How Land Cost Impacts Value

The first steps in a hotel's development are finding the site and acquiring the land. While factors such as location, access, visibility, size, shape, frontage and zoning are important, it is the purchase price of the land that has the greatest impact on the character of the hotel and ultimate success of the project.

The land cost usually determines the type, quality and size of hotel. In addition, its cost might sometimes prove that a hotel is not the best use for the site. This month, I will show how to value a hotel's land component and determine the best use of the property.

A hotel's development consists of three components: the land; the building; and furniture, fixtures and equipment. For a hotel project to have economic viability, the cost of each component must be in balance with each other. You should not develop a 1-star hotel on a site suitable for a 5-star. Essentially, as the cost of the land increases, so must the quality of the hotel. Ideally, the land component should represent approximately 10% to 15% of the total project cost. Once this land component percentage exceeds 20%, it is difficult to find the hotel economically feasible.

The purchase price of a hotel site can be determined using either a comparable sales or income approach. The income approach is best when evaluating feasibility (see table below).

DETERMINING HOTEL PURCHASING PRICE

		Per Room	Room Rate Thumb Rule
Rooms	200		
Occupancy	70%		
Average Room Rate	US$125		
Rooms Revenue	US$6,387,500		
Ground Rent Percentage	4%		
Ground Rent	US$255,500		
Land Capitalization Rate	8%		
Land Value	US$3,193,750		
Land Value as % of Total Value	12.5%		
Total Project Cost	**US$25,550,000**	**US$127,750**	**US$128**
Land Cost	US$5,000,000		
Land Value as % of Total Value	12.5%		
Total Project Cost	**US$40,000,000**	**US$200,000**	**US$200**
Land Cost	US$10,000,000		
Land Value as % of Total Value	20%		
Total Project Cost	**US$50,000,000**	**US$250,000**	**US$250**

Let's says you want to develop a 200-room, mid-rate hotel. Based on a market study, you think the hotel should achieve 70% occupancy with a US$125 room rate. The land value income approach starts by determining the estimated annual rooms revenue, which is US$6,387,500. A typical ground rental percentage is 4% of rooms revenue, which calculates a ground rent of US$255,500. The land value is then calculated by dividing the ground rent by a land capitalization rate, which in this example is estimated to be 8%. This results in a land value of US$3,193,750. If the land component typically represents 12.5% of the total project cost, then the value of the entire hotel (land, building and furniture, fixtures and equipment) should be US$25,550,000 (US$3,193,750/12.5%). On a per room basis, the total value equates to US$127,750 per room. Applying the room rate thumb rule that states that for every US$1,000 per room cost, US$1 in room rate should be created (US$128), the project appears to be in balance with an average room rate of US$125. In other words, this type and quality of hotel represents a good use of the site.

Now let's say you find another site in the heart of the upscale area of the city that costs US$5 million and local zoning allows 200 rooms. Applying the same 12.5% land component percentage results in a total project cost of US$40 million or US$200,000 per room. To make this alternative economically viable, the hotel must be designed, built and furnished as a luxury rather than a mid-rate property to achieve a US$200 room rate. If the site was twice as expensive, say US$10 million, and you pushed the land component percentage up to 20%, the project cost could be US$50 million or US$250,000 per room, which requires a room rate of US$250. In this instance, the luxury traveler might not be willing to pay this much, so the economics do not support this type of hotel development.

In appraisal jargon, we describe these phenomena as a "highest and best use" issue. Typically, when hotel room rates are too low to justify the cost of the land, there is probably another use that is willing to pay more for that particular site. For example, in the top areas of New York City residential condominium developers will outbid hotel developers almost every time for prime sites. At one time land in Hong Kong was so valuable that a developer actually tore down a perfectly good Hilton hotel and replaced it with an office building.

So what can hotel developers do when faced with high land costs in areas such as New Delhi, Paris, London and Beverly Hills? The first option, which can work for 1- to 3-star hotels, is to find good, secondary locations where land prices are generally lower than the prime sites. For 4- and 5-star hotels you might attempt to get approval for a more intense use of the site (more rooms) so the land cost is averaged over a greater number of rooms. Recently, developers are solving this problem by incorporating a residential condominium component within the hotel complex, which effectively subsidizes the hotel's land acquisition price. The synergistic effect of combining hotel and residential uses enables the overall project to justify a higher land cost.

The hotel developer's Holy Grail is to find a way to economically justify building mid-rate hotels on prime, luxury priced hotel sites. While we are not quite there, the combination of factors that seems to work the best is a highly intense use (many rooms) of a relatively small site improved with a limited-service (no food and beverage), branded mid-rate hotel concept constructed with good quality materials and finishes. ♦

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