,000 per year<br>Year 3: $650,000<br>Year 4: $950,000<br>Thereafter: $1 million per year | 16.5 |
| Midrate commercial hotel—Southeast | 136 | — | — | 5% rooms, $18,000 minimum | — |
| Resort hotel—West Coast | — | 1970 | 55 years | Years 1–25: Minimum rent equals $50,000 or $250/room, greater of two renegotiated every 10 years thereafter, plus 5% room revenue, 1% food revenue, 3% beverage revenue, 5% other income, and 25% of sublease and concession | 12 |
| *First-class* commercial hotel—Northeast | — | *1977* | *99 years, 275 days* | *Greater of $96,000 per year or 5% room* revenue | *14.30* |
| First-class commercial hotel—Northeast | — | 1985 | 49 years plus five 10-year renewals | $200,000/year or 3% of room revenue subordinate to first and second mortgages | — |
| First-class commercial hotel—Southeast | 302 | — | — | 2.25% room revenue, 2% beverage revenue, 1% food revenue, $90,000 minimum | — |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| First-class commercial hotel—Southwest | 417 | — | — | 3% room revenue up to $15,000,000, 3.25% room revenue greater than $15 million, $160,000 minimum | — |
| First-class commercial hotel—Midwest | 384 | 1978 | 100 years | Years 1–3: $174,250 per year<br>Thereafter: $29,750 additional rent<br>Option to purchase in year 12, with 6-month notice, for $1.7 million plus 6% net proceeds from refinancing | — |
| Resort inn—Southeast | 175 | 1985 | 20 years | Base rate $193,500 plus 3% gross sales | — |
| Beach resort—Southeast | 160 | 1985 | 99 years | Base rent $100,000 per year<br>Year 1: 2% quarterly gross earnings over $1.25 million<br>Years 2–3: 2.5% quarterly gross earnings over $1 million<br>Year 4: 3% quarterly gross earnings over $833,333<br>Renegotiate base rent after year 10 | 1.4 |
| Budget hotel—Southwest | 130 | 1976 | 20 years, amended 1977 and 1986, 2 successive 10-year options | Minimum rent $77,200 per year plus 6% gross sales greater than $125,000 per month exercise first option, increase base rent to $100,000 per year exercise second option, increase base rent to $125,000 | 1.88 |
| Midrate commercial hotel—Northeast | 62 | 1970 | 15 years with two 10-year extensions | Minimum rent: $65,100<br>Percentage rent: 25% gross room revenue exceeding four times minimum rent, 5% cocktail lounge receipts | 3.6 |
| Midrate commercial hotel—northeast | 104 | 1986 | 10 years with three 10-year extensions | Minimum rent: $360,000<br>Percentage rent: 30% gross room revenue in excess of $1.2 million, 5% cocktail lounge receipts | 3.6 |
| Midrate commercial hotel—Southeast | 253 | 1984 | 4 years with 1-year renewal | $1,862.69 per month | — |
| Midrate commercial hotel—Northeast | — | 1971 | 15 years with three 10-year extensions | Minimum rent $79,200 plus 25% room revenue greater than four times minimum rent | — |
| Suite hotel—Midwest | 266 | 1972 | 51 years with two 25-year options | Base rent: $53,120<br>Percentage rent: 4% room and F&B revenue | — |
| Resort hotel—Southeast | 205 | 1972 | 41.5 years | Years 1–10: $31,500 per year<br>Years 11–20: $42,525<br>Thereafter: 8% fair market value<br>Minimum rent $26,000 and no less than 3.5% gross income | — |
| Suite hotel—Southwest | 183 | 1979 | 51 years with one 10-year extension | 7.5% gross sales | — |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Midrate commercial hotel—Southeast | 225 | 1969 | 20 years with three 20-year extensions | Minimum rent: $108,000 (increasing by $6,000 per year, reaching a ceiling limit of $245,000)<br>Additional rent of 31% room revenue less real estate taxes and insurance payments | — |
| Midrate commercial hotel—Midwest | 149 | 1969 | 21 years with seven 10-year renewals | Base rent: $119,819 annually, or 28% room revenue, 5% F&B revenue, and 25% other revenue | 6.12 |
| Suite hotel—Southeast | 232 | 1988 | 10 years with a 5-year renewal | $5,000 per month plus 2% gross sales (minimum of $3 million) | 3.6 |
| Airport hotel—Northeast | 293 | 1971 | 10 years with two 10-year options | Minimum rent: $30,000 year, plus percentage rent of 3% gross room revenue and 1% gross F&B revenue | 7.84 |
| Midrate commercial hotel—Northeast | 117 | 1962 | 30 years with four 15-year extensions | $78,000 per year | 8.5 |
| Midrate commercial hotel—Northeast | 152 | 1967 | — | $45,000 per year | 4.7 |
| Midrate commercial hotel—Northeast | — | 1964 | 5 years with nine 5-year options | Years 1–20: $12,000 per year<br>Years 21–40: $13,000 per year<br>Years 41–50: $14,000 per year | 1.67 |
| Midrate commercial hotel—Northeast | 72 | 1977 | 8 years with one 12-year renewal and two 5-year renewals | Minimum rent: $79,000<br>Percentage rent: 20% gross receipts in excess of five times minimum fixed rent | — |
| Midrate commercial hotel—Northeast | 557 | 1958 | 56 years | Minimum rent: $13,700, or 10% of room revenue, 10% of first $548,620 in food revenue, 5% of excess food revenue, and 10% of beverage and other revenue (excluding telephone) | 5.25 |
| Convention hotel—Northeast | 557 | 1958, amendment 1983 | 55 years, extended 25 years | 9% of room revenue and 10% of food revenue (up to $548,620), then 5% of remaining food revenue and 5% beverage revenue | 5.25 |
| Proposed beach hotel—Northeast | 163 | 1988 | 99 years | Years 1–3: $25,000<br>Year 4: $75,000<br>Years 5–10: $100,000<br>Years 11–15: $100,000 plus average percentage increase of the CPI from years 5–10 (not to exceed 5%) | 3.5 |
| Convention hotel—Midwest | 887 | 1975 | 99 years | $12,000 per year, increased by the CPI every 5 years | 21,804 square feet |
| First-class commercial hotel—Northeast | 350 | 1985 | 30 years | Payment of bond interest | .74 |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Suite hotel—South Central | 261 | 1985 | open ended | $69,116 per year, adjusted every 3 years by CPI | 48.896 |
| Resort hotel—Caribbean Islands | — | 1984 | 5 years with two 5-year options | Minimum rent $25,000 plus percentage of gross revenue:<br>$2 million to $5 million at 3%<br>$5 million to $8 million at 5%<br>$8 million and greater at 6% | — |
| Resort hotel—Midwest | 393 | 1974 | 25 years with five 10-year renewal terms | 5% of gross room revenue plus a percentage of theater revenue:<br>$400,000 to $900,000 at 4%<br>$900,000 to $1 million at 5%<br>$1,000,001 and greater at 9% | 160 |
| First-class commercial hotel—Midwest | 316 | 1983 | 100 years | $100,000 per year | 1.21 |
| Midrate commercial hotel—Midwest | 159 | 1985 | 15 years | $103,500 per year | — |
| Budget hotel—South Central | 48 | 1982 | 30 years with one 10-year renewal and two 5-year renewals | $14,400 per year | 0.8 |
| Commercial hotel—Northeast | 392 | 1979 | 75 years | Years 1–3: $50,000 per year if positive cash flow<br>Years 4–40: $70,000 per year plus additional rent of $135,000 | — |
| Suite hotel—Northeast | 300 | 1986 | — | Year 1: $48,000<br>Year 2: $48,000 plus 1% room revenue,1% F&B sales, 1% net income, and 5% rentals<br>Year 3: Increase room and F&B revenue to 1.5%<br>Year 4: increase room revenue to 2% | — |
| Budget hotel—Southeast | 149 | 1987 | — | Years 1–5: The greater of $234,700 or 5% of room revenue<br>Thereafter: The greater of $352,051 or 6% of room revenue | — |
| Budget hotel—Southeast | 145 | 1960 | 99 years with option to purchase in year 6 for $300,000 or in year 11 for the greater of $300,000 or fair market value of land | $24,000 per year | 2.57 |
| Budget hotel—Northeast | 146 | 1961, amended 1967 | 50 years with two extensions of 20 years each | $15,000 per year | — |
| Downtown hotel—North Central | 225 | 1963 | 25 years | The grêater of $112,500 per year or 25% of room revenue and 5% of F&B revenue | 0.48 |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| First-class hotel—Midwest | 621 | 1983 | 30 years | $500,000 annually plus percentage rent according to debt structure tied in with operating income | — |
| First-class commercial hotel—Southwest | — | 1989 | 50 years | Minimum rent as follows:<br>Year 1: $400,000<br>Years 2–10: $800,000<br>Thereafter: $1.2 million, plus a percentage of operating revenue | 366,235 square feet |
| First-class hotel—Southwest | — | 1986 | 50 years | Minimum rent as follows:<br>Year 1: $200,000<br>Years 2–10: $400,000<br>Thereafter: $600,000, plus a percentage of operating revenue | 734,741 square feet |
| First-class commercial hotel—Southwest | — | 1968 | 60 years | Minimum rent: $68,500 per year, plus a percentage of operating revenue | 325,910 square feet |
| Resort hotel—Southwest | — | 1969 | 60 years | Minimum rent as follows:<br>Years 1–10: $250,000<br>Years 11–20: $625,500<br>Thereafter: $825,000, plus a percentage of gross income | 1,030,408 square feet |
| First-class convention hotel—Southeast | 1,074 | 1972 | 99 years | Base rent at $309,363 per year, increasing $2,000 per year after year 25; reset base rent at $477,363 in year 26, increasing by $4,000 per year through year 40; base rent adjusted to $460,000 in year 41, increasing by $4,000 per year until year 50; thereafter, base rent will be determined through market appraisals performed every 25 years | — |
| First-class commercial hotel—Southwest | 803 | 1973, amended 1977 | 40 years | $5,249,124 plus 10.25% repair costs; in years 5–15, an additional 15.86% of any excess expended over the reserve accounts | 1.9 |
| Midrate commercial hotel—Northeast | 119 | 1988 | 45 years | $855,000 per year | 3.0 |
| Midrate commercial hotel—Northeast | 71 | 1961 | 60 years | Minimum rent: $137,000, plus 10% of gross income in excess of $252,000 per year | — |
| Midrate commercial hotel—Northeast | 71 | 1968 | 20 years | $200,000 per year plus 15% of gross income in excess of $786,534 | 3.0 |
| Midrate commercial hotel—Southeast | — | 1969 | 20 years with one option of 15 years | $138,000 per year plus 25% of annual gross sales in excess of four times the fixed rental | — |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Suite hotel—Midwest | 237 | 1986 | 50 years with five 10-year renewals | The greater of $225,000 or percentage of suite revenue as follows:<br>Years 1–3: X%<br>Years 4–6: .3%<br>Thereafter: 3.6% | 6.55 |
| Luxury commercial hotel—Southeast | 497 | 1981 | 75 years | $555,556 paid in full | 1.1 |
| Motel—Southeast | — | 1967 | 35 years with four 15-year options | $183,000 per year plus 25% of gross sales | — |
| Airport hotel—Southeast | — | 1965 | 22 years with two 15-year options and two 10-year options | Years 1–15: $69,952 per year plus 10% gross sales in excess of $224,000<br>Years 16–22: Increase gross sales percentage to 25% | — |
| Midrate commercial hotel—Southeast | — | 1971 | 22 years with three 10-year options | The greater of $40,000 per year or 7% of gross income from food and 5% from beverages, 25% of receipts from conference facilities rental, and 7% from other revenue | — |
| Midrate commercial hotel—Southeast | — | 1982 | 10 years with two 5-year options | Minimum rental: $2,160,000 per year plus a percentage of gross sales starting at 5% for $750,000 to $1.5 million and increasing by 1% for every $150,000 increase in gross sales (maximum of 12% at $1.95 million in sales) | — |
| Midrate commercial hotel—Southeast | 72 | 1968, amended 1969 | 25 years with six 10-year options | Minimum rent: $79,200 per year<br>Percentage rent: 25% of annual gross room revenue exceeding $316,800 | — |
| Convention hotel Midwest | 1215 | 1988 | 50 years | Base rent as follows:<br>Years 1–5: $150,000 per year<br>Year 6: $975,000<br>Year 7: $2,100,000<br>Thereafter: $2,100,000 plus percentage of the CPI (between 5% and 10%). | 80,000,000 square feet |
| Commercial hotel Northeast | — | 1971 | 50 years with two 25-year options | Years 1–10: $15,000 plus .75% of gross receipts<br>Thereafter: $20,000 plus 1% of gross receipts | — |
| Airport hotel Southwest | 210 | 1974 | 30 years | Years 1–6: $144,000 per year<br>Thereafter: Adjusted by CPI | 6.61 |
| Proposed first class commercial hotel Southeast | 371 | 1985 | 30 years with two 10-year extensions | $220,000 to opening date;<br>$440,000 to 1992;<br>$528,000 thereafter or 3% or gross sales (whichever is greater) | 1.76 |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Budget hotel Midwest | 130 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $50,000 Years 6–10: $65,000 Percentage rent as follows: Years 1–4: 3% Years 5–10: 3.5% Thereafter: 5.5% | — |
| Budget hotel Midwest | 130 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $38,000 Years 6–10: $58,000 Percentage rent as follows: Years 1–5: 3% Years 6–12: 3% Thereafter: 5% | — |
| Budget motel—Midwest | 129 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $45,000 Years 6–10: $55,000 Percentage rent as follows: Years 1–12: 3% Thereafter: 5% | — |
| Budget hotel—Midwest | 131 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $60,000 Years 6–10: $67,000 Percentage rent as follows: Years 1–12: 3% Thereafter: 5% | — |
| Budget hotel—Midwest | 134 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $55,000 Years 6–10: $68,000 Percentage rent as follows: Years 1–5: 3% Years 6–12: 3.5% Thereafter: 5.5% | — |
| Budget hotel—Southeast | 135 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $90,000 Years 6–10: $101,000 Percentage rent as follows: Years 1–5: 3% Years 6–12: 4.5% Thereafter: 6.5% | — |
| Budget hotel—Southeast | 133 | 1990 | 29 years | Minimum rent as follows: Years 1–5: $50,000 Years 6–10: $72,000 Percentage rent as follows: Years 1–5: 3% Years 6–12: 4% Thereafter: 6% | — |
| Commercial hotel—North Central | 336 | 1981 | 25 years with five 25-year options | The greater of $135,000 or 3% of gross room revenue | 7.11 |
| International commercial hotel—Europe | 223 | 1958 | 99 years | 40,000 pounds sterling | 26,643 square feet |

HOTEL GROUND LEASES

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Midrate commercial hotel—Northeast | 154 | 1970 | 50 years with two 15-year options and one 10-year option | $26,500 per year, inflated every 7.5 years by the corresponding CPI change, beginning in 1979 | — |
| Independent—Southeast | 309 | 1984 | 99 years | $1,200,000 per year plus 75% operating income above $9 million | 3.48 |
| Airport hotel—Northwest | 141 | 1970 | 21 years with six 5-year options | Years 1–6: $16,000, adjusted every five years to fair rental value as determined by an independent appraiser | 189,051 square feet |
| Budget—Southwest | 129 | 1983 | 30 years | Minimum rent: $60,000<br>Percentage rent: Amount by which 5% gross revenue exceeds minimum rent | 3.2 |
| Airport hotel—Southwest | 750 | 1984 | 70 years, not to exceed 99 years | Minimum rent: $540,000, adjusted every five years by the CPI increase | 3.7 |
| First class commercial hotel—South Central | 338 | 1975 | 25 years with two 5-year options | Minimum rent: $1,172,000<br>Percentage rent: 25% operating profit under $800,000 per year and 40% operating profit in excess of $800,000 per year | 1.68 |
| Limited service—Northeast | 189 | 1987 | 49 years with one 49-year renewal | Fixed leverage attached plus 5% gross receipts exceeding the fixed | — |
| First class commercial hotel—Southeast | 401 | 1982 | 49 years with five extensions not to exceed 99 years | Minimum rent: $600,000 per year | 1.8 |
| Suite hotel—Northeast | 112 | 1986 | 16 years with one 15-year option | Commencement to completion date: $62,000<br>Thereafter: $124,000 fixed rent, increased by 4% annually | — |
| Commercial hotel—Northwest | 248 | 1985 | 55 years | $40,000 per year, increasing at 5-year intervals to reflect the fair market rental | 66.76 |
| Suite hotel—Southeast | 214 | 1985 | 50 years with an option to purchase | Years 1–7: 138,000 per year<br>Years 8–13: 396,000 per year<br>Thereafter: $600,000 per year, adjusted by CPI | 8.7 |
| Independent—Northeast | 190 | 1981 | 26 years | Triple net plus $15,000 per year for easement rental; option to terminate in year 16 | — |
| Budget hotel—Northeast | 368 | 1986 | 30 years | $125,000 deposit plus annual payments as follows:<br>Years 1–5: $1.5 million<br>Years 6–9: $1.65 million<br>Years 10–12: $1.7 million<br>Years 13–18: $1.75 million<br>Thereafter: $2 million, with a purchase option after year 8 | — |
| Independent—Northeast | 183 | 1978 | 15 years with eight 5-year extensions | Minimum rent: $252,000 annually<br>Percentage rent: 1% of gross food sales, 2% of gross alcoholic beverage sales, and 3% of gross room revenue | 3.5 |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Commercial hotel—Southwest | — | — | 20 years | Minimum rent as follows:<br>Year 1: $200,000<br>Year 2: $400,000<br>Thereafter: $600,000 or the cumulative total of percentage rents | — |
| Convention center hotel—Midwest | 1,200 | 1987 | 50 years with one 25-year extension and one 24-year extension | Base rental as follows:<br>Year 1: $75,000<br>Years 2–7: $150,000<br>Year 8: $1.6 million<br>Year 9: $1.8 million<br>Thereafter: $2 million, increased by the CPI and capped at a minimum of 5% and a maximum of 10%<br>total percentage rent is equal to the excess of the sum of percentages of gross revenue over base room F&B, and other revenue | — |
| Commercial hotel—Midwest | 247 | 1983 | 65 years with seven 5-year options | Year 1: $29,430<br>Thereafter: $82,000 | 1.525 |
| Resort hotel—Southeast | 1,500 | 1991 | 99 years | Special fee of 3% total revenue<br>Base rent as follows:<br>Years 1–7: X% rooms, 5% beverage, 3% food<br>Year 8: 7.5% rooms, 5% beverage, 3% food<br>Year 9: 8% rooms, 5.5% beverage, 3.5% food<br>Thereafter: 8.5% rooms, 6% beverage, 4% food, plus 25% of all sublease income and 7% other revenue | 38.54 |
| Casino hotel—South Central | 150 | 1982 | 10 years with purchase option | Years 1–2: 27,564<br>Years 3–5: 30,324<br>Years 6–8: 33,072<br>Thereafter: $35,832 | 1.05 |
| Casino hotel—South Central | 150 | 1983 | 23.5 years with two 25-year extensions | First 6 months: $26,496<br>Second 6 months through year 2: $39,750<br>Year 3: $53,000<br>Years 4–10: 66,250<br>Thereafter: Appraised every 5 years, rent determined at 10% of appraised value but not less than 5-year rent | 1.52 |
| Midrate commercial hotel—Southeast | 206 | 1981 | 17 years, renewable for 80 years | Interest and principal on bonds $60,468.75 monthly until 1997, $100 per year thereafter | 14.57 |
| Midrate commercial hotel—Southwest | 149 | 1988 | 55 years | The greater of $100,000 or 7% of room revenue | 3.0 |
| Midrate commercial hotel—Southeast | 203 | 1970 | 25 years with three 20-year renewals | $290,800 per year, payable in advance monthly installments of $24,233.33 | — |

HOTEL GROUND LEASES

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| **Midrate commercial hotel—Southeast** | 170 | 1963 | 28 years and 10 months with one 20-year renewal option | Years 1–3: 6,333.30 per month<br>Years 4–6: $6,500 per month<br>$6,666.66 per month for the life of the lease, increased to $7,500 per month upon completion of additional facilities in year 15 | — |
| **Midrate commercial hotel—Southeast** | 304 | 1965 | 15 years with option of eight 5-year renewals | Tracts 1–5 as follows:<br>Years 1–10: $1,800 per acre<br>Years 11–X: $2,300 per acre<br>152,500 per acre yearly during renewal option<br>Tracts 6–8: $900 per acre | 12.72 |
| **First class commercial hotel—Southeast** | 126 | 1977 | 20 years with option to purchase by year 15 for $2,200,000 | $11,333.34 per month | 5.44 |
| **Midrate commercial hotel—South Central** | 313 | — | 30 years with two 10-year renewals | The greater of 2.5% of room revenue, 1 % of FEB revenue, and 2% of other revenue (not including telephone) or $150,000 annually | 0.71 |
| **First class** commercial hotel—Southeast | 756 | 1980 | 25 years with five 10-year renewal options | 60% of operating profit | 5.79 |
| First class commercial hotel—Southwest | 746 | 1980 | 25 years with five 10-year renewal options | 60% of operating profit | 10.76 |
| First class commercial hotel—Southeast | 400 | 1981 | 25 years with five 10-year renewal options | 60% of operating profit | 15.01 |
| First class resort hotel—Southeast | 759 | 1980 | 25 years with five 10-year renewal options | 60% of operating profit | 189.39 |
| First class resort hotel—Southwest | 348 | — | 25 years with five 10-year renewal options | 60% of operating profit | 24.63 |
| First class hotel—Northeast | 444 | 1981 | 25 years with five 10-year renewal options | Years 1–39: 60% of operating profit<br>Thereafter: 80% of operating profit | 15 |
| Conference center hotel—Northeast | 209 | 1984 | 50 years with option to buy | Percentage of gross revenue that is contingent upon sales volume and mortgage interest rate | 12.8 |
| Proposed suite hotel—Northeast | 120 | 1987 | 75 years with 25-year extension | Year 1–5: $125,000, with increase for each 5-year period calculated as basic annual rent + (basic annual rent × .4% increase in local CPI) | 5.0 |
| Proposed suite hotel—Northeast | 460 | 1988 | 49 years, with three 33-year renewal options | Base rent of $1,009,040 with fixed annual increases of $10,090.40 | 16,924 |

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| Proposed suite hotel—Northeast | 460 | 1988 | 49 years with three 33-year renewal options | Base rent of $230,000 with fixed annual increases of $2,300 | 1,600 |
| Midrate commercial hotel—Southwest | 309 | 1967 | 55 years | Greater of $4,583,33 or 6.375% of gross room revenue plus 5% of F&B revenue | 12.28 |
| Propsed resort hotel—Southeast | 760 | 1991 | 99 years | Special fee of 3% total revenue<br>Base rent as follows:<br>Years 1–7: 7% room revenue, 5% beverage revenue, 3% food revenue<br>Year 8: 7.5% room revenue, 5% beverage revenue, 3% food revenue<br>Year 9: 8% room revenue, 5.5% beverage revenue, 3.5% food revenue<br>Thereafter: 8.5% room revenue, 6% beverage revenue, 4% food revenue, plus 25% of all subleased income and 7% of all other revenue payable monthly in arrears<br>Incentive rent: 15% annual room revenue exceeding base projection | 24.59 |
| Midrate commercial hotel—Northeast | 117 | 1973 | 25 years with five 15-year renewal options | $20,500 per month plus percentage rent of 33% of room revenue in excess of $210,000 | 4.7 |
| Proposed midrate commercial hotel—Northeast | 168 | 1986 | 50 years with two 10-year options | Years 1–5: $100,000 fixed rent, increasing 20% for each 5-year increment<br>Percentage rent: 3% of room revenue | 0.368 |
| Resort inn—Southeast | 276 | 1971 | — | 8% fair market value, 3% of gross income | 14.53 |
| Medical center hotel—South Central | 389 | 1984 | 25 years plus five 10-year renewal options | $160,000 plus 3% of the first $15 million annual gross room revenue and 3.25% of room revenue in excess of stated amount | 0.54 |
| First-class resort hotel—Midwest | 393 | 1974 | 25 years plus five 10-year renewal options | 5% of gross room revenue plus percentage of revenue as follows: $400,000 to $900,000 at 4%; $900,001 to $1 million at 5%; 9% thereafter | 160 |
| First-class commercial hotel—Midwest | 316 | 1983 | 100 years, after which all improvements become the lessor's | $100,000 annually plus rental of 100 parking spaces in lessor's adjacent parking garage | 1.21 |
| Midrate commercial hotel—Midwest | 159 | 1985 | 15 years | $103,500 total rental, at $575 monthly | — |
| Budget hotel—Southwest | 48 | 1982 | 30 years with one 10-year renewal and two 5-year renewals | $14,400 per year or 4.25% of room revenue, whichever is greater | 0.8 |

HOTEL GROUND LEASES

| Property | Rooms | Date | Terms and Renewals | Rental | Acreage |
|---|---|---|---|---|---|
| First class commercial hotel—Northeast | 392 | 1979 | 75 years | Years 1–3: $50,000 annually if positive net cash flow<br>Years 4–40: Net rentable square foot area × $0.50, ground rent of $70,000 per year, and 12% of any monies loaned on convertibles | — |
| Suite hotel—Northeast | 300 | 1986 | — | Year 1: $48,000<br>Year 2: $48,000 plus 1% total room revenue, 1% F&B sales, 1% net income, and 5% office and retail rentals<br>Year 3: increase to 1.5% room revenue and 1.5% F&B revenue<br>Thereafter: 2% room revenue, 1.5% F&B revenue, 1% net income, and 5% rental revenue | — |
| Budget hotel—Southeast | 149 | 1987 | — | Years 1–5: The greater of $234,700 or 5% gross revenue<br>Thereafter: The greater of $352,051 or 6% of gross room revenue | — |
| Midrate commercial hotel—Southeast | — | 1971 | 25 years with one 25-year renewal option | $3,333 per month against 7% gross income derived from 5% beverage revenue, 25% of gross rental receipts, and 7% of other revenue; minimum increases for extended terms to 75% of average annual rent paid for previous 10 years, never less than paid in last year of preceding period | — |

APPENDIX 6

# Selected Provisions of Lease of Land Only

**A. Demise; Description and "Subject to" Provisions**

Lessor hereby leases to Lessee, and Lessee hereby hires, on the terms and conditions hereinafter set forth, the following (which is hereinafter called the "Leased Property"):

All that certain lot, piece or parcel of land, *without the buildings or improvements thereon erected,* situate, lying and being in the .................. City of .................... County of ................. and
State of….............., bounded and described as follows;

Beginning at a point........ (Include here a complete survey description of the Leased Property.)

Together with all the right, title, and interest, if any, of Lessor, in and to any streets and roads abutting the above-described premises to the center lines thereof.

There is not included in this lease the following, Title to which today has been conveyed, sold, and assigned by Lessor to Lessee: Any buildings, structures and improvements, or the furnishings, fixtures, personal property and equipment of every kind whatsoever located therein, now or at any time hereafter erected or situated on the Leased Property. Subject, nevertheless, to:

**1.** Rights of all tenants, licensees, concessionaires and occupants now in possession of portions of the Building pursuant to leases, licenses of agreements heretofore made by Lessor or any former owner of the Leased Property.

**2.** State of facts shown on survey made by ................., dated ................., 19.....and to any additional state of facts an accurate survey since that date, or an inspection, would show;

**3.** Any presently existing defects of title, easements, restrictions, and agreements affecting the Leased Property; but this lease is not subject to the lien of any mortgage which may have affected the fee title to Leased Property on the date hereof.

**B. Initial Lease Term**

To have and to hold the Leased Property unto Lessee, its successors and assigns, for a term of 25 years, commencing on December 1, 19..... and expiring at 12:00 noon on November 30, 20 ....... unless this lease shall terminate sooner, as hereinafter provided.

### C. Acknowledgment of Split Ownership of Land and Building

The parties acknowledge that Lessee holds title to the Building, It is the intention of the parties that such separation of title to the Leased Property from title to the Building is not to change the character of the Building as real property, except that the furnishings and other personal property which constitutes part of the Building shall continue to be treated as the personal property of Lessee.

### D. Nonseparability of Ownership of Leasehold Estate From Ownership of Building

It is also the intention and agreement of the parties that Lessee's ownership of the leasehold estate created hereby and the Building shall be nonseparable, and that any attempt to transfer title to the Building shall be void and ineffective unless accompanied by a valid transfer of this leasehold estate to such grantee; and likewise, any attempt to transfer this leasehold estate without a simultaneous conveyance of the Building to such assignee shall be void, and either event shall constitute an Event of Default under this lease.

### E. Automatic Transfer of Building to Lessor at End of Lease

Lessee covenants that upon the expiration or earlier termination of this lease, Lessee shall without payment therefor execute, acknowledge, and deliver to Lessor a quitclaim deed and bill or sale conveying and transferring to Lessor all of the right, title and interest of Lessee in and to the Building and the furnishings, and personal property therein, and Lessee hereby appoints Lessor irrevocably as its attorney in fact, with an interest, to execute, acknowledge, and deliver on Lessee's behalf said deed and bill of sale.

### F. Basic Rent

**Section 1.** Lessee shall pay to Lessor, at such place as Lessor shall from time to time designate, a rental (hereinafter called the "basic rent") as follows:

- **a.** For the period commencing December 1, 19.,...., and continuing for 15 years at the rate of $375,000 per annum, in equal monthly payments of $31,250 each on the first day of each month in advance.
- **b.** During the last 10 years of the initial lease term a rental in each year equal to the higher of:
  - **i.** 7.5 percent of the fair market value of the Leased Property, determined as of the end of the fifteenth year in the manner provided in Section 3 below; or
  - **ii.** The rent payable during the fifteenth lease year.

### G. Basic Rent for Renewal Terms as Percentage of Reappraised Value of Land

**Section 2.** Lessee may extend the term of this lease for eight separate and successive periods (renewal terms) of 10 years each, upon the same terms and conditions as herein contained, except that (a) there shall be no further right of renewal for any period beyond November 30, 20...., and (b) the basic rent during each year of each renewal term shall be at an annual rate equal to the greater of (i) 7.5 percent of *the fair market value of the land exclusive of the Building* thereon, determined as of November 30 of the last year of the then immediately preceding lease term, in the manner provided in Section 3 below, or (ii) the basic rent payable for the last year of the preceding term.

### H. Manner of Determining Fair Market Value for Setting Rent

**Section 3.** The fair market value of the Leased Property shall be determined as if the Leased Property were then free and clear of all liens, encumbrances and leases and were capable of being devoted *solely to hotel use;* provided, however, that if at the time of such determination the Building is not

being operated as a hotel, the fair market value of the Leased property shall be determined as if it were capable of being devoted to the highest and best use permitted under the ten-applicable zoning laws and regulations.

At least 60 days before the start of the sixteenth year of the initial term, and, if notice of renewal has been given, at least 60 days before the end of each lease term, Lessor and Lessee shall endeavor to agree on the then fair market value of the Leased Property If they have not reached agreement by the thirtieth day before the start of the sixteenth lease year or by the thirtieth day prior to the end of the then-current lease term, Lessor and Lessee shall each appoint a qualified and experienced appraiser, who shall be a member of a professional association of independent real estate appraisers. The two appraisers so appointed shall then jointly appoint a third appraiser similarly qualified, or if they cannot within 30 days after their appointment agree on the selection of the third appraiser, either Lessor or Lessee may apply to the President of the .................. County Board of Realtors, Inc. to appoint the third appraiser. A majority of the appraisers shall determine the fair market value of the Leased Property as soon as practicable, and the rent computed in accordance therewith shall be effective from the start of the relevant lease period, as provided in the preceding subdivisions of this Article ......... Until such new rent is fixed, Lessee shall continue to pay basic rent at the rate it had most recently been paying. If the new rent is higher, the deficiency shall be paid in a single payment by Lessee within 20 days after the decision of the majority of the appraisers shall have been rendered. Each party shall pay the fees and disbursements of the appraiser it selects, and each party shall pay one-half of all other fees, disbursements, and expenses of the appraisal process. The written decision of the majority of the appraisers shall be binding upon the parties as if Lessor and Lessee had themselves agreed on such fair market value. If either party fails to appoint a qualified appraiser, it shall have waived its right to do so and shall be bound by the sole decision of the appraiser appointed by the other party.

**Section 4.** The basic rent shall be paid to Lessor without notice or demand and without abatement, deduction or setoff, except as may be expressly allowed hereinbelow.

**I.** Limitation of Assignability of Lease

Lessee shall not assign this lease, unless the assignee simultaneously acquires fee title to the Building. Nor shall any total sublease be valid unless the total subtenant simultaneously acquires the leasehold estate in and to the Building.

**J. Lessee's Right to Mortgage Lease and Building, But Not Without Building**

Lessor hereby consents to Lessee from time to time mortgaging this lease and the Building (but not the fee title to the Leased Property), on the following terms and conditions:

**a.** No mortgage of this lease shall be effective unless such mortgage also encumbers the Building.

**b.** The leasehold mortgage shall provide that any condemnation proceeds which may be payable shall be applied in the manner set forth in this lease, and not otherwise.

**c.** There shall not be more than one leasehold mortgage in existence at any time.

**K. Leasehold Mortgagee's Right to Receive Copy of Notice of Lessee's Default Under Lease and Opportunity to Cure Default**

If Lessor shall have received written notice of the existence of a leasehold mortgage, together with a conformed copy of the note and mortgage, Lessor thereafter shall simultaneously send to the holder thereof a copy of any default notice or demand which Lessor shall send to Lessee. Such holder shall have an additional period of 15 days after the expiration of the applicable grace period allowing in Article ..... above in which to cure Lessee's default. In the event that this lease shall have been terminated by Lessor in accordance with the terms hereof and either (i) such leasehold mortgagee shall within said

additional 15-day period cure the default, or deposit with Lessor the cost of effecting such cure, or (ii) if the Event of Default which resulted in such termination shall have been any event which also constitutes an event of default under the leasehold mortgage, then, and in any such case, Lessee promptly upon the demand of the leasehold mortgage shall execute (1) a new lease to the leasehold mortgagee or its nominee upon the same terms and conditions contained herein, for a term equal to what otherwise would have been the balance of the then term hereof, together with options for renewal terms equal to the then-remaining renewal terms hereunder, and (2) a quitclaim conveyance to the new lessee of the Building, which conveyance shall recite that the grantee holds title to the Building which title shall revert to Lessor automatically, without payment, upon the termination of this lease or its replacement.

**L. Prohibition Against Lessor's Acceptance of Voluntary Surrender of Lease Without Consent of Leasehold Mortgagee and Sublessee**

Lessor shall not accept a voluntary surrender of this lease (even under circumstances where Lessee is herein expressly granted the right to terminate this lease) not permit a merger of the fee title and leasehold estate, nor agree to any modification of this lease without the prior consent of any leasehold mortgagee and any total subtenant. The exercise by Lessor of any right of cancellation pursuant to the terms of this lease shall not be deemed a "voluntary surrender," nor shall anything herein require that Lessor obtain the consent of any mortgagee or total subtenant before commencing any action or proceeding based upon a default hereunder by Lessee.

**M. Right of Leasehold Mortgagee in Possession to Assign Lease Once Without Lessor's Consent**

Notwithstanding any provision of Section....... of Article ......... hereof to the contrary, if a leasehold mortgagee shall acquire the leasehold estate in the Leased Property and title to the Building, or possession thereof, the mortgagee in possession (or new Lessee) shall have the right to assign the lease and simultaneously convey the Building to the assignee on one occasion only without Lessor's prior, written consent, provided only that there is delivered to Lessor promptly a duplicate original of the written instrument of assignment, in recordable form, containing the name and address of the assignee, and an assumption by the assignee of the lease and of all the agreements and obligations to be observed and performed by Lessee. Any subsequent assignment of this lease or of such new lease shall be valid only if made pursuant to the provisions of Sections ...... and ....... of Article ........ without reference to this section.

APPENDIX 7

# Selected Provisions of Sublease

**A. Basic and Overage Rent**

**Section 1.** Sublessee shall pay to Sublessor, at such place as Sublessor shall from time to time designate, an annual rental (hereinafter called the "basic rent"), in equal monthly installments in advance on the first day of each month as follows:

**a.** For the period commencing December 1, 19..... and continuing until November 30, 20...... at the rate of $1,745,000 per annum.

**b.** For the period commencing on December 1, 19..... and continuing throughout the balance of the initial term and throughout all renewal terms of this sublease, an amount equal to the aggregate of (i) $425,000 per annum, plus (ii) the then-current annual basic rent payable under the Ground Lease, plus (iii) the then-current annual debt service on any leasehold and building mortgage to which this sublease is subordinate. Sublessor shall give to Sublessee prompt notice, from time to time, of any increase in the basic rent under the Ground Lease.

If the basic rent under the Ground Lease shall not have been fixed at the start of the sixteenth lease year or at the date any renewal term of this sublease commences, Sublessee shall pay to Sublessor, within 20 days after demand therefore, the entire deficiency, if any, which Sublessor is required to pay to the Ground Lessor under Section ......... of Article .......... of the Ground Lease, together with all of Sublessor's expenses which may have been incurred in the appraisal process required under the Ground Lease. Thereafter, Sublessee shall make the payments of basic rent as required under the preceding paragraph of this subdivision (b).

**c. (i)** Whenever under the Ground Lease Sublessor is entitled to appoint an appraiser or apply for the appointment of an appraiser to help determine the fair market value of the land, Sublessee shall have the sale right, acting in the name and on behalf of Sublessor, to designate such appraiser, and to make such application. Sublessee shall pay all of the costs and expenses of the Lessee under the Ground Lease in connection with any appraisal process.

**c. (ii)** Except if the fair market value of the land has been determined by a majority of the duly appointed appraisers, Sublessee shall not voluntarily agree with the owner of the land as to either the fair market value of the land or the basic rent to be paid under the Ground Lease without the prior approval of Sublessee in each instance obtained.

**d.** In the event Sublessor fails to observe or perform any of its obligations, under this subdivision (d), the basic rent thereafter payable by Sublessee shall not be increased by reason of any increase in the Ground Rent.

**e.** The basic rent and extra rent shall be paid to Sublessor without notice or demand and without abatement, deduction, or setoff, except as may be expressly allowed hereinbelow.

**Section 2.** Sublessee shall keep records on a calendar year basis, commencing January 1,19..... Within 60 days after the end of each calendar year, Sublessee shall deliver to Sublessor a certified operating report, prepared by a certified public accountant, which shall include a statement of the net profit for such preceding year derived from the operation of the Leased Property (regardless of whether Sublessee is the operator). In determining such net profit, there shall be no deduction for the following: (a) any rent other than the basic rent, (b) salaries or fees paid directly or indirectly to any individual who is an officer, director, stockholder or member of Sublessee or any operator; (c) management fees in excess of 5 percent of the gross revenues collected by Sublessee; (d) income, franchise, or related taxes of Sublessee or any operator; (e) interest, depreciation or amortization arising in connection with the present investment of Sublessee or any operator in the sublease or the Leased Property. The only deduction for interest shall be interest charges in connection with the financing of any capital improvements, alterations, or installations, at rates not exceeding those normally charged by commercial banks in similar transactions.

Sublessee shall deliver to Sublessor with such report as "overage rent," a sum equal to 50 percent of the amount by which the net profit shown on such report exceeds $155,000. Sublessor may, during normal business hours, upon five days' written notice to Sublessee, inspect the operating books and records of Sublessee for the purpose of verifying any report within three years after the report is submitted to Sublessor.

Sublessee shall also furnish to Sublessor, within 15 days after written request is made by Sublessor, any other financial data or statements which may be required by the Ground Lessor, fee mortgagee, leasehold mortgagee, or by any bona fide prospective purchaser, subleasee, or mortgagee of the Leased Property

**Section 3.** The receipt by Sublessor of overage rent shall not be deemed to create any partnership or joint venture between Sublessor and Sublessee.

**B. Renewal Rights and Renewal of Ground Lease**

Sublessee may extend the term of this sublease for eight separate and successive periods (renewal terms) of 10 years each, upon the same terms and conditions as herein contained, except that there shall be no further right to renew beyond November 29, 20 .......... Written notice of each election to renew shall be given by Sublessee to Sublessor not less than 20 months prior to the expiration of the then-current sublease term. Sublessor covenants that if Sublessee gives notice of its election to renew this sublease, Sublessor shall promptly exercise its comparable option to renew the Ground Lease; and if Sublessor fails to do so within 10 days after receiving notice of renewal of this sublease, Sublessee is hereby authorized, in Sublessor's name to give notice of renewal of the Ground Lease to the Ground Lessor.

**C. Subordination to Ground Lease and to Fee and Leasehold Mortgages**

**Section 1.** This sublease is and shall be subordinate to the Ground Lease, and all renewals thereof, and to all leasehold and building mortgages and to every modification, extension, consolidation, and replacement of such leasehold and building mortgages which may now or hereafter encumber the Lease Property, provided that the aggregate payments for interest and principal (excluding the principal payment due at maturity) required to be made thereunder shall not in any one year exceed $1,370,000, and provided further that the leasehold mortgagee shall agree not to terminate this sublease upon a foreclosure of the leasehold mortgage if Sublessee is not then in default in the performance or observance of Sublessee's obligations hereunder. Sublessee shall execute any documents to indicate such subordination which Sublessor shall submit to Sublessee.

## SELECTED PROVISIONS OF SUBLEASE

**Section 2.** If Sublessor shall default in the payment of any rent due under the Ground Lease, or any leasehold mortgage installment of interest or principal, Sublessee may at its option pay such rent or debt service installment, and may deduct such payment, together with interest at 16 percent per annum and any costs paid by Sublessee, from the installments of basic rent next becoming due hereunder.

**Section 3.** Notwithstanding anything in this sublease to the contrary, Sublessee covenants that (a) it will duly comply with all of the provisions of the Ground Lease and of any leasehold and building mortgage to which this sublease is at any time subordinate, except for the payment of basic rent under the Ground Lease or interest and principal under any such leasehold mortgage; and (b) it will execute and deliver any documents which may be necessary to permit the due compliance with all the provisions of any such leasehold mortgage and the Ground Lease by the party responsible thereunder for such compliance.

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