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Hotel Land Values and the Ground Lease Approach

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The sales comparison approach is the most appropriate method for land valuation when data pertaining to recent sales of comparable sites is available. However, in mature, densely developed, urban and suburban markets, it is often difficult to find transactions of comparable sites. An alternate approach to land valuation is the ground lease approach. In this approach, a ground rent for the land is hypothesized and capitalized into an estimate of land value. For hotels, the ground rent can be estimated based upon an appropriate percentage rent formula tied to department revenues. Hotel ground leases are generally structured as a minimum rent against a percentage of revenues. By applying the percentage rent formulas to an existing or proposed hotel's revenues, annual ground rent can be estimated and capitalized into an estimate of value. The key to this approach is that the improvements must represent the current highest and best use of the land. Thus, if a site is improved with an obsolete hotel that underutilizes the site, the ground rent formula would most appropriately be applied to revenues generated by the type of hotel that would be developed on the site today.

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The difficulty in applying the ground lease approach to estimate current land values is the lack of recently negotiated ground leases. Hotels have been developed on leased land over the years when landowners have wanted to retain long-term ownership of the site. Ground leases were particularly prevalent in hotel development that occurred during the building cycle of the 1980s. During this decade of high inflation and high interest rates, ground leases were often structured as a form of gap financing. It was less costly to incur ground rental payments in future years out of cash flow than to finance site acquisition costs.

Hotel Ground Leases Today

Hotel ground leases are less prevalent today for several reasons. First, lenders (particularly those who intend to securitize their mortgages) do not like to finance the development of leasehold improvements. Secondly, many landowners who leased their sites to hotel developers and subordinated their interests to first mortgages in the 1980s lost their ownership during the numerous foreclosures of the early 1990s. Landowners are averse to taking the same risks today and typically will not subordinate their interests. Subordination by the landowner is usually required to secure financing; thus, these deals have difficulty reaching fruition. Thirdly, the current lower-interest-rate environment, with greater liquidity and equity investment contributions, does not necessitate the creation of leasehold positions to as great a degree as during

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the building cycle of the 1980s.

So, in the absence of recently negotiated ground leases, what percentage rent formula does one employ in the application of the ground lease approach? In some markets, significant sales activity exists to assess current trends in hotel land values. The development of new extended-stay hotels has become quite common in densely developed suburban markets where traditionally limited-service development is not feasible. For these new projects, we are commonly seeing sites transact at prices in excess of $20,000 per room - with some prices exceeding $30,000 per room. How can these wood-frame, limited-service facilities that are projected to achieve only a $75 average rate afford to pay so much for their land? The answer lies in the greater profitability of the extended-stay product.

Extended-stay hotels generally achieve higher stabilized occupancy levels than their limited-service counterparts due to a greater proportion of weekend stay-overs. Extended-stay demand is woefully underserved in most markets with high barriers to entry. These products, once constructed, ramp up quickly to a high stabilized occupancy. Greater profitability is also achieved through a reduction in rooms expense. With a lower guest turnover, housekeeping and front desk staffing can be reduced. Many extended-stay products only clean the rooms once a week, with a mid-week light touch. Rooms expense can be reduced from a traditional range of 20% to 25% to 13% to 18%, resulting in substantial savings. These savings translate to a bottom line profit ratio of 45% to 60%, as compared to the 35% to 50% that characterizes traditional limited-service operations.

With significantly greater profitability and only marginally greater construction costs, extended-stay hotels can afford to allocate a higher percentage of total development costs to land value. A site located in a deep, mature, and underserved market can readily justify high land expense due to the virtual guarantee of sustained high occupancy and profitability. Consequently, the traditional rule of thumb that land value should be 10% to 20% of total costs has been adjusted upward, to 15% to 25%. Let's see how the ground lease formula for the extended-stay products of today compares with the formula for the limited-service hotels constructed during the 1980s:

Table 1: Historical Rental Formula

Net Income Ratio		Land Value%		Rental %
50%	x	15%	=	7.50%
45	x	15	=	6.75
40	x	15	=	6.00
35	x	15	=	5.25

Table 2: Current Rental Formula

Net Income Ratio		Land Value%		Rental %
60%	x	20%	=	12.00%
55	x	20	=	11.00
50	x	20	=	10.00
45	x	20	=	9.00

Source: HVS International

With an average net operating income 10 percentage points higher than non-extended-stay hotels, and a land allocation percentage of 20% as compared to 15%, the traditional percentage rent formula for limited-service hotels of 5% to 7% of rooms revenue increases to 9% to 12%. Let's see how this plays out in the application of the ground rental formula.

Historical Limited-Service Hotel Land Value via the Ground Lease Approach:

($75 average rate x 70% occupancy x 365 days per year x 6% of rooms revenue) / 9% capitalization rate = **$12,775 per room**

Current Extended-Stay Hotel Land Value via the Ground Lease Approach:

($75 average rate x 80% occupancy x 365 days per year x 10% of rooms revenue) / 9% capitalization rate = **$24,333 per room**

Thus, an extended-stay hotel expected to generate a net operating income of 50% and able to allocate 20% of total development cost to land can afford to pay 10% of rooms revenue for ground rent. Keep in mind that many extended-stay hotels are being developed corporately by companies that do not have to pay a third-pay franchise or management fees, thereby increasing the net income percentage by an additional 8% to 10%. These corporate projects can support an even higher land acquisition cost.

What About Full-Service Hotels?

Due to the paucity of new full-service development, we do not have a significant amount of evidence regarding current trends in land values for this category. While we are finally seeing a wave of new full-service hotel development in major U.S. cities and resort destinations, many of these projects are being constructed as part of mixed-use developments or as renovations/ conversions of office or other buildings where a land price per room is not clearly evident. Land for resort development has often been held for a decade or more, or has been purchased in the anticipation of synergistic resort, timeshare, and residential development.

Full-service hotels have gained in profitability over the past decade, but the cost of constructing these hotels has risen significantly as well. Land leases being negotiated in recent years are structured based upon percentage rent terms that are similar to those executed in the 1980s, although we have seen a slightly more aggressive posture by lessors in very strong markets with high barriers to entry. With the significant appreciation in urban hotels, the percentage of land value to total development cost has likely risen in markets where location is a key factor in the hotel's feasibility.

Let's see how the numbers work for full-service hotels (see Table 3 on following page).

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Table 3: New Rental Formula Based on Higher Land Allocation%

Net Income Ratio		Land Value%		Rental %
35%	x	15%	=	5.25%
30	x	15	=	4.50
25	x	15	=	3.75
20	x	15	=	3.00
Net Income Ratio		**Land Value%**		**Rental %**
35%	x	20%	=	7.00%
30	x	20	=	6.00
25	x	20	=	5.00
20	x	20	=	4.00

Source: HVS International

Full-service hotel profitability during the 1980s was typically 20% to 25% of net income, as opposed to the 25% to 30% common today. With a land allocation of 15% and a profitability of 20% to 25%, rent typically was negotiated in the range of 3% to 4% of rooms revenues; higher percentages were often negotiated for sites in highly desirable urban or coastal areas. One can see that with increased profitability and a greater allocation to land, current rental formulas for full-service hotels are likely trending higher than those witnessed in the past decade. However, this increase is proportionately much less than in the extended stay scenario, given the greater cost and complexity of full-service hotel projects.

Clearly, care must be taken in employing the ground rent approach to land valuation. Sales of comparable sites provide the best indication of land value, but the ground lease approach is a useful alternative when the percentage rent formulas employed reflect the reality of current conditions in the local marketplace and the hotel industry at large.